



Missing More Madoff Mayhem

Ron Surz 1/23/09

Television and print media have sought out expert advice on avoiding the likes of Bernard Madoff. The irony is that these experts, who are usually financial intermediaries, are part of the problem because they enabled Madoff's fraud. It's like asking gun manufacturers to opine on homicide abatement. Consequently, the real issue of lax due diligence has been deflected toward *"(1) be suspicious of good performance and (2) insist on financial audits."* Suspicion is the job of financial intermediaries, not investors. Investors rely upon their consultants and fund-of-fund managers to scrutinize performance for potential fraud. Similarly, financial audits are not designed to validate reported performance; audits verify procedures and pricing. The best defense against fraud is a strong offense in the form of real due diligence rather than the sham that has been played upon investors by their advisors. Hedge fund due diligence has been a fake, at least until now. The Madoff Mayhem is a wake-up call for investors to scrutinize their advisors. Trust but verify your advisors. The gun in Madoff's hands was advisor complacency.

Yale endowment manager David Swensen set off alarms throughout the investment community with the following remarks, which he provided in a January 13 interview with Wall Street Journal reporter Craig Karmin:

WSJ: *What about fund of funds and consultants? Can they be a solution?*

Mr. Swensen: Fund of funds are a cancer on the institutional-investor world. They facilitate the flow of ignorant capital. If an investor can't make an intelligent decision about picking managers, how can he make an intelligent decision about picking a fund-of-funds manager who will be selecting hedge funds? There's also more fees on top of existing fees. And the best managers don't want fund-of-fund money because it is unreliable. You need to be in the top 10% of hedge funds to succeed. In a fund of funds, you will likely be excluded from the best managers. [Mr.] Madoff also relied enormously on these intermediaries. He wouldn't have had nearly as much resources were it not for fund of funds.

Consultants make money by giving advice to as many people as possible. But you outperform by finding inefficiencies most of the market has not yet uncovered. So consultants ultimately end up doing a disservice to investors.

Mr. Swensen goes too far when he suggests malicious intent by consultants and fund-of-funds. Cancers never intend anything good. Nick Diamos, author, advises the following in these situations: *"Never attribute to malice what can adequately be explained by stupidity."*

Due diligence can be distilled down to two crucial questions:

- (1) Do we like the strategy that this manager employs?
- (2) Does this manager execute the strategy well?

Common hedge fund due diligence, as it is practiced today, answers the first question with hot performance, and accepts conceit and concealment as answers to the second.

This is a shame because investors have been shammed by fake due diligence. The Madoff scam was enabled by the due diligence sham. In the following we describe a due diligence approach that is rigorous and sham free.

Profiling Addresses Question (1): What does this manager do?

The adage “Don’t invest in what you don’t understand” is particularly relevant to hedge fund investing. To address this issue we recommend that the researcher complete a fairly straightforward profile like the following:

Sample manager profile

- Approach long: Exposures to styles, sectors, countries, etc., as well as exposures to economic factors.
- Approach short: Exposures to styles, sectors, countries, etc., as well as exposures to economic factors.
- Direction: Amounts long and short
- Leverage
- Portfolio construction approach: Number of names, constraints, derivatives, etc.

If we can complete this profile we can move on to the question of manager competence. The profile gives us the option of replicating or hiring (make or buy), so we want to know that value added exceeds fees. The traditional approaches to this assessment are peer group and index comparisons, but these are unreliable backdrops for evaluating hedge fund performance. Everyone who has earned the CFA designation has learned the problems with peer groups: they are loaded with biases. But biases are not the major problem with hedge fund peer groups. The fact that hedge funds are unique is the big problem. Dr. Harry M. Kat [2003] documents the lack of correlation among funds in the same peer group. Accordingly, it is virtually impossible to construct an appropriate peer group for a specific hedge fund manager. And since hedge fund indexes are constructed from these faulty peer groups they are also unreliable. We need a better skill assessment approach, such as that described in the next section.

Hypothesis Testing Addresses Question (2): Does the manager execute well?

Albert Einstein once said *“The problems we face today cannot be solved at the same level of thinking that created them.”* A corollary is that it’s unlikely that the people who created the problems can succeed at fixing them.

The solution to the problems with peer groups and indexes is actually quite simple, at least in concept. Performance evaluation ought to be viewed as a hypothesis test where the validity of the hypothesis “Performance is good” is assessed. To accept or reject this hypothesis, construct all of the possible outcomes and see where the actual performance result falls. If the observed performance is toward the top of all of the possibilities, the hypothesis is correct, and performance is good. Otherwise, it is not good. In other words, the hypothesis test compares what actually happened to what could have happened. For a detailed description of hypothesis testing to evaluate investment performance see Surz [2005 & 2006].

Using the profile described above, a computer simulation randomly generates portfolios that comprise a custom scientific peer group for evaluating investment performance. A reported return outside the realm of possibilities is suspicious, and can be explained in one of three ways: the return is in fact extraordinary, the return is fraudulent, or the strategy has not been followed. Of course the test itself cannot tell us which of the three possibilities the reality is, but it does give us motive to look. In other words, the hypothesis test either validates the credibility of reported performance or provides the wherewithal to question the incredible. Financial audits are not designed to provide this validation.

Conclusion

Sociopathic fraudsters like Bernie Madoff are keen to capitalize on our complacencies. But there is a defense. Hypothesis testing sets off fraud alerts that cannot be achieved with antiquated due diligence approaches, and this testing also puts an end to the due diligence sham.

Madoff was no garden variety bandit. Few appeared to be more trustworthy. So some say that the important lesson from this mess is that no amount of due diligence can protect us from violations of trust. I disagree, and advocate a “trust but verify” approach rather than resolving to be tricked by the next Madoff. Fool me once shame on you. Fool me twice shame on me.

ENDNOTE

Many thanks to Larry Siegel of the Ford Foundation and Kenneth Phillips of RCG Capital Partners LLC for their helpful comments and suggestions

REFERENCES

Kat, Harry M. “10 Things That Investors Should Know About Hedge Funds.” *The Journal of Wealth Management*, Vol 5, No. 4, Spring 2003, pp 72-81.

Surz, Ronald. “A Fresh Look at Investment Performance Evaluation: Unifying Best Practices to Improve Timeliness and Reliability.” *Journal of Portfolio Management*, Vol. 32, No. 4, Summer 2006, pp 54-65

_____. “Testing The Hypothesis ‘Hedge Fund Performance is Good’.” *The Journal of Wealth Management*, Vol. 7, No. 4, Spring 2005, pp 78-83.