

CHAPTER 1

Recent Hedge Fund Scandals

PALM BEACH, FLORIDA

Palm Beach, Florida, is home to some of the highest net worth individuals in the country. This community has been investing in hedge funds for several decades and unfortunately has also been a target of several scam artists. As Palm Beach has featured in several financial scams and scandals in the press of late, it behooves me to delve a little bit deeper into the makeup of its denizens and the psychology of the society. I believe that it will help in understanding the way people generally approach investing and the overreliance on relationships rather than due diligence.

The island of Palm Beach is an exclusive community that runs about fourteen miles in length, but most of the multimillion-dollar mansions are located in a two-mile stretch along South Ocean Boulevard. It is often confused with West Palm Beach, but once you cross one of the three bridges connecting Palm Beach island to West Palm Beach you quickly realize that there is little in common between Palm Beach and what lies OTB (“over the bridge” in Palm Beach lingo). Palm Beach serves as a summer home for the super-rich Wall Street tycoons, industrialists, recording artists, and European aristocracy. While deserted almost six months of the summer, the height of the hurricane season in Florida, it comes to life from October to April. The lavish and umpteen charitable galas held every year at the Breakers Hotel and Donald Trump’s Mar-a-Lago Club are a must-attend for the socialites of Palm Beach. My girlfriend at the time ran one of these charitable foundations on Palm Beach. As a result, we both frequented these charity balls. Being an outsider, I was often amused and befuddled by my observations. While sipping glasses of Dom Perignon and being entertained by crooners like Wayne Newton, the conversations often covered the latest exotic vacations, yacht acquisitions, and the best-performing investments of

the year. The competition to climb the social ladder in Palm Beach and being on the invitation “A” list is second to none. Being feted in the *Shiny Sheet*, the Palm Beach society newspaper, by a charitable organization is far more important than knowing the destination of one’s philanthropic dollars. Need for social recognition and being a part of an exclusive group or invitation list is a panacea. There is no wonder that in such an environment a hedge fund that advertises superfluous or metronomic returns and admits investors on an invitation-only basis would be highly sought after. As we take a look at the following scandals, we will see that blind greed, a herd mentality to belong to an exclusive club, and lack of proper due diligence has often led to financial ruin.

KL FINANCIAL, MARCH 2005

John Kim, one of the founders of KL Financial, a hedge fund, once said, “I cannot promise one hundred and fifty percent annual returns, but I won’t rule out the possibility.” The story of KL Financial starts in a San Francisco apartment in the late 1990s at the peak of the internet boom and the day trading fad. John Kim and Mr. Won Sok Lee, two of the three partners of KL Financial, started day trading technology stocks. Neither of them had any formal training or experience prior to this as stock traders. Mr. Lee grew up in Las Vegas and earned a law degree at Tulane University in 1996. He then worked as an associate in the gambling department at a Las Vegas law firm, and, in the late 1990s, in the tax department at a San Diego law firm. John Kim and his brother, the third partner, Yung Kim, grew up in a Virginia suburb of Washington. John Kim often regaled his friends and associates with the story of how upon graduating from George Washington University he had operated a coffee importing business in South Korea, but had it taken away by the despotic government because of its huge success. No record of such a coffee importing business or its usurping by the South Korean government can be found. Mr. Kim also liked to brag about his days as a mergers and acquisition banker at Merrill Lynch, although Merrill Lynch has no record of his ever working there. Furthermore, the NASD, a regulator that licenses securities professionals, says it has no records that any of the firm’s three principals ever applied for the necessary licenses to trade stocks for clients on Wall Street. Despite such a nebulous track record, Mr. Kim and Mr. Lee rode the tech boom and managed to set up a trading operation in Irvine, California, and in 2002 an office in Palm Beach, Florida. They hired a staff of inexperienced, usually fresh college graduates. Mr. Kim acted as the Chief Investment Officer, his brother Yung Kim as the Chief Financial Officer, and Mr. Lee handled back-office duties.

Ritz Palm Beach Offices: Looking the Part

It is often said that if you want to be successful, you have to look the part. The principals of KL Financial took that to heart: When one is trying to woo the Palm Beach crowd, one has to really impress. They conjured up returns of 70 percent in 2003 and 40 percent in 2004, according to doctored statements given to investors. To complement their outsized returns, they bought outsized lifestyles. They bought flashy cars: Maserati, Porsche 911, and Mercedes SL 500. The firm's personal masseuse drove a Jaguar X-Type that was provided by KL Financial. End-of-year holiday parties were held in Las Vegas, where Mr. Kim and Mr. Lee were high-rolling VIPs at several casinos. They shopped on Worth Avenue, the equivalent of New York's Fifth Avenue and made themselves very conspicuous. They befriended the right people, who provided them with access to society functions and thereby introductions to their wealthy clients. To create the right impression, they spent \$1.8 million in decorating their office space, which spanned most of the 17th floor of Esperante, a signature tower with bird's-eye views of KL Financial's target market: Palm Beach. According to a report by the *Palm Beach Post*, the \$47,000-a-month suite's private landing had a \$15,000 wall-size waterfall, a feng shui ceiling of carved wood and a floor of wenge planks, a dark, black-veined hardwood from Tanzania. The lobby had a rotunda-style coffered ceiling, dark mahogany built-ins, gray plush sofas, pewter-hued suede walls, and Wenge floors. Dakota Jackson custom furniture included Aldabhra conference room chairs of kiln-dried solid mahogany. Opposite a window wall overlooking the waterfront were double-faced wood-trimmed panels of frosted glass filled with reeds of bamboo. John Kim, the chief investment officer and senior principal had a \$6,000 Inada black leather Shiatsu massage recliner in his spacious corner office. The large sunlit offices were filled with gorgeous desks designed by Dakota Jackson and a conference table that had to be hoisted seventeen floors through the building's elevator shaft. The trading floor had large flat-panel televisions scattered throughout. Spread on end tables and John Kim's credenza were brochures for Palm Beach, America's International Fine Art & Antique Fair, a book on Korean folk painting, and brochures for the Ritz-Carlton Golf Club, the Bear's Club, and PGA National Resort and Spa. John Kim's trading station had eighteen screens hooked up to ten computer towers. Former employees cooperating with the investigation told investigators that Kim's computers looked at times like rockets at liftoff, with lights blinking and fan motors revving. While KL Financial's offices were very expensively decorated, there are several hedge funds whose offices are even more stupendous. But the difference is that the principals of KL Financial used money stolen from its clients not earned in the markets.

