The Madoff Scandal: Old News is New News by Shirley M. Mueller

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As early as 2001, a group of more than a dozen investment specialists including money managers, consultants, quantitative analysts and fund-of funds executives questioned Madoff's consistency of returns.

Last May, a NYC acquaintance told me his investor advisor made him 20% per year since the late 1980s. "That's remarkable," I said. "You must be taking on risk?" The response, "No, my investments are perfectly safe."

At the time, I thought my acquaintance was too financially unsophisticated to appreciate his real investment return or the hazards associated with it. Now I'm wondering if he had invested with Bernie Madoff.

Others have wondered about Madoff for far longer. As early as 2001, a group of more than a dozen investment specialists including money managers, consultants, quantitative analysts and fund-of funds executives questioned Madoff's consistency of returns. This was documented in an article written by Michael Ocrant for MAR/Hedge in May of that year (#89).*

The puzzle investigated in this article was how Madoff could achieve his investment returns with so little risk reported. "What is striking to most observers is not so much the annual returns—which, though considered somewhat high for the strategy, could be attributed to the firm's market making and trade execution capabilities—but the ability to provide such smooth returns with so little volatility," Ocrant wrote.

Madoff's trading strategy was to use a "collar"—a limit on both gains and losses. To do this, he said he sold "out of the money"** calls on an index similar to stocks he owned long, and bought "out of the money" puts on the same index. The idea was create a floor for losses and a ceiling for gains. The problem, according to the questioning group, was that others who used the same technique had nowhere near the same success as Madoff.

In response, Madoff indicated to Ocrant that he was "piloting the plane," but he provided little in the way of specifics. Madoff said, "I'm not interested in educating the world on our strategy and I won't get into the nuances of how we manage risk."

Other questions about Madoff's trading strategies were also addressed, but Madoff's similarly flippant answers didn't satisfy the skeptics. Ocrant wrote, "…most continued to express bewilderment and indicated they were still grappling to understand how such results have been achieved for so long."

Now, of course, all of us know how Madoff managed risk. He used incoming money from new investors to pump up portfolio returns for as long as the money kept coming in. But with the current market conditions unwinding positions everywhere, outflows became more common than inflows. Thus, Madoff couldn't mange his elaborate scheme anymore.

So, the old news to a select group of skeptics from 2001 is suddenly the new news to the rest of us. What made the early doubters different? What qualities did they have that other investors, including very sophisticated ones, didn't? I would suggest that it was not only knowledge, but also the ability to question results that seemed too good to be true.

Most of us operate using the general guideline of "optimism over realism." But when investing, "realism over optimism" is a more secure principle to follow in order to achieve the most optimal investment results. In the end, it will put money in the investor's pocket, and that is where any sensible human being wants it.

Notes:
* The skeptics talked to Ocrant on the condition that they wouldn't be identified. Ocrant also interviewed Madoff for the article.

** Out of the money: For a call, when an option's strike price is higher than the market price of the underlying asset. For a put, when the strike price is below the market price of the underlying asset. It is basically an option that would be worthless if it expired today.