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Wealth Without Risk

I am just a poor boy
Though my story's seldom told
I have squandered my resistance
For a pocketful of mumbles
Such are promises
All lies and jest
Still, a man hears what he wants to hear
And disregards the rest.

Paul Simon didn't have Bernie Madoff's investors in mind when he wrote these lyrics to the song, The Boxer, yet these lyrics provide a warning to investors that has been ignore all too often.

I must admit that I am unable to resist stories about investment scams and their perpetrators. Recently I watched the Netflix documentary series - Madoff: The Monster of Wall Street. On December 11, 2008 Bernie Madoff was arrested and charged with criminal securities fraud after confessing to his two sons that he had been running a "giant Ponzi scheme" in the investment management division of his firm -- Bernard L. Madoff Investment Securities.

First, some background. In the Italian section of Boston in December 1919, Charles Ponzi established The Securities Exchange Company for the purpose of trading postal reply coupons. He promised his investors a 50% return in 90 days.

The Securities Exchange Company, for and in consideration of the sum of exactly $1,000 of which receipt is hereby acknowledged, agree to pay to the order of ___________, upon presentation of this voucher at ninety days from date, the sum of exactly $1,500 at the company's office, 27 School Street, Room 227, or at any bank.

The Securities Exchange Company,   Per Charles Ponzi

Postal reply coupons were used to facilitate sending mail between countries whereby the sender could prepay return postage in the country of origin. Ponzi claimed that because of currency devaluations in Europe after World War I, he could buy coupons for a penny in Europe and exchange them in the US for four cents worth of US postage stamps. Being a generous, humble man, he was willing to share some of his fourfold profit with his fellow Italians. He accused banks of making similar profits but only returning 5% to depositors and keeping the rest for themselves. Then, just as now, there's nothing like a little class envy to sucker people into a scam.

Until April 1920, Ponzi was a one-man scam. In May, he opened an account with the Hanover Trust Co. -- the bank that became the financial hub of his scheme. There is no evidence that he ever bought postal reply coupons, but he used investors' money to buy almost 40% of the bank's common stock. Bank officers knew that current investors were being paid from the deposits of new investors, but they hid the truth of Ponzi's activities from state bank regulators. By mid-summer of 1920, reports by early investors of their 50% return spread like wildfire. Ponzi's operation expanded throughout New England, New York and New Jersey. By July 1920 it is estimated that he was receiving new deposits of $1 million per week, equivalent to $15 million today. The inflow of cash was so great that many early investors received their 50% return in only 45 days. When asked about his strategy, he said, *"How do I cash the coupons? This is what I do not tell."*

It's hard to imagine the charm that Ponzi must have possessed. Contemporary reports described him as handsome and quick-witted. How else could he have convinced people to give him their money in exchange for nothing more than his promissory note? In less than a year he went from being a penniless immigrant to a household name who lived in a mansion on banker's row. It is reported that crowds followed him wherever he went, proclaiming him "the greatest Italian of them all." In all modesty, Ponzi is reported to have admitted to being only in third place -- behind Columbus and Marconi. Unknown to his investors was the fact that he had spent time in a Canadian prison for forgery and in an Atlanta prison for smuggling Italians into America.

Government officials were suspicious of Ponzi's activities because the aggregate postal coupon volume did not support the size of his purported activity. Yet there was no evidence of illegality since all investors had been paid in a timely manner. The Massachusetts district attorney met with Ponzi to discuss his business. Surprisingly, Ponzi agreed to stop accepting new deposits until an auditor could verify the soundness of his operation. Why Ponzi agreed to this, since he had not been accused of any wrongdoing, is hard to imagine, since without the money from new investors his scheme would collapse. After newspaper reports of the audit became known, investors lined up to get their money back. Eventually, Ponzi's bank account was depleted, and the scheme collapsed. It is estimated that Ponzi had taken in more than $10 million and paid out just under $8 million. Ponzi's scheme was so notorious that his name has become associated with this type of swindle - in which gains paid to initial investors come from the deposits of new investors.

Which brings us to Bernie Madoff. Unlike Ponzi, who was unknown prior to his scam, Madoff was a prominent businessman, a 40-year Wall Street veteran with impeccable credentials and a widespread reputation as a philanthropist. (Being a philanthropist is fun and easy to do when you're giving away other people's money.) He helped develop the NASDAQ stock market, had been an advisor to the Securities and Exchange Commission and the National Association of Securities Dealers (NASD), the self-regulatory organization for the US securities industry.