Ronald Kochman: The Facilitator

Ronald Kochman has been mentioned in several press articles and investigator reports as the person instrumental in introducing the KL Financial principals to the Palm Beach elite. Since the late 1990s, Mr. Kochman had built a lucrative trusts-and-estates practice, counting a number of Palm Beach's movers and shakers as clients. "Kochman had one of the pre-eminent practices down here," said Richard Rampell, an accountant who worked with Mr. Kochman on several occasions. "In the last couple of years, he probated two estates that were well into nine or even ten figures. He was the envy of a lot of lawyers." According to investigators and KL employees, Mr. Kochman became increasingly involved with the firm and formed a close friendship with John Kim, who made Kochman a principal in KL Financial. Mr. Kochman, these people said, believed that there were greater riches to be reaped if KL were sold to a large Wall Street firm, as Mr. Kim indicated it eventually would be. They said Mr. Kochman planned to downsize his trusts-and-estates business in order to play an even bigger role at KL. Trusting his new friends, Mr. Kochman provided introductions to his clients and friends and was responsible for bringing in many of KL's investors, according to investigators. The aura of success and exclusivity around KL Financial was so strong that investors often begged to be let into its funds, some of which were said to have astounding annualized returns of 125 percent for several years. Among the funds' over two hundred investors were some of Palm Beach's elite, including Jerome Fisher, the founder of the Nine West shoe store chain; Carlos Morrison, an heir to the Fisher Body automotive fortune; and golf pros Nick Price and Raymond Floyd, according to people who have seen lists of investors.

The Duping and the Post Mortem

In the fall of 2004, several of KL Financial's investors started asking for certified audits of the funds. John Kim kept promising to get the audit done but kept delaying it. Investors started to get jittery and decided to redeem their assets. On February 22, 2005, Securities and Exchange Commission (SEC) officials unexpectedly visited KL Financial's offices and asked to see documents. After the meeting, investigators said, Mr. Lee walked out of the office, leaving a half-eaten bag of cookies on his desk. The next morning he went to the airport and bought a one-way ticket for South Korea, using frequent-flier miles. The day after that, Yung Kim disappeared as well. A few days after the SEC appeared on KL's doorstep, John Kim invited about thirty employees to his home. As the employees listened in shock, he said that the company was under investigation and that his brother and Mr. Lee

were missing. John Kim squarely put the entire blame on his two partners and played the innocent victim.

KL Financial principals ran a Ponzi scheme, i.e., paying out any redemptions to existing investors from funds received from new investors. All the superfluous returns were doctored and \$190 million of investors' money was either lost in the markets through incompetent trading activity or spent in personal pursuits by the principals.

On July 17, 2008, John Kim and his brother Yung Bae Kim were sentenced by the Honorable Kenneth L. Ryskamp in the United States District Court in West Palm Beach, Florida. John Kim was sentenced to 220 months imprisonment followed by three years of supervised release. Yung Bae Kim was sentenced to 75 months imprisonment followed by three years of supervised release. Each defendant was also ordered to pay restitution, which will consist of 50 percent of any income they earn in a Federal Prison Industries job, and following their release, ten percent of their monthly gross earnings. Won Lee, the third principal who is also named as a co-defendant in the indictment, remains a fugitive from justice.

The post mortem of the KL Financial in the presses produced the usual warnings from the various experts that went unheeded. First was the sloppy doctored re-creation of brokerage statements. The brokerage statements did not look professional and should have been spotted by the investors. Second, fingers were pointed at a lack of due diligence on John Kim's background. The offering memorandum of KL Financial did not give details on John Kim's professional background. And finally, the third red flag was the lack of audited statements.

These blatant red flags beg the question, How could such smart, successful and savvy investors from Palm Beach be duped by the charlatans of KL Financial? I feel that the answer to the question is twofold—an overreliance on relationships and not enough on due diligence; second and more important, improper due diligence. Many people have blamed greed for high returns as a culprit, which in my opinion is a ridiculous statement. We all have the option of keeping our money in cash or under the mattress.

My friend Steve Malone, a successful businessman, never invests in the stock market, let alone hedge funds. He invests in himself; he identifies businesses that he has a passion for, then he invests not just his money but time as well in these businesses. For those of us who do invest in the capital markets and hedge funds around the world, our main motivation for doing so is because we want higher returns while acknowledging that we are taking higher risks as well. The key is understanding all the risks involved in our investment decisions and then making prudent investment choices. The fault lies not with the desire to invest in high yielding investments but in not reconciling our expectations with the risks associated with them. The

reason why the investors in KL Financial got duped was not because they were greedy but because they did not understand or care to find out all the risks involved in their investment.

