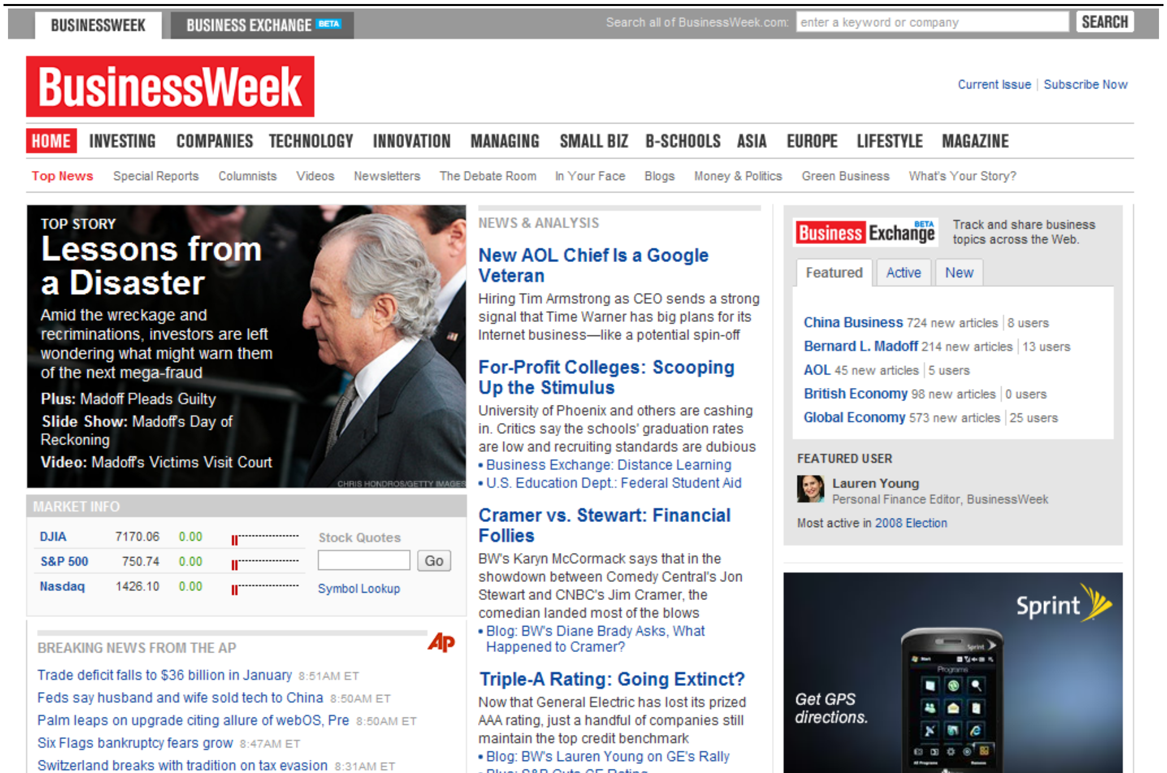

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Madoff: Lessons from a Disaster

Amid the wreckage and recriminations, investors are left wondering what might warn them of the next mega-fraud

By Ben Levisohn

On Mar. 12, victims of Bernard Madoff's Ponzi scheme finally had one of their wishes come true. After a judge denied bail, Madoff is going directly to jail, and he isn't passing "go." But Madoff's victims still want answers.

They want to know where the money went. They want to know who else was involved. And they want to know how they got scammed.

At the courthouse, many victims said there were no warning signs and Madoff himself, in his courtroom statement, backed them up on at least one count. "The clients receiving trade confirmations and account statements had no way of knowing by reviewing these documents that I had never engaged in the transactions," Madoff said during his guilty plea.

Maybe not. But to Harry Markopolos, the risk manager who alerted the SEC to Madoff's fraud in 1999 to no avail, the foul play seemed obvious. Madoff was supposedly using a complex trading system to generate returns, a strategy he dubbed the "split-strike conversion strategy." He would buy stocks in the Standard & Poor's 100 and sell options to reduce volatility. But Markopolos' firm was running a similar strategy and couldn't match the returns. A look at the returns was all it took for Markopolos to know something was up.

