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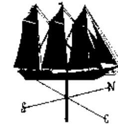

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Learning from Bernie

Just over four years ago, the Bernie Madoff scandal erupted -- a $65 billion Ponzi scheme that started in the 1970s and spanned decades. Friends, family and acquaintances of the Madoffs, as well as organizations, funds and others found their portfolios gone and their funds missing. The tragic scandal is complex and still evolving, and only $9 billion has been returned to investors so far.

Many of us in the investment advisory business were disturbed by numerous aspects of the fraud. Among the most egregious: Madoff's firm provided both advisory and custody services, thus removing the checks and balances present when different firms furnish these services. He cultivated a personal mystique with an inside "edge" and preyed on the normal human desire to be with the crowd "in the know." Finally, he lured his prospects in with the all-too-common desire for steady returns that "beat the market."

Madoff claimed predictable returns on equity investments -- a consistent 1 to 1½% increase each and every month no matter what was happening on Wall Street. With his "split strike conversion" strategy, returns supposedly averaged 11-12% per year, even when the markets were volatile and prices were dropping for extended periods of time.

Some potential clients declined his services after examining his performance and one knowledgeable observer, Harry Markopolos, tried to alert the Securities and Exchange Commission to Madoff's claims. He found not only did they not make sense, they were mathematically impossible to achieve.

Unfortunately, Madoff's clients did not seem to care how he generated his performance, just that he did. And their complacency is an important lesson to be learned from the fraud -- investors do themselves a great disservice as well as potential harm if they focus only on performance and not how it is achieved.

To be sure, Wall Street tends to market performance as the end-all and be-all. Thus, the public is led to believe that weekly, monthly and quarterly performance is the same as investment success over the long haul. But by definition, focusing on short-term performance requires strategies for trading while focusing on returns generated over the long term requires strategies for investing.

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Trading strategies typically involve jumping in and out of the market as trends in prices are detected. A currently "hot" stock might be purchased, but then the second decision of when to sell has to be made -- hopefully before the stock becomes "cold." Extreme examples include Wall Street's high frequency trading firms where computer algorithms are used to troll the markets in search of price discrepancies, or to create discrepancies, which can then be acted upon -- all within milliseconds.

Fundamental characteristics have no place in short-term trading strategies. A company's products or services, its market share, the strength of its financial statements or the caliber of its management team are of little interest to the trader -- who is, after all, trading, not investing.

In contrast, an investor focused on the long haul identifies an attractive company, chooses a reasonable entry point to purchase its shares, and then remains a part-owner of the company for as long as the fundamental characteristics remain intact. Of course, trading and investing both involve risk but some strategies are more risky than others. As Madoff's unfortunate clients discovered, disregarding the details can have perilous consequences.

In addition to understanding how investment returns are generated, it is also important to understand the benchmark used to measure performance. While many investors think of benchmarks as static goal posts which show whether or not you have beaten the market, in reality they are constantly changing, sometimes with far-reaching implications.

The Standard & Poor's 500 Index is one of the most widely used benchmarks on Wall Street and consists of 500 large U.S. companies. S&P chooses the companies to include in the Index based on its own criteria and changes occurring on Wall Street and in the economy. In any given year, some companies are added to and others deleted from the Index.

But the S&P 500 Index is subject to trends on Wall Street. During the "dot.com" bubble of the late 1990s, S&P added to the Index a number of wildly popular technology companies with weak fundamental characteristics, some at their share price highs. At the bubble's peak, technology stocks comprised about 30% of the Index. Investors who did not jump on the "dot.com" bandwagon found it difficult to outperform the Index during this period; however when the bubble eventually burst, it was altogether a different story.

A similar phenomenon happened during the bubble of 2004-2007. Wall Street fell in love with the stocks of home builders and financial institutions, and the latter eventually came to represent over 22% of the S&P 500 Index. Investors who did not like the fundamental characteristics of either the home building or financial industries lagged in comparison -- but once again, when the bubble burst the story changed.

Thus, there are a number of facets to performance and "beating the market" is not as cut and dried as commonly thought. For experienced investors, approximating a benchmark is often an acceptable tradeoff in return for reduced risk, lower volatility, a plan for managing capital gains taxes, and a sensible and understandable investment strategy. Perhaps the best lesson taught by Bernie Madoff is the ultimate wisdom of the old saw "if it is too good to be true, it probably is."