Ronald Kochman was the estate and trust attorney for a lot of wealthy families on Palm Beach that invested in KL Financial. He was an attorney who was an expert in understanding the tax code, IRS regulations, and drawing up proper legal contracts to fulfill his clients' tax obligations. He was very good at that job, but how did that qualify him to become an expert on hedge fund trading strategies? What in Ronald Kochman's resume made his clients feel that he had the expertise to guide them toward a proper investment choice while explaining all the risks involved? Nothing. Ronald Kochman had excellent relationships with his clients built as a result of his work as an attorney for them. He used his relationships to open doors for KL Financial principals and to persuade his clients to invest with them. His clients put blind faith in their relationship with him and performed no due diligence. They should have hired experts who would have examined in great detail John Kim's trading models, their historical performance history, and the correlation of that performance with market cycles. Then they would have checked his trading background to verify his experience, education, and past performance, and finally they would have insisted on an audited track record. KL Financial would have never passed this rigorous due diligence process, and the investors would have been saved \$190 million and Ronald Kochman his relationship with his clients.

AMARANTH ADVISORS, SEPTEMBER 2006

The everlasting red pigment of the Amaranth flower has stood as a symbol of immortality since the time of ancient Greece. Nicholas Maounis, the founder of Amaranth hedge fund picked the famed flower for the name of his hedge fund when he opened the fund in September 2000 with \$600 hundred million in assets. Maounis graduated from the University of Connecticut in 1985 with a finance degree, started his career at investment bank LF Rothschild, Unterberg, Towbin and hedge fund Angelo, Gordon & Co., both based in New York. In 1992, he joined Greenwich-based Paloma Partners LLC, a hedge fund, and eventually traded \$400 million, the largest amount managed by any individual at the hedge fund. After eight years, Maounis left to form Amaranth with twenty-seven employees. Based in Greenwich, Connecticut, Amaranth started out trading a convertible arbitrage strategy. Convertible bonds are bonds issued by companies that give the bond holder the option to buy the company's stock at a predetermined price. Convertible arbitrage traders profit from trading the perceived value

of that embedded stock option. This strategy was Nick Maounis's expertise, what he knew best, and his original intention for starting his hedge fund.

Outgrowing Its Core Competency

Amaranth flourished, and the fund was able to attract big money from some of the biggest institutional investors, including funds run by Goldman Sachs Group Inc., Morgan Stanley, Deutsche Bank AG, and Bank of New York Co.'s Ivy Asset Management Corp. Pension funds of 3M Co. of St. Paul, Minnesota, and the San Diego County public employees also signed on. At its peak, according to Amaranth's marketing materials, it described itself as a global, multi-strategy hedge fund. Amaranth had over 400 employees, including 170 investment professionals, and managed in excess of \$9 billion for institutional investors, including corporate and public pension funds, endowments and foundations, insurance companies, banks, family offices, and funds of hedge funds. The basic rule of capitalism is that money will flow where there are the biggest money-making opportunities or inefficiencies. Money will keep flowing until those inefficiencies have been taken out of the market. This is what happened to the convertible arbitrage market in the early 2000s and why Nick Maounis decided to diversify his ever-growing hedge fund into other areas.

Brian Hunter

The area that Nick Maounis picked was energy trading, and the trader he picked to run that area was Brian Hunter, a 26-year-old trader. Hunter, who grew up near Calgary, had earned a master's degree in mathematics from the University of Alberta before starting to trade natural gas in 1998, according to Amaranth marketing materials. He traded for Calgary-based TransCanada Corp., then joined Deutsche Bank in New York in May 2001. In his first two years, he earned \$69 million for the bank, according to a complaint Hunter later filed in New York State court in Manhattan that claims the bank owes him bonus money. By 2003, Hunter was head of the bank's natural gas desk. In December 2003, Hunter and his colleagues were up \$76 million for the year. In the first week of the month, however, the desk lost \$51 million after an "unprecedented and unforeseeable run-up in gas prices," according to Hunter's lawsuit. Hunter says in the suit that even with the loss, he made \$40 million for Deutsche Bank that year and more than \$100 million in three years. Hunter left Deutsche Bank in April 2004 and joined Amaranth shortly thereafter. According to former employees, by the end of 2005, Hunter was the highest paid trader at Amaranth. Hunter earned 15 percent of any profit he made, while most traders made

an average of 10 percent. In 2005, Hunter took home about \$75 million, primarily from his Katrina bet, compared with about \$4 million in 2004. At the end of 2005, Maounis let Hunter move his wife and two children back to Calgary and open an office with eight traders. By this time, Brian Hunter was running by far the largest risk position in Amaranth's \$9 billion fund and was concentrated in the natural gas market. So much for the diversified, global multi-strategy fund, as Amaranth advertised itself.

