Simuliacin®: A Simple Prescription for Treating Madoff-Stanford Disease

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For months now the media have been trotting out experts -- financial intermediaries, for the most part -- to advise people on avoiding the likes of Bernard Madoff and Allen Stanford. That's like asking gun manufacturers to weigh in on ways to lower homicide rates. Predictably, the real issue --lax due diligence -- has been lost to such sterling insights as *be suspicious of good performance* and *insist on financial audits*.

Beside the point

These insights are bad placebo prescribed by those who spread the disease. Skepticism about performance is the province of financial intermediaries, not investors. Investors rely on their consultants and fund-of-fund managers to scrutinize performance for potential fraud. Similarly, financial audits are not designed to validate reported performance; audits verify procedures and pricing.

The best defense against fraud is a strong offense in the form of real due diligence rather than the sham that has been played upon investors by their advisors. Hedge-fund due diligence has, by and large, been a big fat fakeout. The gun in Madoff-Stanford's hands was advisor complacency; the fallout from Madoff-Stanford should be greater scrutiny of advisors by their clients.

But before we go too much further, it's worth noting that Madoff and Stanford are completely different diseases, other than their proclivity for infecting the "smart" and wealthy. Madoff is an inaccessible recluse with two small operations, one legitimate and the other not. By contrast Stanford is a flamboyant persona with dozens of companies, thousands of employees, and a single hidden deception in the form of mispriced international bank CDs. The lesson here is that bandits come in all shapes and sizes. Madoff's mystique was the whisper referral while Stanford's was bravado hiding in plain sight. In both cases, the ability to set their own prices created the opportunity for deception.

Shortly after Madoff confessed, Yale endowment manager David Swensen set off alarms throughout the investment community with the following remarks, which he

provided in a January 13, 2009 interview with Wall Street Journal reporter Craig Karmin:

> WSJ: *What about fund of funds and consultants? Can they be a solution?*
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> Mr. Swensen: Fund of funds are a cancer on the institutional-investor world. They facilitate the flow of ignorant capital. If an investor can't make an intelligent decision about picking managers, how can he make an intelligent decision about picking a fund-of-funds manager who will be selecting hedge funds? There's also more fees on top of existing fees. And the best managers don't want fund-of-fund money because it is unreliable. You need to be in the top 10% of hedge funds to succeed. In a fund of funds, you will likely be excluded from the best managers. [Mr.] Madoff also relied enormously on these intermediaries. He wouldn't have had nearly as much resources were it not for fund of funds.
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> Consultants make money by giving advice to as many people as possible. But you outperform by finding inefficiencies most of the market has not yet uncovered. So consultants ultimately end up doing a disservice to investors.

Mr. Swensen goes too far when he suggests malicious intent by consultants and fund-of-funds. Cancers never intend anything good. Nick Diamos, author, advises the following in these situations: *"Never attribute to malice what can adequately be explained by stupidity."*

Simuliacin®

Fortunately there is a cure for Madoff-Stanford Disease. Developed over the last decade, *Simuliacin®* is a process rather than a pill that has proven extremely effective at detecting fraud as well as identifying legitimate investment professionals.

The Madoff-Stanford Disease exposes our vulnerabilities: (1) We're too trusting, and (2) Fraud viruses are spread by advisor and regulator complacency. It's time to protect our investments with a potent due diligence inoculation, as prescribed in this opinion

Due diligence can be distilled down to two crucial questions:

(1) Do we like the strategy that this manager employs?

(2) Does this manager execute the strategy well?

Common hedge fund due diligence, as it is practiced today, answers the first question with hot performance, and accepts conceit and concealment as answers to the second.

This is a shame because investors have been shammed by fake due diligence. The Madoff-Stanford scams were enabled by the due diligence sham. To remedy this sham we prescribe *Simuliacin*®, a simple 2-step due diligence approach that is rigorous and sham free.

