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Invest in a crazy scheme and lose \$13.9bn? You'd be Madoff not to!

How the world's Investment 'Professionals' lost \$13.9bn

I remember my first experience of Pyramid Selling (back in the 1980s). Then a large number of people had become involved in a simple scheme to make money fast. By investing £1,000 and 'doing a little marketing' it was possible to make many thousands in the space of a few weeks.

Now before you panic, rest assured this return was apparently 'guaranteed'. You had to invest £1,000 then get four others to invest £1,000 themselves and then each of those had to recruit another five investors. When your five secured their five investors you got £16,000 or something similar....

The idea was simple and by securing five investors to find five additional investors each that generated £25,000 of incoming cash flow, from which your £16,000 could be paid. And on and on the scheme went with week by week thousands of investors delighted with their enormous (and seemingly guaranteed gains). All over the country people from all backgrounds were rejoicing in their good fortune....

Then the inevitable crash came, as they always do with pyramid schemes, because their survival depends on the inflow of fresh investor blood (and money) to ensure those earlier entrants get paid their return. The increasing number of 'success' stories feed this inflow and more investors join the fray and in fact it becomes some sort of feeding frenzy as the number of 'pumped up' investors grows and the enthusiasm swell gets out of control. At that point the media (always eager to dwell on a spell of frenzy in the masses) get involved and help to expose the rather dubious longevity of schemes that represent merely an imbalanced redistribution of wealth (poorer to richer as usual).

The problem is when investors become thin on the ground, which is often caused by the media stirring concerns and sometimes just because the 'inexhaustible' supply of incoming investors has apparently run out?

And at that point the last two layers of the pyramid lose their money, which at £1,000 is a lot of money to lose just like that. But it's far far worse in reality. At that stage in the frenzied cycle people often invest more than once and may have thousands at risk (well if you had seen a friend turn £1,000 into £16,000 in two weeks you would have a go, surely!???)

And to get additional investors who would ordinary people turn to? Friends, family, work colleagues and so on, those who your life revolves around. But imagine if the pyramid scheme collapses when you're in (and more importantly when those friends, family and work colleagues are also in.)

This kind of thing destroys finances and wider relationships at the same time and it worries me every time I read about another new pyramid scheme (Google this – you will be amazed!)

Whilst I can understand how these schemes spread amongst most of us, I always thought our 'Investment Professionals', as 'Sophisticated' Investors, would never suffer from such an atrocious situation. But not so, how wrong could I be!

It seems that despite extensive education, formal training and the risk management processes that could bore an actuary to death, some of the world's major financial institutions have managed to lose up to \$13.9billion by investing in Bernard Madoff's investment scheme in the US.

Bernard, who has run this scheme for years, is awaiting trial in the US. This is bad for Bernard. The US take financial crime very seriously and would send you 'away' for dipping your fingers in the till and stealing a few bucks, but \$13.9bn ouch, he's in trouble!

Bernard ran his scheme with an iron determination it seems, and with a touch of arrogance that tends to accompany financial misdemeanours, sometimes refusing to let investors join the club if they didn't suit his investor profile.

Running a scam on Wall Street required diligent monitoring and administration to make sure the regulators or your investors don't find out. But it seems they did find out eventually, albeit it probably was the credit crunch that did for them in the end (isn't it ironic that in the credit crunch a bent investment scheme actually outlasted some of our more 'legitimate' investment houses!)

The Madoff scheme seemed to involve taking in investors cash on the basis that, through diligent investment, high returns could be achieved. With the first money in you use that to market the scheme more widely to get some more money in, which you use to pay the high dividend to the first investors and to market for more investors in the third tier. The third tier has to be bigger to pay big dividends to the first and second tier and so on it goes.

The problem comes if your dividend payments grow too high and you can't fund them from incoming new investments. Or when your redemptions (people who want their cash back) can't be repaid because you don't have the money. Or when new investors dry up and your incoming cash flow falls away.

So the credit crunch, which saw new investment fall away, redemptions shoot through the roof and investors demanding a much higher return for their cash, was just too much of a triple whammy and the Madoff scheme just fell away.

At present he is hunting around for \$6.5mn bail money to he can stay out of jail (well for now anyway). That's quite difficult because most of his money seems to be overseas (and by all accounts held in good old cash.)

And as for the finance houses that invested directly or indirectly this amazingly includes RBS, Santander, RAB Capital, HSBC and many others.... To cap it all certain insurers are now bracing themselves for PI claims for the placing of investments without adequate research and checks into the veracity of the Madoff fund.

These things are always more complicated than they appear of course, and as for who in the major finance houses should carry the blame, who knows? It's important to find out where things went wrong and if it carries value, assign blame for this debacle. But worth mentioning right now is the

fact that RBS has just announced £400mn at risk, HSBC £600mn (indirectly lending to funds who wanted to gear up their Madoff investment) and Santander £2.1 billion, so this is no chump change and it's right to ask what should have been undertaken to check this fund and what needs to be done to prevent this from happening again. More to the point who the heck were auditing and regulating the fund and what the heck were they doing (apart from charging fees of course?)

Despite the doubtless complexities of this matter, on the face of it does appear that certain individuals or organisations may have displayed an incredible lack of judgement, experience or plain old auditing skills. Could it actually be that our seasoned investment professionals within our major finance houses really have no more investment knowledge than the rest of us? Could it really be that our pensions, savings and investments are really run by highly paid 'professionals', who have about the same financial market capability as the rest of us?

If so why are they paid so much and why do we pay so much in the way of fees? More to the point why are we trusting them with our money (excepting of course in the areas where we have little choice and then perhaps the government and regulators should be asking the same questions?)

It would all be rather funny but ultimately much of this money is our money, the savings, investments and pensions of all the people who invest with the large institutions in the belief that their money will be managed by experienced, capable and assured managers. Ouch!

Be careful out there – is anything what is seems any more in the financial world?

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