Risk Management Failure

In the month of September 2006, Amaranth lost \$6 billion or 65 percent of the fund's capital on a single natural gas trade. Hunter speculated on the direction of natural gas price based on weather and hurricane forecasting and placed most of his trades in the futures market over NYMEX. Futures contracts are derivative instruments that let you leverage your bet. Given the way the initial margins were structured, you could hold a position with a \$100 exposure with only \$12.50 in actual capital, thereby giving you an eight to one leverage. In 2005 Hunter made a lot of money when hurricanes Katrina and Rita caused massive spikes in natural gas prices. In September 2006, Hunter bet on a repeat of 2005 hurricane season and took long positions in natural gas futures contracts. The exact composition of his trades is not known. By the third week of 2006, as the sun shone brightly on the Gulf of Mexico and there was no sign of any impending storms, the price of natural gas started to fall precipitously. During the second week of September 2006, the natural gas contract broke through an important price support level at \$5.50 and proceeded to drop another 20 percent in a two-week period. As the price of natural gas continued to drop, Amaranth's losses grew to \$6 billion.

Amaranth was not a fly-by-night Ponzi scheme like KL Financial that I discussed earlier. It started out as a \$600 million convertible arbitrage strategy run by a trader who was an expert in his field. It had a reputable auditor, and the fund would have passed on all due diligence metrics. After all, it did receive capital from some of the most well-respected institutional investors who are known for conducting rigorous due diligence, like banks and pension funds. So what went wrong and when did it start going wrong? It was not until 2004 when Amaranth had grown substantially bigger than \$600 million, and the opportunities in convertible arbitrage had dried up, that Amaranth started to lose its way. Nick Maounis wanted to model his hedge fund on Ken Griffin's multi-strategy \$20 billion fund, Citadel. Citadel runs at least twenty independent strategies across its funds managed by different portfolio managers. The risk and capital are well distributed across these strategies. Amaranth chased Brian Hunter's short-term track record

and became invested almost 100 percent in the long natural gas trade. At least one diligent investor did spot this. "It looked to us like the Amaranth multi-strategy fund was a pure energy bet," says Edward Vasser, chief investment officer of Wolf Asset Management International LLC, a Santa Fe, New Mexico-based fund of funds. "Almost all of their profits came from their energy portfolio." He decided against investing in Amaranth, but several other investors blindly followed Amaranth's track record and jumped in with an additional \$379 million in June 2006, the biggest inflow of the year, according to an Amaranth document given to investors. The firm's energy allocation was unchanged as of July 31, according to an investor letter sent in August. "While we are targeting a smaller allocation for natural gas in the future, we believe opportunities in the natural gas market remain attractive and continue to maintain positions where we believe fundamentals are disconnected with current prices." A month later Amaranth had lost 65 percent of its capital and all on one trade.

Here in lies a very important lesson in hedge fund investing. As any other traditional investment needs to be monitored on a regular basis, so do hedge fund investments. Most investors, even the most diligent ones, tend to perform their due diligence at the onset of the investment and then as long as the returns are good, they do not care to keep track of capital growth, strategy shifts, or risk management. In fact, given the esoteric nature of the strategies deployed at hedge funds, the level of ongoing due diligence has to be meticulously performed by qualified people. As Amaranth grew in capital and the opportunities in the convertible arbitrage market shrank, Amaranth changed its strategy. It produced 15 percent returns when other multi-strategy hedge funds were producing 5 percent returns over the same period of time. This should have been a red flag; instead, it caused investors to throw more money at Amaranth. As Ed Vasser of Wolf Asset Management discovered, most investors would have realized that Amaranth was far from a well-diversified multi-strategy fund. It was betting the pensions of 3M Co. and the San Diego County public employees on one trader and one trade. It might have had better odds at a craps table in Vegas, and the drinks would have been free as well.

BERNIE MADOFF, DECEMBER 2008

As I write this book, the Bernie Madoff Ponzi scheme is unfolding before our eyes. When KL Financial lost \$190 million in its Ponzi scheme back in 2005, it was billed as the largest financial scam in history. Bernie Madoff's \$65 billion Ponzi scheme over the course of the last 15 years easily tops that.

Senio Figliozzi, owner of the Everglades Barber Shop in Palm Beach, cut Bernie Madoff's hair, gave him facials, manicures, and pedicures for seventeen years and described him as a "very nice man who was always polite and gentlemanly" and tipped the standard 20 percent. Bernie Madoff was described as low key. The Madoffs rarely appeared at major Palm Beach charity balls, the island's chief vehicle for social climbing. Some of Mr. Madoff's sales agents, who recruited investors, also had little contact with him. As Charles Gradante, a hedge fund adviser who met him regularly on the Palm Beach social circuit, observed, "When I saw him at cocktail parties, he would be in the corner and investors would sometimes go over to him. He didn't have a charismatic presence; he wasn't exuding confidence."

Bernie Madoff worked as a lifeguard on Rockaway Beach, on the edge of New York, and installed sprinkler systems. After receiving his undergraduate degree from Hofstra University in 1960, at the age of 21, he founded Bernard L. Madoff Securities LLC with the \$5,000 he had managed to save up working as a lifeguard and doing other odd jobs. Mr. Madoff's firm, like several at the time, was known as a "third market" trading company—buying and selling stocks that weren't listed on the NYSE. Mr. Madoff got his big break in 1975, when fixed commissions for stock trades were abolished. This allowed him to trade blue-chip stocks on the Big Board that had once been off limits to non-member firms such as his. Mr. Madoff handled large blocks of trades for brokerage giants A.G. Edwards & Sons and Charles Schwab & Co and profited from small commissions per share.