Shamless

(1) Take a Dose of Profiling to Identify What the Manager Does

Possible side effects: Dizziness and confusion

The adage "Don't invest in what you don't understand" is particularly relevant to hedge fund investing. To address this issue we recommend that the researcher complete a fairly straightforward profile like the following:

<u>Sample manager profile</u>

- Approach long: Exposures to styles, sectors, countries, etc., as well as exposures to economic factors.
- Approach short: Exposures to styles, sectors, countries, etc., as well as exposures to economic factors.
- Direction: Amounts long and short
- Leverage
- Portfolio construction approach: Number of names, constraints, derivatives, etc.

If we can't complete this profile, we don't invest. That's the deal. If we can complete this profile we can move on to the question of manager competence. The profile

gives us the option of replicating or hiring (make or buy), so we want to know that value added exceeds fees. The traditional approaches to this assessment of skill are peer group and index comparisons, but these are unreliable backdrops for evaluating hedge fund performance. See [Surz, 2005 and 2006] for details on the problems with peer groups and indexes. In a nutshell, because hedge funds are unique we need better skill assessment approaches than indexes and peer groups, such as the second part of the prescription.

(2) Perform Scientific Tests of Manager Competence: There's nothing worse than a mediocre doctor or a mediocre hedge fund manager.

Albert Einstein once said "*The problems we face today cannot be solved at the same level of thinking that created them.*" A corollary is that it's unlikely that the people who created the problems can succeed at fixing them.

The solution to the problems with peer groups and indexes is actually quite simple, at least in concept. Performance evaluation ought to be viewed as a hypothesis test where the validity of the hypothesis "Performance is good" is assessed. To accept or reject this hypothesis, construct all of the possible outcomes and see where the actual performance result falls. If the observed performance is toward the top of all of the possibilities, the hypothesis is correct, and performance is good. Otherwise, it is not good. In other words, the hypothesis test compares what actually happened to what could have happened.

Using the profile described above, a computer simulation randomly generates portfolios that comprise a custom scientific peer group for evaluating investment performance. A reported return outside the realm of possibilities is suspicious, and can be explained in one of three ways: the return is in fact extraordinary, the return is fraudulent, or we do not understand the strategy. Of course the test itself cannot tell us which of the three possibilities the reality is, but it does give us motive to look. In other words, the hypothesis test either validates the credibility of reported performance or provides the wherewithal to question the incredible. Financial audits are not designed to provide this validation. There's a good chance that a true due diligence researcher would have reacted to the Madoff hypothesis test with

acknowledgement of not understanding, which under the rules of Step 1would have kept us away from him. That is, we might not have detected fraud but we would have been spared the harm anyway. The reader can ask himself if, in light of the scientific evidence, he would have ascribed Madoff's incredible track record to extraordinary success without first exploring the other two possible explanations.

Efficacy

Simuliacin® has undergone extensive clinical trials over the past 5 years conducted by RCG (Risk-Controlled Growth) LLC, a Boulder Colorado fund of hedge funds. Actual performance results confirm that *Simuliacin®* eliminates Madoff-Stanford Disease while simultaneously increasing the occurrences of good investment managers. It's like *Resveretrol*'s success in lowering bad cholesterol and elevating good.

Fool me once…

Sociopathic fraudsters like Bernie Madoff are keen to capitalize on our complacencies. But there is a defense – medicine for the Madoff-Stanford Disease. Hypothesis testing sets off fraud alerts that cannot be achieved with antiquated due diligence approaches, and this testing also puts an end to the due diligence sham.

Madoff and Stanford are no garden variety bandits. Few appeared to be more trustworthy. So some say that the important lesson from this mess is that no amount of due diligence can protect us from violations of trust. I disagree, and advocate a "trust but verify" approach rather than resolving to be tricked by the next Madoff or Stanford. Fool me once shame on you. Fool me twice shame on me. *Simuliacin®* is good immunization against deception.

REFERENCES

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