



Lessons From Madoff

The fund of funds model is more valid than ever

DIXON BOARDMAN

What a difference an “L” makes. The other morning I read on the internet that Optima, the fund of funds firm I founded over 20 years ago, had fallen victim to the Madoff fraud. That was certainly news to me! I know all the managers we are invested in, and we never had invested with Madoff or any of the feeder funds to Madoff. The report was dead wrong—the victim was “Optimal”, not “Optima.” Needless to say, we quickly contacted the people responsible for the article, and a correction duly appeared.

The moral of the story is not that this was one “L” of a typo, or even that we must remind ourselves that not everything we read is true. As investors, the moral that came to our minds was far more fundamental: due diligence trumps appearances. In common sense terms, if it is too good to be true, it isn’t. Madoff was too good to be true.

Madoff could have happened to us, but it didn’t. We reviewed their returns and found them to be unrealistically smooth. We knew other money managers using comparable strategies, and no one had ever produced such consistency, which raised serious questions about the integrity of the reported performance record.

As we talked to people who were active in the options markets, an integral aspect of Madoff’s presumed strategy, there were serious questions about how he could trade in the volume that he would need to without moving the market. When we learned that there was no independent prime broker or custodian, this raised serious questions about safeguards. Seeing that Madoff used an obscure accounting firm to conduct the audit function also raised questions.

Yes, Madoff had a “good” reputation and was involved prominently in Wall Street organizations. Yes, there were plenty of other “smart” investors investing with him. But there were more serious questions than there were reassuring answers. So we decided to take a pass.

The greatest Ponzi scheme in history?

This is not an exercise in *schadenfreude*. I don’t believe it is right to gloat over other people’s misfortunes. Investing is a humbling business, and we’ve all made our fair share of mistakes. But there undoubtedly are lessons to be learned from the greatest Ponzi scheme in the history of the world.

Simply put, successful investing requires limiting the number of mistakes we make, and conducting proper due diligence is the starting point for that. We in the fund of funds world are paid to do this due diligence for investors.

Despite news reports to the contrary, Optima and the vast majority of hedge fund of funds go to great lengths in their due diligence efforts. We don’t ignore red flags like unbelievably good returns. We think carefully about the types of risk that the managers might be taking, and whether they are sensible or not. We make sure the brokerages and accounting firms utilized by fund managers we invest in are independent. And, perhaps most important, we require assets to be held at independent custodians. Without being smug, it is no coincidence that we missed the big hedge fund blow-ups at Amaranth, Bayou, Beacon Hill, Wood River, Sowood, Lancer, Lipper & Company, Maricopa, MotherRock, and Long Term Capital.

I’m not implying that all of these were frauds; some were and some were not. Some blew up due to leverage; some blew up due to mismatches between their exposures and their “hedged.” But they all were blow ups and we succeeded in avoiding them all, not due to dumb luck, but due to intensive operational risk review and a careful research process.

Many investors believe that somehow the Madoff scandal represents the culmination of all the negative aspects of hedge funds, a symbolic nail in the coffin for the entire hedge fund industry and for funds of funds that invest in them. I don’t. In fact, I believe quite the opposite.

More than ever, funds of funds who have demonstrated the ability to avoid frauds and high risk fund blow-ups will have a very viable business going forward, precisely because investors need their skills, and will reward them commensurately.

Having said that, I believe that the industry will contract severely, much as it did in the late Sixties and early Seventies. There are too many hedge funds, as I have said so many times. Ultimately, talent is what makes hedge funds successful, and there just are not that many geniuses out there.

When the dust settles, what will be left are the best and the brightest—the managers who people should want to invest with and will be happy to do so. But it will still require a discerning eye and careful due diligence to determine who it makes the most sense to give your money to. If you can do that on your own, by all means, have at it. If you do not have the time, expertise and experience, then find an accomplished fund of funds group that has demonstrated their ability to identify talent and avoid unnecessary risk.

Despite the panic selling that gripped markets in 2008, long/short hedge funds have reduced losses significantly more than long only funds. The

average long only fund was down approximately 40% last year, but hedge funds of funds were down 20%. Losing money is never a good thing, and better relative performance is only something to cheer about when it is positive. But in this difficult year, funds of funds did add value by picking managers who were able to suffer much less than the general market. As we look forward, we believe that good long/short managers are well prepared not only to take advantage of the volatility that is bound to prevail for the foreseeable future, but also to benefit from a better environment for investing when it does occur. That is what we at Optima are looking for.

Where do stocks go from here? Let us not kid ourselves: investment markets have entered uncharted waters, given the seriousness of the global economic downturn and the unprecedented challenges facing the world’s financial system. It is not the end of the world, though. The Federal Reserve and other central banks are in the process of using all the tools at their disposal to support the system. Markets are substantially down, and they could have further to fall, but the preconditions for recovery are taking shape, as valuations become more attractive. We also note that there is a huge amount of cash sitting on the sidelines, earning little if anything.

Policy responses may be imperfect, recovery may be slow, investors may be tentative in tip-toeing back into stocks, but at some point – perhaps sooner than most people expect, perhaps later – markets will anticipate the eventual economic recovery.

The Madoff scandal comes at a time when investors’ confidence is at the lowest level that I have ever seen in my career. But my 35 years of investing have shown me that the time of maximum fear and pessimism is the right time to invest. Long term investors who make commitments to good funds of funds now, when equities are at historically low valuations, should garner high returns going forward. **THFJ**

BIOGRAPHY

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Dixon Boardman is the Chief Executive Officer of the \$6.5 billion Optima Group which he founded in July 1988. Prior to that, he was a Senior Vice President of Kidder Peabody before joining UBS Paine Webber where he was also a Senior Vice President and a member of the Chairman’s Council. He has over 30 years’ investment experience and has been allocating to hedge fund managers for more than two decades.