Since the early 1970s, Madoff's business included an investment advisory firm that drew in billions of dollars from institutional investors, wealthy individuals, charities and endowments. He told clients he was using a "split-strike conversion" options trading strategy that would generate positive returns regardless of market conditions. At this point, anyone with any sense should have fled for the exits. In the real world, the capital markets are too volatile under the best of conditions for anyone to be able to generate positive returns every year. His explanations of his strategy included phrases such as "put options", "call options" and "option collars." These three phrases likely confused 90% of potential investors - who were more interested in making easy money than understanding options strategies.

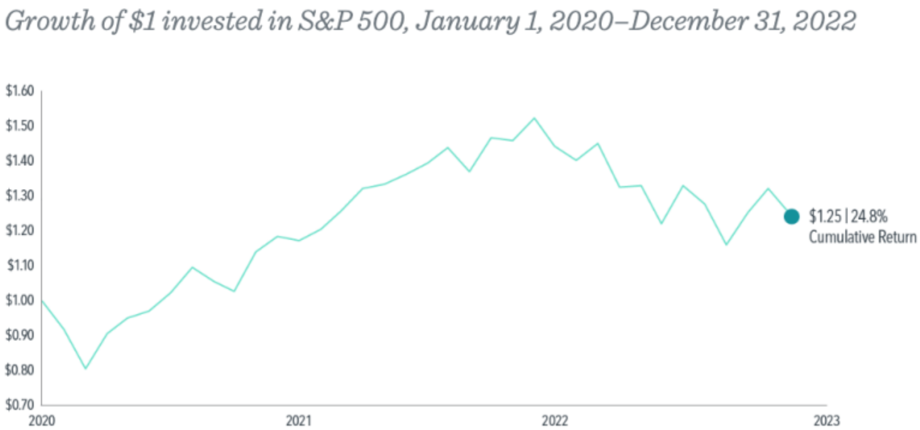
Like Ponzi, Madoff never invested his investors' money. It was a cash in, cash out operation and as long as there was more cash coming in than going out, all was well. Madoff refused to provide his investors online access to their accounts. Fictional client statements noting non-existent trades were printed on a dot matrix printer by two employees whose skills were apparently limited to keeping quiet and not asking questions. Charles Ponzi took advantage of uneducated immigrants who didn't understand that the investment opportunity that he was offering them was a sham. But no such criticism can be made on behalf of Madoff's investors. They included banks, hedge funds, charitable foundations, universities, pension funds, and many other affluent, sophisticated individuals – the smart money, in Wall Street parlance. Smart money that didn't ask questions. They heard what they wanted to hear and couldn't throw money at him fast enough.

An article in *Barron's* magazine in May, 2001 - "Don't Ask, Don't Tell: Bernie Madoff Is So Secretive, He Even Asks His Investors To Keep Mum" provided a warning seven years before Madoff's downfall. The article noted that *"Bernie Madoff manages more than $6 billion for wealthy individuals. That's enough to rank Madoff's operation among the world's five largest hedge funds."* The article noted that Madoff's fund yielded annualized average returns of 15% for more than 10 years with only four down months in 12 years. When asked how he accomplishes this Madoff, mimicking Ponzi, said: *"It's a proprietary strategy. I can't go into it in great detail."* Analysts and rival fund managers stated that they were unable to replicate the fund's past returns using historic price data for the stocks and options Madoff used in his strategy. Nevertheless, several hedge funds placed billions of client dollars under Madoff's management. A partner of one of the hedge funds said *"It's a private fund. And so, our inclination has been not to discuss its returns."* Secret sauce! What could go wrong? The article concluded - *"Madoff investors rave about his performance - even though they don't understand how he does it. "Even knowledgeable people can't really tell you what he's doing" one very satisfied investor told Barron's."* One investment manager said *"What Madoff told us was, "if you invest with me, you must never tell anyone that you're invested with me. It's no one's business what goes on here.""* No one cared how Madoff made money, because a man hears what he wants to hear and disregards the rest. In a 2011 interview, Madoff asserted that unidentified banks and hedge funds were complicit in his Ponzi scheme. In his words, *"They had to know. But the attitude was, 'If you're doing something wrong, we don't want to know.'"* Madoff was sentenced to 150 years in prison and has since died in prison.

