The Madoff Mess

Bernard Madoff has been sentenced to prison for perpetrating a classic financial fraud. Sampling the extensive media archives uncovers Lifestyles of the Rich and Famous, mixed with Tales from the Gypped. Interspersed among the hard luck stories are reports of seemingly incompetent Federal securities regulators, who ignored warnings made years earlier by Harry Markopolos. He is a quantitative analyst who made a very well-educated, correct guess that Madoff was running a Ponzi Scheme.

Perhaps the most galling media reports describe middlemen who readily turned over their clients' money to Bernard L. Madoff Investment Securities. Some functioned as informal go-betweens, while others were "feeder" hedge funds that in turn placed client funds with Madoff. Their aggrieved clients, who were invested until the December 2008 end, will likely be joined by some of their clients who got out years ago, but whose returns could still be "clawed back" through the legal process. Should all these investment advisors/feeder funds be sued for fraud, as the Massachusetts Secretary of State recently sued one prominent feeder fund?

I am pleased to admit that I am not a lawyer -- listed fourth in a recent list of the ten least trusted professions -- so I will not opine about the legal standard for fraud and who may have violated it. I am a business school professor, and while we are not yet on the least-trusted list, we sometimes act like we are looking to move up. I will do my part to speed the inevitable by rousing the ire of many honest investment advisors and pundits. Even though the vast majority of investment advisors are honest, are they competent enough to avoid delegating funds to future Madoffs? Are they competent enough to meet the greater challenging of avoiding investment strategies that are unlikely to produce as good returns as they have in the past, despite being offered by honest managers?

Madoff claimed to produce his steady, stellar returns through use of an option strategy called "split-strike conversion". It is not hard to grasp the rudiments of that options strategy, and how it could produce returns that are less volatile than a stock index fund. It is more difficult to determine whether or not Madoff's reported monthly return numbers could have been produced by systematic use of that type of options strategy. This requires quantitative analysis -- the kind that uses the skills of those who can still do algebra problems and a calculus problem or two. The required quant skills are less than those acquired by working financial engineers, but are within the skill set obtained by our very best college finance majors. For those suitably enlightened, it takes less than a day's competent quant work to cast grave and verifiable doubt on Madoff's claims. Yet this is still more skill than was mustered by the numerous advisor/enablers of the Madoff Mess, and is less skill than could be mustered by many successful and honest financial advisors who have or will delegate the management of part of their clients' money to others.

There were some professionals who knew enough to discount the likelihood that Madoff's returns would continue; the aforementioned Mr. Markopolos is one of them. But others either did not know or did not care enough to quantitatively analyze the strategy. Such advisors were not earning their fees, even though they may have been experienced, respected, and honest. Like E.F. Hutton's employees, they may have made money the old-fashioned way, but now should *earn* money the new-fashioned way -- via consistent application of quantitative analysis when re-examining appropriate asset allocations, choice of investment strategies, and/or firms to implement them.

Any professor will tell you that the problem students are not those who know that they are confused; they are those who believe that they are well-informed, but are not. Stay open to the need for better quantitative analysis.

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