



## The Lessons of the Bernard Madoff \$50 Billion Fraud

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Like many of you, I was shocked when I read the report last Thursday morning in the Wall Street Journal that Bernard Madoff had swindled investors out of \$50 Billion. Worse yet, as I read, I was concerned about a neighbor of ours, *who is not a client*, that had invested all of his family's money with a "genius" in New York. As I read the report, there were so many similarities, but I convinced myself that my neighbor, we'll call him Bob, must have been with someone else, because the WSJ indicated that Madoff only had two dozen or so clients.

Then, Thursday morning, about an hour later, I got the phone call. It was Bob. He and his family were all part of the Madoff swindle. They had lost everything. In their mid 60s, Bob and his wife would be selling their house, hoping to clear enough to pay off the mortgage and then starting all over again, like they did in their 20s. They were even considering bankruptcy, although now that seems unlikely. It's really sad.

They had invested for twenty years with Madoff. The few times we talked about investments, Bob was always very smug about the performance of his accounts. He said that Madoff had a complex system (also known as "split strike conversion") that produced a return of 1 to 2% every month, without fail. Madoff could "see changes coming in the market before they happened and made trades that resulted in profits". In up and down markets, Madoff never lost money. Some investors called investing money with Madoff the "Jewish bond" because it "returned" 12-15% every year.

**Lesson One:** When something sounds too good to be true, it probably is.

For the last eight years, there have been

reports by analysts who have studied Madoff's programs and didn't believe the results. Back in 1999, there were some skeptics who thought Madoff might be running a Ponzi scheme. It was incomprehensible that one man could see all the changes coming and never have a down month, in all kinds of markets.

At Detterbeck Wealth Management, we are very proud of the investment performance of our clients. A good deal of that success comes from understanding our clients' risk profiles and objectives and matching the asset allocation to specific needs. It includes long-term forecasting that most investment managers don't consider. However, regardless of how astute we or any other advisor may be, negative results are bound to happen from time to time, especially in highly unusual years like 2008.

When I talked with Bob Friday morning, I asked him about the custodian statements (e.g. from a company like Schwab or Fidelity) he should have received. He indicated he never got any statements directly from a traditional custodian. His statements came

from Madoff. Actually, his statements came from a CPA. You see, Madoff created huge partnerships with partnerships within partnerships. That's why the WSJ had reported only two dozen clients. Madoff would send information to Bob's CPA who split the information into 400 partnerships. Bob's family had their own partnership. Their information came on an excel spreadsheet from the CPA who got it from Madoff.

**Lesson Two:** Get your brokerage statements directly, and, if possible, have online access directly with the custodian for any and all transactions in your account.

Our DWM clients know that they have Schwab access 24/7 to all of their accounts. Most of our clients now get their statements via email from Schwab. While our quarterly reports may be valuable because they can recap everything, including performance, don't underestimate the well being you should have by being able to access your Schwab accounts directly at any time.

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### INTRODUCING OUR NEWEST TEAM MEMBERS



**Yiqi Wang** will be working on investment research, trading, and portfolio management strategies. He came here from China about a year ago and has been excelling at IIT in Chicago, where he's majoring in Finance and pursuing the Chartered Financial Analyst (CFA) program. Yiqi will be completing his Co-Op internship at DWM in 2009.



**Anna Filipkowska** comes to us with extensive administrative experience in the financial services industry, which makes her a quick learner at DWM. She has taken over many duties required to keep the office running smoothly. Anna was born in Poland and came to the US as a child. Don't be surprised to hear her friendly voice the next time you call.

## Fraud (continued)

Also, when I talked with Bob, he told me that he sent in new money to invest directly to Madoff and not the custodian. Further, all of the withdrawals (e.g. automatic monthly withdrawals) came directly from Madoff as well. This should have been a red flag.

**Lesson Three:** Don't make out checks to the Investment Adviser; make them payable to the custodian, or in the case of direct investment, directly to the program sponsor.

At DWM, we won't accept checks for funds to be invested made payable to us. Technically, this would give us "custody" of assets and subject us to an additional level of review by the SEC. We don't want that responsibility; we **never** hold client funds.

Some of our DWM clients invest in direct participation programs as partners. While these investments may appear on their Schwab statements, the information comes directly from the partnership.

**Lesson Four:** If you are in an investment partnership, make sure that any one partnership is no more than 10% of your holdings for risk management purposes.

Unfortunately, it is impossible to rid the world of criminals. There will always be people like Madoff who commit frauds. Bob and his family committed 100% of their money to Madoff and lost it all. They had no diversification. By diversifying your portfolio at a reputable custodian like Schwab and limiting your direct participation investments to a maximum of 10% each, you reduce your chance of loss,

specifically fraudulent loss.

Lastly, I asked Bob how he came to know Madoff. He told me a friend of his had recommended Madoff, but told Bob he didn't know if Bob had enough money to get in. Madoff was such a "genius" that investing with Madoff was an "exclusive club". Bob told me he was thrilled years ago when he got the call that he had been "accepted". Bernard Madoff would manage his money and from day one, Bob's statements showed positive returns.

**Lesson Five:** Make sure you do your due diligence, particularly on partnerships.

DWM provides SEC Form ADV Part II disclosure form to all clients and prospective clients on or prior to our first meeting. The ADV tells who we are, our backgrounds, our services, our fee schedules, etc. DWM has been registered with the SEC from our first day of business. Madoff first registered with the SEC in 2006, though he started his business in the 1960s.

In addition, any direct participation programs that our clients might invest in through our broker/dealer receive our due diligence, the due diligence of our broker/dealer and often the due diligence of securities law firm before we ever discuss this information with a client. And, of course, as you know, we



encourage clients to actually read these private placement memoranda, and if there is any concern after further review, to not make the investment.

In conclusion, we understand that our role as investment and wealth manager to our clients is a major responsibility. We take our role very seriously. We will do everything in our power to help our clients meet their financial goals by only recommending suitable strategies and products, and being honest and ethical.

What Madoff did is appalling and is going to give the financial industry another black eye in a year of many disasters. Furthermore, we expect to see more stories like the Bernard Madoff fraud in the papers and on TV. By working only with hardworking people with integrity and following the lessons of this article, you can avoid becoming another victim.

We'd be happy to discuss these matters at any time. Happy holidays!



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