By the 1990s, Bernie Madoff had built a successful and reputable stock trading operation. On certain days his firm was handling close to 10 percent of NASDAQ shares. His firm's competitive advantage came from the technology platform he built with help from his younger brother Peter. Cerebral and reserved, Peter Madoff joined the company in 1970 after graduating from law school. With the system, traders at other firms could electronically buy and sell at the best prices available on NASDAQ. The Madoff brothers seemed to make a good team, with Bernie the trader and Peter the technician. By the late 1980s, the firm moved from Wall Street to the gleaming Lipstick Building on Third Avenue, a granite and steel clad tower designed by famed architect Philip Johnson. At first, the company occupied two of the building's 34 floors, with the trading operations on the eighteenth floor and his money-management operation one floor below. Mr. Madoff's two sons joined the firm after graduation as well, starting out as entry-level trading.

Bernie the Broker Overnight Becomes a Derivatives Trader

Bernie Madoff spent a lot of time in Washington lobbying for moving more of the trading from the stock exchange floor to an electronic platform. He

also became more involved in NASDAQ and was appointed its nonexecutive chairman in 1990, 1991, and 1993. He used this success and the cachet of being appointed the chairman of the NASDAQ to launch his asset management business in the 1990s. Bernie had no trading strategy, technical trading models, or intention of investing his client's capital. He had been an executing broker his entire career and had made his money through commissions. Given his successful career thus far and the reputation he had earned, one has to assume that Bernie started out with good intentions of investing his client's capital and then somehow something went horribly wrong that sent him down the path of ruin. No rational person would ever imagine that he or she could get away with a Ponzi scheme, and he had worked too hard to simply want to throw it all away. Details of the scandal are still emerging, and I am sure we will learn more about what actually happened behind the scenes over the years to come.

Bernie started out with friends' and family's capital like most startup hedge funds do. He advertised 10 to 12 percent steady returns for years and naturally started to attract attention from the investors. When I started my hedge fund in 2004, an industry advisor and friend told me that all I had to do was produce 1 percent net returns a month and I would raise more capital than I could handle. After all, if somebody told you that you could earn 12 percent returns a year with little or no risk, why would you invest your money in government bonds that yield 3 percent right now or the stock market, which has produced only a 6.5 percent annualized return with massive volatility? Heck, you would even want to borrow money at 5 percent and invest in a strategy that delivered you 12 percent year after year—it would only be good economics.

The investing community bought into Bernie's story hook, line, and sinker. High net worth individuals, pension funds, banks, and endowments started lining up to invest in Bernie Madoff. He had a stellar reputation in the markets and was promising and delivering metronomic returns. Bernie also understood the human psyche extremely well. He knew that perception was reality, and the more you shrouded that perception in a cloak of mystery and opaqueness, the more vehemently people would believe in it. To perpetuate this mystique, he refused to answer, in any detail, questions regarding his strategy. Bernie not just avoided his investors but also his own marketers who were responsible for raising capital for his fund. Over a 15-year period, Mr. Spring, one of his agents in Boca Raton, Florida, had only eight or ten brief meetings with Mr. Madoff, according to one person familiar with their relationship. Eli Budd, a former Minnesota accountant who worked with some of Mr. Madoff's investors, said he only met Mr. Madoff once or twice. Mr. Madoff also could be inaccessible to bankers who were interested in helping potential investors. "You couldn't meet Madoff. He was like a

pop star,” said one banker who was considering offering loans to customers so they could invest in Mr. Madoff’s funds.

Palm Beach Connection and Robert Jaffe

On Wall Street, any money-making strategy attracts not just a lot of capital but also middlemen. Bernie Madoff signified the latest gold rush, and men like Robert Jaffe of Palm Beach jumped in to sell shovels. Robert Jaffe and his wife Ellen were big names in Palm Beach social circles. Robert Jaffe was on the boards of the Palm Healthcare Foundation, the Palm Beach Chapter of the American Cancer Society, the Palm Beach Civic Association, and the Morse Life foundation. His wife Ellen sat on the board of the Kravis Center, the local performing arts center, and both of them were major fundraisers for the Dana-Farber Cancer Institute of Boston. Robert Jaffe shared a business relationship with Bernie Madoff through New York based Cohmad Securities Corp. Robert Jaffe was a vice president and principal of Cohmad, and “mad” in Cohmad stood for Madoff. The Massachusetts secretary of state subpoenaed company records in January 2009 to try to figure out its relationship with Madoff Investment Securities. In June 2009, the SEC finally charged Robert Jaffe and two other principals of Cohmad Securities Corp. with fraud. According to the court documents, Cohmad Securities Corp. acted as a marketing firm for Madoff and in the process collected more than \$10 million in fees since 2000. This was in addition to the fees paid directly to Robert Jaffe, which were in excess of \$10 million. Robert and Bernie not only shared a business relationship, but they also lived within a thousand feet of each other—Madoff in a \$10 million home and Jaffe in a \$17 million mansion on North Lake Way on Palm Beach Island. They also belonged to the same country club, the Palm Beach Country Club, with annual membership dues of \$350,000.

