



Wealth Management, LLC

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Re: Bernard L. Madoff Ponzi Scheme Showed Warning Signs of a Bad Investment.

The investment world has recently been shaken by the release of information regarding the securities fraud allegedly committed by Bernard L. Madoff, head of Bernard L. Madoff Securities LLC. The primary targets of this fraud were many of New York's and Palm Beach's wealthiest clients and other hedge fund investors. Those individuals scammed included Fred Wilpon (co-owner of the New York Mets), New Jersey Senator Frank Lautenberg, the Yeshiva University Endowment, and Steven Spielberg's charity-the Wunderkind Foundation. While Mr. Madoff may have carried out one of the largest and longest running frauds in Wall Street history, there were many red flags and improper tactics that would alert prudent clients. The investing principles that can be ascertained from this scandal and placed into action include:

1) Never invest in something you do not understand:

Madoff promoted a secret trading strategy that supposedly made money in all markets. Even the experts could not explain how he produced consistent returns with a "black box strategy". Most of his clients who lost money were accredited investors, who by qualification of high income and net worth were afforded significantly less protection via disclosure. Most hedge funds require accredited investor status to participate and give the manager almost unfettered discretion on how to invest. It was not just direct investors in the fund run by Madoff Securities who were hurt. Many investors in portfolios of hedge funds, known as "Funds of Funds" were victims as well. The largest reported loss in the scandal was suffered by Fairfield Greenwich another hedge fund who had given Madoff \$7 Billion of their fund of fund investments.

Hedge funds lack many of the disclosure requirements of other registered investments, as the law presumes the wealthiest investors need less protection and disclosure. Many hedge funds also permit levels of asset leverage much higher than most exchange traded funds or mutual funds, so that losses and gains are magnified. This scandal, combined with losses sustained by auction rate securities and other hedge funds, will undoubtedly damage the already battered reputation of these exotic financial vehicles.

2) Stick to Basic Asset Allocation and Diversification Guidelines with investments:

Fundamental investment principals have shown that the adage of not having all your eggs in one basket not only helps mitigate market down turns but also protects clients against catastrophic loss. Many investors suffered in 2000 by having all of their investments with managers who specialized in technology focused companies. Likewise, those clients who had 100% of their money allocated to Madoff Securities have conceivably lost everything. Those who had 5 to 7% of their investable money in Madoff's fund will recover. Experts may disagree on the topic of whether or not hedge funds should be a part of anyone's investment portfolio. However, they would be unanimous in agreeing that no one should have the majority of their money in these vehicles or that a single manager's strategy should be the sole deciding factor in a person's financial future.

3) Counterparties provide checks and balances and protection for investors:

Since Madoff Securities firm acted as its own custodian of assets for both his hedge fund and Registered Investment Advisor, there was no independent custodian involved with advisory or hedge fund accounts held by clients of the firm. The statements his firm sent were the only evidence of what clients were supposedly invested in. Recent securities filings showed that Mr. Madoff's firm held less than \$1 Billion in actual shares of securities, while he purported to manage in excess of \$15 Billion in assets. Some clients have reported to media

sources that they were told that the firm would put the majority of the assets into cash equivalents at the end of each quarter, which was part of the attempt to cover the scheme. However, Mr. Madoff consistently failed to verify where the cash holdings were. **Independent custody statements and confirmations provide verification of actual investment. Investors should insist on these statements and monitor them.**

4) The trading strategy carried out by Madoff Securities did not match the returns they reported:

Madoff Securities reported to employ a simple investment strategy of purchasing stocks and subsequently trading options contracts in a way to limit losses on the long stock positions. The strategy could conceivably reduce volatility in the right type of markets; however, it would be unlikely to produce positive returns in a severe down market. Further, the strategy would be highly unlikely to produce steady gains each month, regardless of market movements, as Mr. Madoff reported to clients.

The conflict between Mr. Madoff's reported returns and the returns of the relative investment vehicles did not go unnoticed. Harry Markopoulos, at the time working for a rival firm, wrote several letters to the U.S. Securities and Exchange Commission (SEC) in 1999 with the words "Madoff Securities is the world's largest Ponzi Scheme." These letters sparked an SEC investigation that was closed without cause in 2007 and reopened on December 11, 2008. SEC Chairman Christopher Cox counts the failure to follow up on this investigation as a significant lapse.

Evidence has been shown that Mr. Madoff actually kicked out some investors for asking too many questions. Likewise, he had a reputation for shunning questions from investment media about his strategy. Unlike mutual funds and ETFs, within independently custodied brokerage accounts; Mr. Madoff had no requirement to reveal the inner workings of his strategy or regularly provide independent holdings reports to clients. Clients should be aware that confirmation statements should tie to actual returns and holdings, which would help to highlight fraud of this kind.

5) Review third party audits of Hedge Funds from a reputable accounting firm:

Yet another red flag was in the way in which Madoff Securities carried out their independent audit. It has been reported by the *Wall Street Journal* that Mr. Madoff used the small accounting firm of Friebling and Horowitz, 3 person firm operating out of a strip mall. One of the employees was in his late 70's working out of Florida, and another employee completed only secretarial duties. The fund of fund hedge funds will likely be liable for their failure to closely look at the audited statements and many should have asked why this firm was chosen. Clients who invest in a hedge fund should insist on a major accounting firm's independent audit.

The majority of the firms in good standing that are registered with FINRA and/or the SEC maintain policies of overall compliance and practice procedures that lead to proper client service. Reporting requirements such as 13F (SEC), which requires systematic filings of holdings, are in place to stop fraudulent actions by firms such as Madoff Securities. Two major lessons can be learned from the fraudulent activities of Madoff Securities. The first major lesson that can be garnered from this illustration of fraud is that tremendous value is added for clients by firms that take the moral, ethical, and legal high road. The second major lesson is that investments, even with the best managers, will tend to have up and down periods. Therefore, if it sounds too good to be true, it likely is.

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