Preying on a Community

Markopolos had plenty of incentive to doubt Madoff; he was a competitor irked by Madoff's claims of too-good-to-be-true returns. For most of Madoff's clients, the math that Markopolos employed would have been out of their league. Some Madoff investors were sophisticated enough that they might have dug deeper into their statements and trade confirmations. A quick comparison of their returns with those of the actual markets might have been enough to tip them off that at least some of the trades were phony. Some of them might have realized that the average returns were too high and too constant, based on the mathematical probabilities. "If the standard deviation is too low and the mean too high, something is wrong," says Utpal Bhattacharya, finance professor at the Indiana University Kelley School of Business. Still, "the retail investor would need some help."

Experts say investors can avoid Ponzi schemes and other scams without relying on math. The first step: Take a look around; who are your fellow investors? Often in a scam, a pattern emerges. There's a reason why many Madoff-like scams are called "affinity crimes." Charles Ponzi, for whom the scam is named, targeted Italians. Joseph Forte ripped off his friends. And before Madoff branched out into Europe in recent years, his clients were primarily Jews and Jewish foundations.

"Ponzis involve preying on people who have some association. The same clubs, religion, geographic location," says Tim Kochis, chief executive of financial advisory firm Aspiriant. "Madoff's investors all trusted each other. They assumed that was good enough." If investors get a sense that their adviser caters to a very narrow group, they should probably dig a little deeper.

Do Your Own Due Diligence

That starts with doing your own due diligence. Scamsters often make claims to bolster the confidence of investors that they're dealing with a heavyweight. Allen Stanford built an image of a successful businessman whose family's financial-services roots went back to 1932. In fact, his banking empire consisted of a Montserrat bank founded in 1986 that had its license revoked by the local government. Go back further, and Stanford filed for bankruptcy not once, but twice.

Victims of Tom Petters, the mastermind behind another recent Ponzi scheme in Minnesota that cost investors $2 billion, didn't check out basic claims, such as Petters' assertion that he was a major supplier to Sam's Club. He wasn't, which the investors could have figured out if they'd picked up the phone and made a call.

Madoff's investors might have been able to determine if their trades were legitimate if they'd checked how a stock or option traded on any given day. Even something as trivial as the accounting firm can be a tip-off. Both Madoff and Stanford used tiny accounting firms that would have been hard-pressed to handle the job. "Investors have to do their own due diligence," says Gregory Hays, managing principal of Atlanta-based Hays Financial Consulting. "They need to make sure what they're investing in is accurate."

Investors also should dig into the firm and the background of its managers. A quick check on the Financial Industry Regulatory Authority, or FINRA, Web site could alert investors to a black mark on an adviser's record. Its Broker Check function alerts investors to any regulatory proceedings against an adviser, from bad record-keeping to misuse of client funds for firms and advisers. If the firm doesn't have a solid explanation, it could be time to look elsewhere.

The Defense of Skepticism

Even a quick search of Google (GOOG) can be revealing, yet it's a step few victims take. It would have revealed accusations from the 1990s that Madoff was front-running his customers, that is, buying or selling shares before filling their orders. The charges may amount to nothing. "But," says Billy Procida, founder of William Procida Inc., a turnaround management firm for middle-market real estate companies, "do I really want to take that chance?"

Still, the best defense may be a healthy dose of skepticism. Most people with money to invest with people like Madoff worked very hard for it. In business, they wouldn't have taken anybody's word for something. They'd have checked it out. But they didn't do the same with their advisers.

Richard Friedland, a CPA and Madoff investor, said on Mar. 12 that he could have recognized the scam if he had been looking for it. But he saw no reason to look for it. "Madoff was the chairman of Nasdaq," Friedland said.

And that's what the Madoffs of the world depend on to build their webs of deception. They have fancy offices, fancy cars, and travel in private jets. They have pictures of governors, mayors, movie stars, and athletes.

"People love that," Procida says. "They want to be with a star."

Levisohn is a staff editor at *BusinessWeek* covering finance and personal finance.