People on Palm Beach were so drunk on the Madoff Kool-Aid that they joined the Palm Beach Country club, paying the massive annual membership dues, so they could be introduced to Bernie Madoff, often through Robert Jaffe. “He was the man you went to, to get to Madoff. You had to grovel,” said one club member, who, like most, declined to let his name be used for fear of being ostracized at the club. Richard Rampell, a CPA whose clients include those who lost millions in the scheme, said it was common knowledge that Jaffe was the go-to guy for those who wanted to invest with Madoff. Robert Jaffe does not deny this relationship either. In an interview with *The Palm Beach Daily News*, Jaffe readily admitted that he would introduce potential clients to Bernie Madoff and earn a fee for consummating the transaction. Jaffe described his take as “common practice in the business.” At a party in February 2009

at Mar-a-Lago, just a few weeks after the Madoff scheme became public, Nine West shoes founder Jerome Fisher lashed into Jaffe. “You’ve got a lot of nerve showing up here!” Fisher told Jaffe, according to others at the party. By the way, this is the same Jerome Fisher who was also invested in KL Financial. Within a week of the Madoff scandal, four multimillion-dollar condominiums at Two Breakers Row, a complex just north of the landmark Breakers hotel, were put up for sale by owners who invested with Mr. Madoff, said Nadine House, a real-estate agent here. In a telephone interview recently, one of the Madoff investors said, “We went to sleep rich with a \$140 million in the bank and woke up completely broke.” I guess money invested with Madoff was not necessarily money in the bank, but prior to December 11, 2008 that was the perception. This investor recently put his house on the market as well.

Conclusion: Failure of the So-Called Experts: The Funds of Funds

Madoff’s mystique, steady returns, and the never-ending quest of wealthy Palm Beach investors to belong to the latest exclusive club ensured that Madoff had his steady supply of new capital from the high net worth community. But what is absolutely mind-boggling is the fact that so-called experts in the field of hedge fund investing, the funds of hedge funds, also were completely duped by Madoff’s Ponzi scheme. Funds of hedge funds are supposed to be experts at conducting due diligence on hedge fund managers and understanding their strategies. Some of the biggest funds of hedge funds in the industry, like Mass Mutual, owned Tremont Capital Management, Ezra Merkin’s Ascot Partners, and Fairfield Greenwich Group completely failed in their fiduciary responsibilities to their investors in conducting appropriate due diligence on Madoff. The list of high-profile investors that invested in Madoff is endless. Even the famous Hollywood director Steven Spielberg’s Wunderkinder foundation was completely let down by the so-called expert advisors who decided to invest its money with Madoff.

J. Ezra Merkin, the former chairman of lender GMAC, also is head of Gabriel Partners, a \$5 billion money-management firm whose clients include wealthy families and university endowments. One of Mr. Merkin’s funds, the \$1.8 billion Ascot Partners LP, had substantially all of its assets invested with Mr. Madoff, according to a letter from Mr. Merkin sent to clients. Several Ascot clients say they had no idea that Mr. Merkin had most of the fund’s money invested with Mr. Madoff. One Ascot investor was a charitable trust established by real-estate magnate Mortimer Zuckerman, the chairman of real-estate firm Boston Properties and owner of the

New York Daily News and *U.S. News & World Report*. In a recent interview on the Fox News Channel, Mr. Zuckerman said he had no idea that such a large amount of money was invested with Mr. Madoff through one fund. Ascot Partners basically channeled its client's capital to Madoff and charged a whopping 1.5 percent annual management fee for that privilege. It conducted no meaningful due diligence on his strategy, which is the primary responsibility of a fund of hedge funds. By investing the entire sum with one manager, it did not diversify the risk on its clients' capital, another responsibility of a fund of funds. It also conducted no meaningful due diligence on its operations, otherwise it would have realized that Madoff's accountant was a small three-person shop with prior links to Madoff.

Fairfield Greenwich, a \$14 billion fund of hedge funds, had half of its assets or \$7.5 billion, invested with Madoff. This lucrative relationship earned Fairfield Greenwich \$160 million in 2007 alone and ended up costing its investors \$7.5 billion. Walter Noel, the founder of Fairfield Greenwich group, was a master at raising capital from its vast network of global contacts. His four sons-in-law had connections among the wealthy in Rio de Janeiro, Madrid, Milan, London, and Geneva, who brought socialite flair and few demanding questions for Mr. Madoff. I decided to pay a visit to the Fairfield Greenwich group website, www.fggus.com, for a peek at its due diligence process. The following two out of over twenty bullet points in Fairfield Greenwich's due diligence process would have been sufficient to assess that Madoff's strategy was infeasible and his returns doctored:

- Conducts detailed interviews to better understand the manager's methodology for forming a market view, and for selecting and exiting core positions
- Performance return in calm versus volatile markets

But quite clearly, stating a due diligence process and actually conducting it are two completely different processes. Fairfield Greenwich Group did not fulfill its fiduciary responsibilities by conducting its own stated due diligence process, otherwise Madoff's strategy and track record would not have stood up to the scrutiny.

Split Strike Convergence

Madoff's strategy was simply termed as "split-strike convergence," which in simple terms meant buying the S&P 100 index and giving up some of the upside for downside protection. Let us assume that at the start of a given month, the S&P 100 index was at 900. Madoff's strategy involved buying the index at 900, buying downside protection say 2 percent lower, index

