

Madoff Reminds Investors (Painfully) to Do Their Homework

by Benjamin N. Alpert, CFA | 01-29-09 | 06:00 AM

Over the last six weeks, the news has introduced many institutions and individuals who were duped into investing with Bernie Madoff. There has been too little discussion, though, of what individual high-net-worth investors and other institutions should have seen to avoid a Ponzi scheme of this sort in the first place. Many institutions and investors performing appropriate due diligence should have noticed warning signs that now look like blinking neon lights.

Following are some of the biggest red flags, which can serve as useful warnings for any investor performing due diligence on a portfolio manager. While none of the problems would automatically exclude a prospective investment in a hedge fund, any of these should trigger additional research to determine if the investment is suitable for your portfolio. When more than one is present, extra scrutiny is required.

Unusual Structure

Unlike most private pooled investments where the investor is in a partnership with the manager, it appears that most investors with Bernie Madoff were invested through secondary partnerships. Madoff's organization essentially subadvised hedge funds offered by other institutions. While this structure isn't necessarily a problem on its own, it does limit the number of investors who are able to examine the details of the investment operations to the firms that run the feeder funds. This structure prevented many individual investors and funds-of-funds from performing effective due diligence. Those that were in a position to perform the due diligence, the institutions sponsoring feeder hedge funds, simply failed. The take-away here is that investors in unusually structured hedge funds need to be vigilant and ask questions, as this added complexity can hide problems.

Related Brokerage and Custody

It is always amazing to see that when fraud occurs within the investment world, there is often a related brokerage company involved that is also operated by the con artist. While the brokerage may engage in legitimate operations, there is inherent risk when the control individuals of the brokerage are the same as those of the hedge fund. In the case of Bernie Madoff, Madoff Investment Securities (brokerage) had operated legally since 1960 and was a founding member of NASDAQ. Although the brokerage itself was legitimate, the principals operating both the legit brokerage and the fraudulent hedge fund were one and the same. It shouldn't surprise anyone that no one at the brokerage would tell the boss that he couldn't take letterhead-- which Madoff subsequently used to produce fake account statements

and trade confirmations. While related-party transactions are not an automatic sign of fraud, these relationships are a warning sign that should trigger a higher level of scrutiny as related brokerage and custody can provide an avenue for fraud to be perpetrated, without independent parties that might investigate questionable behavior.

Unknown or Related Auditor

Once the fraud came to light, journalists quickly determined that the auditor listed for Madoff Investments was a small operation owned by his brother-in-law. In contrast, nearly 90% of the single strategy hedge funds in the Morningstar database are audited by one of the top 10 audit providers; nearly 70% of those funds use one of the global divisions of the Big Four accounting firms. Don't get me wrong--I'm not saying that all small auditors are unqualified; in fact, some of the top 10 providers are small auditors that specialize in fund accounting. Still, as so few funds hire auditors that are unfamiliar to hedge fund investors, the lack of a known provider is a red flag. Unknown auditors should be investigated to ensure that they are qualified to audit hedge funds, which may have difficult-to-value assets and typically manage many millions of dollars.

What is most disheartening when looking at the Madoff case is that none of the feeder funds or their auditors discovered or cared about this relationship. The hedge fund auditor should be an independent third-party that believes that it is working for the investors and not management. Conflicts of interest should be avoided entirely.

Self-Administration

Although it is not clear that an outside administrator at a Madoff feeder fund wouldn't have had the wool pulled over its eyes by fake account statements from Madoff Investment Securities, it is clear that an outside administrator along with independent custody and brokerage relationships can help prevent this type of fraud. Third-party administrators for hedge funds perform back-office operations including valuing infrequently traded securities, calculating net asset values, and preparing account statements. Outside administration together with an independent custodian holding the assets eliminates most paths to imaginary account information. Recognizing this after suffering Madoff-related losses, two Swiss banks, UBP (Union Bancaire Privee) and Mirabaud, recently announced that they no longer will invest in hedge funds that run their own back office. That action eliminated from their approved funds lists some of the most well-known hedge funds, including Citadel, Renaissance Technologies, and SAC Capital.

Access

Press reports indicate that many standard due-diligence procedures were ignored because investors were sold on the reputation of Bernie Madoff. Many investors were also told that the hedge fund was closed to new investors and the only chance to invest was immediately. Should exclusivity convince investors that there simply wasn't time for due diligence? It's like buying a house without having a home inspector check if the building is structurally sound. There are many hedge funds that limit access, but this is the first one I've heard of blocking investors from performing due diligence. Typically funds restrict access by raising investment minimums, performance fees, and/or lockups in order to generate an investor base with investment philosophies in line with management. The investors that Bernie Madoff wanted were those that trusted him blindly.

Returns Cannot Be Duplicated

As the now famous letter from Henry Markopolos highlights: With the aid of hindsight, any investment strategy should be able to be replicated. When Markopolos obtained strategy information and attempted to replicate Madoff's returns, no amount of modeling could explain the results. Additionally, the amount of assets being managed in the supposed strategy dwarfed the open interest on the securities in which the fund was theoretically trading. While not an exercise for nonmathematicians and the like, Markopolos' analysis is certainly something that institutions bringing investors to Madoff's Ponzi scheme should have been able to see.

People and institutions who invested with Madoff funds were afraid of missing the big payoff. With few questions asked, the investors believed that they were following the methods of successful investors like David Swensen of Yale University by allocating to alternatives. But when asked recently by *The Wall Street Journal* if it was acceptable for a hedge fund to provide nothing other than general strategy information, Swensen revealed that Yale demands complete transparency. Although not every hedge fund investor has the kind of clout that Yale commands to require real-time transparency, a full accounting of positions and activity should be available with some regularity. The argument made by secretive managers that their investment ideas are proprietary can be easily resolved with a nondisclosure agreement. The lesson here is that even when investing with the "smart money," it pays to demand transparency and ask questions.

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