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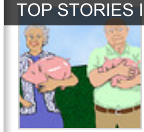
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WEALTH ADVISER

Vonnegut: Five Years after Bernie

One lesson learned: Have a 'quant' for a friend

By NORB VONNEGUT

Nov. 21, 2013 10:58 a.m. ET

The Federal Bureau of Investigation arrested Bernie Madoff on Dec. 11, 2008. His guilty plea and 150-year prison sentence were almost non-events, at least compared with the finger-pointing, lawsuits and trials that have ensued. They turned the Ponzi scheme into a gift that keeps on giving five years later.

So what does this mess still mean to financial advisers?

I put together a list of takeaways. Some of the observations are mine. The real eye-openers come from a quant and a private investigator.

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1. Invincible competitors are red flags. Mr. Madoff didn't have clients. He had a cult of happy, supremely loyal investors. Who could blame them? From January 1998 to January 2008, they suffered only six down months. Those losing months totaled less than 10% in aggregate.

After a fierce struggle, I once managed to wrest a $5 million account away from Mr. Madoff. "It's crazy for you to put all your eggs in one basket," I told the client, who parked more than ten times that number in the Ponzi scheme and played golf with the

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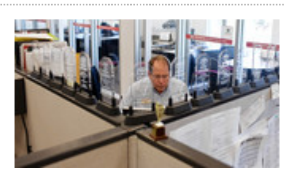

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Bari Goodman

When I left my brokerage firm for greener pastures at a registered investment adviser, my client refused to follow. He moved his money back to Mr. Madoff instead. The returns were better and he wanted to "simplify" his affairs by consolidating everything in one shop. I should have pushed harder.

2. It's possible that nobody has your back. Does anybody else find it ironic that the federal prosecutors in New York and the Office of the Comptroller of the Currency may fine J.P. Morgan Chase JPM +1.80% & Co. for failing to alert authorities about Madoff? The government itself had been given plenty of advance notice.

I'm not defending J.P. Morgan, its due diligence or its judgment in a two-decade-long relationship with Mr. Madoff. If there's one lesson here, it's that advisers can't place blind faith in employers to smoke out the bad guys.

Of course when it comes to the proverbial blind eye, the Securities and Exchange Commission sets the gold standard. In 2000, 2001, and 2005, Harry Markopolos alerted the SEC. The facts he offered are white-hot. He gift-wrapped the case a full three years before Mr. Madoff confessed, and the SEC never unwrapped it.

So maybe those prosecutors should fine the SEC, which is plenty rich from its recent settlement with a certain hedge fund in Stamford, Conn. Just sayin'.

3. Top-quartile managers call for twice as much due diligence. It's easy to sell clients on top-performing managers, but it takes work to distinguish between friend and fraud. And it's among the outliers--the managers who make you drop your guard because their returns are so exceptional--that the rogues congregate. The charges of rampant insider trading at SAC Capital Advisors are a more recent sign of that.

That's not to say great managers are all cheats. But all great managers should get extra scrutiny.

Herb Blank of S-Network Global Indexes says we tend to hear about glittery results when legitimate managers are at the peak of their game. And that's when, even if there's no cheating involved, their performance is poised to trend down.

"Hiring them is like signing A-Rod," he says, "to a twenty-year contract at age thirty-five."

4. Beware of inefficient markets. I know this sounds like heresy. Those swashbuckling money managers, the ones who scour for value where others fear to tread, are the Indiana Joneses of private wealth management.

Or proto-Madoffs. His "split-strike conversion" pitch sounded obscure enough to be sexy. So many former members of the cult used to tell me with knowing gravitas, "Bernie's figured out a way to work the bid-ask spread."

Where could the next shoe drop? Given the recent sale of a Bacon triptych for $142.4 million and a Picasso for $104.5 million, I offer the following observation from L. Burke

Files, a private investigator with Financial Examinations & Evaluations: "Art funds always lose money...investors always lose in an engineered and contrived market."

5. Make friends with a quant, like Mr. Markopolos. He uncovered Madoff's scam by trying to reverse-engineer those sterling results.

There's even hope for those of us who don't have the mathematical tools to grind through complex algorithms. A group called Qwafafew--it stands for Quantitative Work Alliance for Applied Finance, Education and Wisdom--has 10 chapters in cities across the country. Why not attend a meeting and ask somebody over a beer about that investment that's too good to be true?

Or, simply: If you don't understand it, don't sell it.

Write to Norb Vonnegut at norb.vonnegut@dowjones.com

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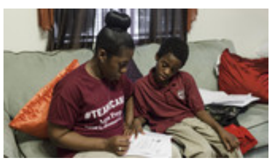

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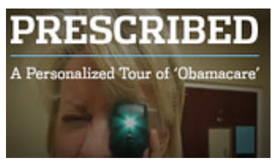

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