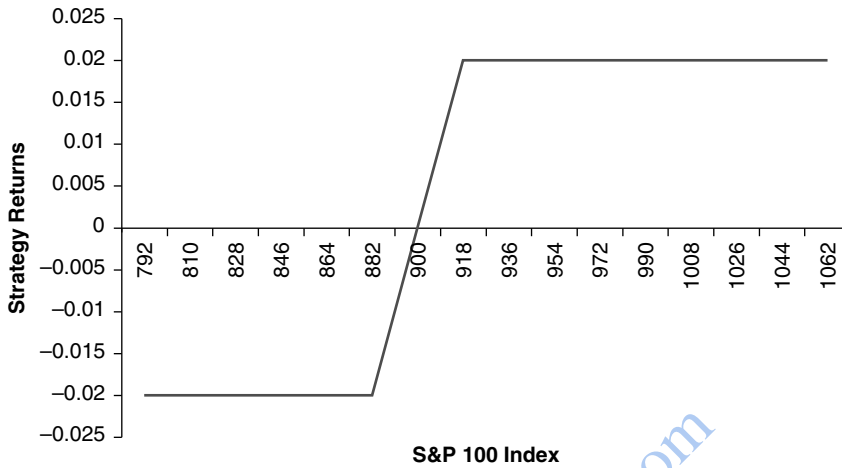


FIGURE 1.1 Madoff's strategy return chart.

value of 882, and selling the upside 2 percent higher, index value of 918. Let us further assume that the volatility structure allowed the purchase of the put and the selling of the call option to be at a net zero cost. Assuming no leverage in the portfolio, his return chart would look like Figure 1.1. The strategy would make no more than 2 percent in any given month that the market went up, and the strategy would lose no more than 2 percent in any given month the market went down either. This implies that Madoff's strategy would have only performed in the periods that the stock market went up. A study of the S&P 100 monthly data over the last 10 years, 1999 to 2008, shows that the S&P 100 was up 63 months and down 57 months. Any level of in-depth due diligence would have shown that Madoff's strategy could not have produced the steady unerring returns of 10 to 12 percent over that period by executing his split-strike convergence strategy. Therefore, most likely what happened was that strategy due diligence was never conducted and Madoff's reputation and stature was deemed sufficient.

The Mystery of the Missing \$65 Billion

As the investigators pour over all the data and try to piece the missing clues together, the big question in everybody's mind is what happened to the missing \$65 billion. Madoff hardly ever traded the capital; therefore, it is unlikely that the money was actually lost in the markets. Over the course of 19 years, from the early 1990s onwards, Madoff reported 10 to 12 percent net returns. While most investors left their capital with Madoff and let it compound, very few investors took out the returns and the capital

investments. We also know that the funds of hedge funds that invested their clients' capital with Madoff charged hefty fees. Fairfield Greenwich capital charged management fees of 1 percent and 20 percent of annual profits. Kingate Global Fund Ltd., charged 1.5 percent of assets a year, in addition to a 5 percent initial fee. Madoff claims that he got paid with commissions of as much as 3 percent on the stocks and options he traded per annum. Using this data I have put together, the following tables show how most of the capital would have been paid out in fees to Madoff and the funds of hedge funds over the course of time. Now it is up to the prosecutors to look at the records of the funds of funds as well to try to claw back the fees collected by them on fictitious returns, not to mention shoddy due diligence.

Table 1.1 shows how a \$100 million investment with Madoff through a fund of funds would have trickled down to zero by the end of year eleven. Over the course of the eleven years, nearly \$49 million would have been

TABLE 1.1 Fees and Commissions Collected on \$100 mm by Madoff and Feeder Funds

Net Reported Returns				11.00%
Madoff Annual Commissions				3.00%
Feeder Management Fees				1.00%
Feeder Performance Fees				15.00%
Year	Reported Capital	Fees Collected by Madoff	Fees Collected by Funds of Funds	Real Capital
0	\$100.00			\$100.00
1	\$107.42	\$3.00	\$3.02	\$ 93.98
2	\$115.40	\$3.22	\$3.24	\$ 87.52
3	\$123.97	\$3.46	\$3.48	\$ 80.58
4	\$133.17	\$3.72	\$3.74	\$ 73.12
5	\$143.06	\$4.00	\$4.02	\$ 65.11
6	\$153.68	\$4.29	\$4.31	\$ 56.50
7	\$165.09	\$4.61	\$4.63	\$ 47.26
8	\$177.34	\$4.95	\$4.98	\$ 37.33
9	\$190.51	\$5.32	\$5.35	\$ 26.66
10	\$204.65	\$5.72	\$5.75	\$ 15.20
11	\$219.84	\$6.14	\$6.17	\$ 2.89
		\$48.43	\$48.69	

collected by Madoff in fees, and another \$49 million by the funds of funds. The calculations assume that no capital or returns are redeemed by investors, and there were no losses or gains from any investment activity.

Table 1.2 shows how a \$100 million investment made directly with Madoff without involving a middleman would have trickled down to zero by the end of year 15. Over the course of the 15 years, nearly \$100 million would have been collected by Madoff in fees. The calculations assume that no capital or returns are redeemed by investors, and there were no losses or gains from any investment activity.

