THE COMPASS CHRONICLE

Highlighting important wealth management issues *Winter 2009*

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A client-focused wealth management firm dedicated to providing objective advice to individuals, families, and corporate retirement plans.

Our wealth management services include:

- Investment Management and Consulting
- Retirement Planning
- Education Funding
- Gift Planning

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"Made Off" with $50 Billion

What Can Be Learned from the Bernie Madoff Scandal?

Investors, who were already suffering from a crisis of confidence as a result of the economic and stock market downturn, learned in early December that Bernie Madoff, a highly regarded hedge fund manager and former chairman of NASDAQ, admitted that he had bilked his investors out of an estimated $50 billion in the largest Ponzi scheme ever uncovered. Since that disclosure, at least one other hedge fund manager has gone on the lam after reportedly stealing money from investors.

A Ponzi scheme is named after the notorious swindler, Charles Ponzi, who cheated millions of dollars from investors in the early 1920's. In its simplest form, a Ponzi scheme provides investors with a "return" by taking principal from new investors. Since the principal is never actually invested, the Ponzi perpetrator can claim whatever "returns" he wishes and pockets whatever is not needed to pay off departing investors.

Concerns had been voiced about Madoff's performance claims for years both in the financial press and directly to the U.S. Securities and Exchange Commission (SEC). Back in 2001, an article entitled "Don't Ask, Don't Tell" appeared in *Barron's*, in which Madoff's returns were questioned. At least one investment consultant informed the SEC numerous times over a period of years and provided the SEC with a detailed listing of serious discrepancies regarding Madoff's performance record and operations. Nothing was done. In fact, Madoff was not even registered as an investment advisor until 2006. When he finally did register, the SEC found no serious issues.

Although there are facts in the Madoff case that still need to come to light, apparently his sons, who are partners in the business, learned of their father's misdeeds and informed the FBI. The fraud began to unravel after some of Madoff's investors requested redemptions totaling $7 billion, more than he could meet with the cash he had on hand and from new investors.

Such actions by someone in a position of trust can have disastrous consequences for those affected. Given the size of this fraud, many investors lost significant sums of money. Among the reported investors who were defrauded by Madoff are some of the world's largest banks (such as Spain's Grupo Santander, Britain's HSBC Holdings and Royal Bank of Scotland, France's BNP Paribas, Japan's Nomura Holdings, and Switzerland's UBS), charities (such as Steven Spielberg's Wunderkinder Foundation and Elie Wiesel's Foundation For Humanity), and others, including Mort Zuckerman, the owner of the *New York Daily News* and *U.S. News & World Report*, Liliane Bettencourt, the heiress to the L'Oreal empire, and Leonard Feinstein, cofounder of Bed Bath & Beyond.

What can we learn from the Madoff scandal?

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1. **Diversify**

The old investment adage "don't place all of your eggs in one basket" holds true in the Madoff case. When investing you never want to place all of your assets in one investment. Instead, you want to diversify across different types of investments that will respond differently to changing economic and capital market conditions. Many of Madoff's victims invested a significant portion (or all) of their liquid net worth in Madoff's hedge fund, enamored by the consistently positive returns that he claimed to generate in every market environment. Another adage, "if it sounds too good to be true, it probably is," also comes to mind as relevant here too.

At COMPASS, each client portfolio is well-diversified with investments in at least a dozen different mutual funds, representing different market exposures.

2. **Separation of Advisor and Custodian**

When entrusting your investments to an advisor or investment manager, you want to ensure that your assets are held by a custodian, which is a third party separate from the advisor or investment manager. When you make deposits to your account(s) any check you write should be made payable to the custodian for your benefit—never make a check payable to the advisor or investment manager unless it is to pay their fee. Although an advisor may provide supplemental information or reports to clients, investment statements and transaction confirmations should come directly from the custodian, not the advisor. In the case of Bernie Madoff, his firm provided its own custodial and clearing services, and his hedge fund used a nondescript, local accounting firm for audit purposes. Obviously, the checks and balances that should have been in place were not.

COMPASS uses the services of Fidelity Investments, one of the largest and best capitalized financial services firms, as the custodian of its clients' assets. Clients receive their statements and transaction confirmations directly from Fidelity.

3. **Regulators**

While regulators exist to protect investors, they are unfortunately not always successful in their mission. Several different regulators oversee different parts of the financial services industry and some are more effective and have more resources than others. Though most advisors maintain compliance with the myriad of regulations already in place, there will always be advisors and investment managers who do not have their clients' best interests at heart and even the most effective regulatory system will not prevent every fraud in the future.

COMPASS has never been cited for any regulatory violation. For any interested party, we actually provide the telephone number for the Commonwealth of Massachusetts' Securities Division in our Form ADV filing, a regulatory filing offered to every client annually, as well as provided to each prospective client.

4. **Hedge Funds**

The Bernie Madoff fiasco also points to some of the problems with hedge funds. Hedge funds are not regulated by any government agency, lack transparency, and lack liquidity. A couple of years ago the SEC took steps to provide regulatory oversight of hedge funds, but the effort ultimately failed. In testimony before a U.S. Senate committee in July 2006, SEC Chairman Christopher Cox stated:

> …given the general lack of public disclosure about the way hedge funds operate, the lack of standards for measuring a fund's valuation and its performance, the possibilities for undisclosed conflicts of interest, the unusually high fees, and the higher risk that accompanies a hedge fund's expected higher returns, these are not investments for Mom and Pop. They are generally risky ventures that simply don't make sense for most retail investors.

As far as transparency, a hedge fund is not required to provide its investors with the underlying holdings of the fund or the data to allow independent third parties to verify performance claims. From a liquidity perspective, normally a hedge fund allows its investors the ability to redeem their shares only once a quarter on a date determined by the hedge fund. However, under most hedge fund agreements, a fund can delay client redemptions for up to one year, an option some hedge funds are now taking advantage of.

If these concerns were insufficient, the typical hedge fund's fees are exorbitant and enrich the hedge fund manager at the expense of investors. The average fund charges an annual fee of 2% of the assets invested, plus 20% of the gains generated. The attraction of hedge funds is that they are supposed to protect an investor's principal in poor market environments and appreciate in good markets. Unfortunately, hedge funds overall had a disastrous 2008 and have not lived up to their hype. In fact, one-fifth of all hedge funds still in existence at the end of 2008 had declined more than the S&P 500 for the year.

COMPASS has never invested client assets in a hedge fund due to the concerns cited above.

> "These are the times that try men's souls."
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> —Thomas Paine