A characteristic of investors who fall for investment scams is that they think that they can earn returns that are too good to be true. The involatile rule of investing is that reward and risk are proportional. All assertions that claim otherwise are lies. The Bernie Madoff that his investors believed in was a fictional character, an illusion, a chimera, a figment of their imagination. He lives in the world of fantasy, along with the Easter Bunny, Santa Claus and Superman. In the real world, markets are too volatile and unpredictable for anyone to suffer only 4 losing months in 12 years. But it's not just Ponzi schemes and other investment scams that vaporize billions of investors' dollars. Every day, from sea to shining sea, investors pour money into legitimate investments that they don't understand, with promised returns too good to be true, that don't deliver on their promises. All based on, "You can trust me...", or "I know a guy…"

In The News

Surely, a century after Ponzi, nobody is foolish enough to fall for an investment promising a quick, risk-free, 50% return. But last month it was revealed that attorney Matt Beasley was arrested by the FBI for running a five-year $450 million Ponzi scheme. He told investors that his law firm had relationships with personal injury attorneys whose clients were awaiting payment for settled lawsuits. By investing in a fund that provided short-term loans to these people, Investors were told that they could earn risk-free annual returns of up to 50%. What could go wrong? But the lawsuits were not real, and the organizers allegedly pocketed the investors' money. Some of the promoters of the scheme, and most of its 900 victims, were Mormons, making this a classic affinity fraud - a financial crime that exploits bonds of trust, such as shared affiliation with a religion, family relationship or social group.



This chart, from Dimensional, shows the growth of $1 Invested in the S&P 500 Index from January 1, 2020 through December 31, 2022. If you were told on New Year's Day 2020 that the next 3 years would include a global pandemic, a collapse in global economic activity, that stocks would fall 35% in 33 days, that a ground war would begin in Europe, and that inflation would rise to a 40-year high leading to a sharp rise in interest rates, what would you have done? Don't kid me, you would have sold all your stock funds and parked your money in cash until "things get better". Yet despite all the bad news, including dividends, the S&P 500 rose by more than 25% from the beginning of 2020 through the end of last year – an annualized rate of 7.8%. An important lesson to learn from the stock market's long-term returns is that companies don't just sit and do nothing when new obstacles arise, they adapt and innovate to overcome them.

Many investors are suffering from "recency bias" - making their investment decisions based on the recent past instead of the long-term. If I was a betting man, I'd put my money on the likelihood that, despite the problems we face today, capitalism will survive and that owning a diversified portfolio of index funds will yield satisfactory returns over the long run. Nobody knows what the next 3 years will bring, but just as in the past, investors who have a plan and the discipline to continue funding their portfolio, regardless of the headlines, will likely do just fine. And the stock market will continue to act as a conduit that transfers wealth from the anxious to the patient.

Former NBA star Paul Pierce, who was nicknamed "The Truth" during his career, has agreed to pay $1.4 million to settle the Securities and Exchange Commission's allegation that he promoted the crypto token EMAX on Twitter without disclosing that he was paid $244,000 for doing so. SEC rules require anyone who promotes an investment to disclose from whom and how much they are getting paid to promote the investment. Pierce posted a screenshot on Twitter of an account boasting impressive EMAX holdings and earnings. However, he failed to disclose that the account wasn't his. The fact that people take investment advice from celebrities and athletes is proof positive that we live in a society in which financial ignorance is all too common.

Leave it to Wall Street to ruin a good thing. The first ETFs were low-cost, tax-efficient diversified funds that tracked broad stock market indexes. But now, there's a new kid on the ETF block - single stock ETFs that either bet against an individual stock or use leverage in an attempt to amplify a stock's daily gains. These funds have attracted much criticism, leading their issuers to claim that they're designed for "sophisticated active traders" – Wall Street's favorite way to describe rich, performance chasing suckers. There aren't enough sophisticated active traders to make their issuers rich, so you can be sure that these funds will also be marketed to not-so-rich, performance chasing suckers. Purveyors of financial products are primarily in the business of making money for themselves, not for their customers. Customer education is not high on their to-do list. They make a fortune exploiting their customers' lack of financial knowledge. Picking individual stocks is difficult, even for highly experienced fund managers. Shorting them is even harder. Throwing leverage into the mix just adds fuel to the fire. Stay away from single stock ETFs.