There are several takeaways from looking at the calculations in the above displayed tables. The first is that the sum of \$65 billion was a fictional amount that was reported based on doctored net returns of 10 to 12 percent a year. The reality is that the total amount of capital invested with Bernie

TABLE 1.2 Commissions Collected on \$100 mm by Madoff

Net Reported Returns			11.00%
Madoff Annual Commissions			3.00%
Yr	Reported Capital	Fees Collected by Madoff	Real Capital
0	\$100.00		\$100.00
1	\$110.58	\$3.00	\$ 97.00
2	\$122.28	\$3.32	\$ 93.68
3	\$135.22	\$3.67	\$ 90.01
4	\$149.52	\$4.06	\$ 85.96
5	\$165.24	\$4.49	\$ 81.47
6	\$182.84	\$4.96	\$ 76.51
7	\$202.18	\$5.49	\$ 71.03
8	\$223.57	\$6.07	\$ 64.96
9	\$247.22	\$6.71	\$ 58.25
10	\$273.38	\$7.42	\$ 50.84
11	\$302.30	\$8.20	\$ 42.64
12	\$334.29	\$9.07	\$ 33.57
13	\$369.65	\$10.03	\$ 23.54
14	\$408.76	\$11.09	\$ 12.45
15	\$452.01	\$12.26	\$ 0.19
		\$99.81	

Madoff never grew but kept dwindling down toward zero as it was paid out in fees and commissions. It is very likely that some of the invested capital was paid out to investors as principal or return redemptions as well, but, as the calculations above show, most of that money is still either with Bernie Madoff or has been paid in fees to the middlemen like the fund of funds.

LESSON 1: RELATIONSHIPS DO NOT TRUMP DUE DILIGENCE

The three recent hedge fund implosions and outright scandals described above are a small subset of the poor investment decisions made by investors over the course of time. The lessons from these mistakes are few but occur with very high frequency. In too many cases, individual high net worth investors have relied on personal relationships and not on due diligence in making an investment. Investing your hard-earned money is not a hobby and should not be treated as one, especially when investing in an esoteric strategy that is not transparent. Too often we have seen cases where well-educated and successful businessmen have relied on their golfing and country club buddies to become their investment guides. Just because your golfing buddy of twenty years or a well-respected socialite is investing in a particular strategy does not mean that you should blindly follow them as well. You might end up losing not just your hard-earned money but also your golfing buddy of twenty years. Often we see such people conducting more due diligence on buying a \$100,000 car than putting \$10 million in an investment strategy.

LESSON 2: WHEN INVESTING IN HEDGE FUNDS, HIRE EXPERTS

The second lesson for high net worth individuals that can to be drawn is that there is a big difference between investing and trading. Buying stocks or investing in a long-only mutual fund is not the same as investing in a hedge fund. You would not ask your local pharmacist to perform a surgery or buy a do-it-yourself kit, you would research and find an expert surgeon. Hedge fund strategies are complex, risks myriad and ever evolving. Hedge funds are constantly trading the capital; they might change the portfolio direction several times a month, deploy leverage, sell volatility to collect premium, and take other risks that would not be obvious in any offering memorandum or in any monthly newsletter. Such risks can only be determined by experts who have traded similar strategies and are familiar with the risks to ask the right questions. I wish I could tell the reader that his or her hedge fund investment would be safe if he or she just avoided managers

with short track records, superfluous and steady returns, or no-name auditors. Hedge fund investments are a lot more involved than that and thereby require a great deal of initial as well as ongoing due diligence. There is much discussion on proper due diligence of a hedge fund manager as well as on going monitoring of hedge funds in later chapters. Therefore, I would highly recommend that any high net worth individual investor who is considering investing in a hedge fund seek out appropriate advisors and consultants. My consulting firm, MACM Hedge Fund Consulting, www.MACMLLC.com does offer these services to the retail as well as the institutional investor.

LESSON 3: "WE DID NOT KNOW WHAT WE WERE INVESTING IN" IS NOT AN EXCUSE

It seems like with every scandal or big market loss we hear the common excuse from investors, "We did not know what we were investing in, therefore the blame must be put on somebody else." When the credit markets were awash with cash, homebuyers took out ARMs so they could buy a \$1 million house while making a \$50,000 salary. Investors bought credit-related securities that provided a 10 percent yield because they did not want to buy government securities that provided a 5 percent yield. Investors bought into Madoff's steady 12 percent returns a year because they did not want to stomach the gyrations of the stock market. All these decisions were made consciously and willingly by the investors and not forced upon them by any government entity. Maybe they were marketed aggressively, but that is a basic precept of a market-based economy. The investor always has the option to take the safer route and invest his or her money in a government bond or buy a house with a 30-year fixed mortgage. The reason we invest in stocks and alternative investments or buy a house with an adjustable rate mortgage is because we want higher returns or a better life style while acknowledging that we are taking higher risks as well. The key is to understand all the risks involved in our investment decisions and then make prudent investment choices. If later it turns out that our choices were not prudent, we only have ourselves to blame for them.

CONCLUSION: SO CALLED EXPERTS, FUND OF FUNDS, HAVE FAILED

Another startling observation, especially from the Madoff scandal has been the ineptitude of some of these so-called experts on hedge fund strategies, the funds of funds. Several high net worth individuals, university

endowments, and charitable foundations did the right thing by employing funds of funds to conduct due diligence on their behalf. But, as we can see from the failure of Fairfield Greenwich Group, Tremont Holdings, Ascot Partners, and others that the funds of funds did not conduct appropriate due diligence on Madoff either. Walter Noel of Fairfield Greenwich was very capable at raising capital for his fund of funds. He came from a management consulting and private banking background. His expertise was establishing and maintaining relationships with the wealthy investors around the world. His founding partner, Jeff Tucker was a lawyer by training. In fact, taking a look at the senior members of Fairfield Greenwich team, I could not find one person who had the requisite trading background to be able to properly assess the trading strategies that the company was investing in. Fairfield Greenwich confused its asset-raising ability for its asset-investing ability. This common problem can be seen throughout the funds of funds industry, where the institutions are very capable of raising capital but do not possess the proper expertise to deploy it effectively. We will explore this broken model and discuss how to fix it in later chapters.

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