WESTWOOD CAPITAL, LLC

OPINION

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Avoiding Financial Graft: What Madoff and Other Scandals Can Teach Investors

Madoff was a disaster, but red flags were prevalent. What can we learn from investors' mistakes to prevent future debacles?

As the Congressional hearings on the Madoff scandal unfold, we reflect back on how investors can avoid scams. Frankly, and assuming they did due diligence, it is hard to understand how professional investors were fooled by Madoff. We believe that some sophisticated, yet unethical, investors may have actually invested nefariously. Perhaps they believed that Madoff was "front running" (more on this later) and they could participate without risk of retribution. Regardless of their motivations, it is hard to understand how a sophisticated investor could not see through such a simple scam.

The hearings remind us that complacency is not an option, and one must be wary of anything that appears too good to be true. Unfortunately, each era produces its share of malevolent Madoffs—and while there are no foolproof ways to detect every fraud, you can exercise due diligence when investing your money.

What clues should have tipped off Madoff's investors? Which red flags were hiding in plain sight? Here are some thoughts to consider before investing:

Too Good to Be True? Boiler-room schemes tout stocks with astronomical potential returns. Madoff claimed to have never lost money and promised returns that far exceeded "safe" investments—in essence, defying gravity. If it's too good to be true, it flies in the face of reality. As any experienced investor will tell you, if someone claims to have a history of consistently high returns and never losing money over decades, there is a one-in-a-billion chance he is telling the truth.

Diversify. We've all heard the investing adage, "Don't put all your eggs in one basket." But we continue to hear about Madoff investors who lost most or all of their money. One explanation we've heard is: "Madoff traded many stocks." Putting all your money with one manager who executes a single strategy is not diversification. Diversification means splitting your assets among different managers, investment strategies, securities, and asset classes (e.g., stocks, bonds, gold/commodities, cash and real estate). A grifter cannot devastate diversified investors.

Use Common Sense. Madoff charged a fee of four cents per share. Even the worst money managers charge oodles more. Would you trust a heart surgeon who claimed to have a perfect track record, yet charged you only ten dollars an hour for an operation?

Conduct Due Diligence. If the firm with which you want to conduct business is regulated by an entity, chances are that the basic information can be found on its regulator's website (for example, the Financial Industry Regulatory Authority or FINRA). Clearly, anyone doing even the simplest Google search would find accusations that Madoff "front-ran" -- unethically purchased securities using knowledge of customers' pending orders. That in and of itself wouldn't have resulted in the kinds of losses he generated, but would have prompted further inquiry. Unanswered questions regarding improprieties should be answered before you hand over your life savings.

Don't Believe You Can Consistently Beat the Market. There's an old saying on Wall Street: "Pigs get fat; hogs get slaughtered." Madoff touted high returns in excess of 10%, with no history of loss. Riskless investments yield less. Be happy with returns that equal or slightly exceed those of similar-risk investments.

Don't Do Anything You Don't Understand. Madoff used a so-called split price option conversion strategy—a term few investors probably understood. Never invest in anything you don't understand. In truth, most investment and trading strategies are remarkably simple, and if a money manager can't explain the nuts and bolts, he either doesn't understand them or is likely to con you.

Make Sure Someone Else Is Holding and Counting the Assets. Madoff cleared all "trades" through a close affiliate. There was no third party to accept delivery and verify security positions. This is a breach of accepted operating policies and procedures.

Watch Out for Affinity. Con artists tend to prey on a specific group. Ponzi's victims were Italians, and Madoff frequently focused on Jews and Jewish foundations. Madoff marketed extensively on Long Island and in Florida. Learn who the other investors are, and watch out for affinity relationships.

Remember: The Wizard of Oz Hid Behind a Curtain. Madoff wouldn't meet with investors directly. Instead, they had to meet through his entourage. He had a reputation for turning investors away. In general, there's no logical reason Madoff would do so; all money is green. But in the end, we've now learned virtually anyone could invest as Madoff desperately sought investments to perpetuate the scheme.

Be Wary of Companies Where Power Is Concentrated on a Single Individual. Grifters commonly have weak subordinates (or family members) whose knowledge of company operations is fragmented. This allows the scheme to continue. Conduct some additional due diligence on companies with a small executive team and a huge middle-management gap.

Follow the Money. It's easy for the most experienced investor to get confused with financial statements. This is especially true when accounting results vary from cash receipts (often, legitimately). To test the veracity of a business or portfolio investment, trace cash.

While many frauds will not contain as many red flags or be as simple as Madoff's, most have at least a few. Of course, just because an investment has a red flag doesn't mean fraud is present, but it certainly raises the due-diligence bar. And, red flag or not, investors should always conduct due diligence.
