Lassus Wherley ...a view from the top

Building Better Futures

Issue 15: January 5, 2009

The Markets, Madoff and a New Year!

The Year In Review

Oil peaked at $147 on 7/14/2008 and fell to $35 by 12/24/2008. Gasoline sold for $3.05 per gallon, peaked at $4.18 and ended at $1.65.

Ten-year US Treasury yields fell to 2.2% from 4.0% while 3-month T-bill yields fell into negative return territory in December.

An incredible declining market began in September and ran through November before stabilizing in December.

The US Government rescued Bear Stearns, Fannie Mae, Freddie Mac, and AIG.

The US Government allowed Lehman Brothers to fail leading to fallout that did much of the damage to the markets resulting in increased volatility, extremely elevated risk premiums and destroyed trust in the system. Generally, the Fed and the Treasury made some pretty good decisions. However, this particular one was devastating to the credit markets and will probably be remembered as the catalyst for the Armageddon that followed.

A capital injection into Citigroup, other banks, and the auto industry was made by the US Government before Christmas.

This year will certainly be remembered as one of uncertainty, fear, panic, disillusionment and disappointment. As we look forward to 2009 we will continue to look back and review 2008 and the many things that "went wrong."

Here are some of the representative returns for the year 2008:

US Large Cap	-37.87%
US Small Cap	-36.60%
Intl Large Cap	-44.15%
Europe	-49.76%
Global Real Estate	-46.94%
Short-Term Bonds	- 4.24%
Inter-Term Bonds	- 4.85%
Emerging Markets	-54.54%

Source: Morningstar Fund Category Returns.

Looking Forward

Our challenges will continue in 2009 and will include high unemployment, slow economic growth and continuing issues with regulation of the financial industry. We are optimistic that we will be able to at least get a good start in solving some of the issues in 2009. However, we know that the issues weren't created overnight and will certainly not be solved overnight.

The best case will be a recovery starting in early summer and the worst case is a recovery starting in the late fall. Typically, financial markets lead the economic recovery by 6 months or more. So……...if we expect that the economy will begin to come out of the recession in the summer, we could see a positive move in the financial markets beginning in January. If we expect the recovery to be slower, the financial markets may continue to trade sideways for the first quarter before beginning more positive moves. We will continue to slowly rebalance to bring accounts back in line with targets. We will also maintain a slightly higher cash position for those who require cash.

We need to keep in mind that we have a tendency to believe that what has happened in the recent past will continue in the future. That means that we want to own those investments that have done well in the recent times and avoid those that haven't done well. This can be very costly since we know different asset classes typically go up and down at different times. So…….just because the market was down last year doesn't mean it will stay down through 2009.

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The good news is we finished the year in a positive way with a good rally at the end of December and we have kicked off 2009 in a positive way. It isn't super meaningful because of the light trading but it is certainly a lot more fun. This week will give us a better indicator of where January 2009 will take us.

The Madoff Story

As Chair of the National Association of Personal Financial Advisors (NAPFA), I issued a press release recently on how consumers can protect themselves against shady characters like Bernie Madoff. The reason we issued it is so individuals could learn more about how to determine whether their advisor was trustworthy. Madoff's organization fit the classic definition of what I call black box investing. This is the kind of investment scheme that people looking really closely and asking the right questions will stay away from. As most of you know, we avoid any type of investment where we can't clearly understand and see what the investment manager is doing. Madoff would never have passed our screens for many reasons, but primarily because he owned both the brokerage firm and the investment business which meant he had total control over the reporting of investment accounts.

Madoff raised many red flags but no one wanted to see them because the returns were so good. Well………...usually if it is too good to be true, it probably ***is*** too good to be true. The critical part of protecting your investments and making sure no one can steal them is to make sure you get statements direct from your Custodian (Schwab, Fidelity or National Advisors Trust) as you do with Lassus Wherley. In Madoff's case, the brokerage firm was his and he was able to control all the statements and the information they contained. That means there was no independent accounting for the investments.

He also employed a three person accounting firm that could not possibly have effectively audited a 20 billion dollar plus operation. This was probably the biggest red flag of all.

Another part of the equation is making sure you understand the basics of how your portfolio is being invested and that there is basic diversification. Of course, that is exactly what we do but not what someone like Madoff does. He took all the dollars and basically invested according to his one size fits all model. Of course, that is assuming that he really did invest some of the dollars during the last thirty years. Any one who handed over all of their money to Madoff ended up with no diversification and probably most of their money disappeared.

A critical piece of protecting your assets is having transparency so that you are able to see what is happening in your portfolio. When you have access to your account online this provides another level of assurance that your dollars are there and working for you. So……we had no exposure to Madoff or any of the fund of funds that invested with his organization.

I have attached a copy of an article from the *Wall Street Journal* titled "Why We Keep Falling for Financial Scams" by Stephan Greenspan. He is emeritus professor of educational psychology at the University of Connecticut and his review of historical scams is very interesting.

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Here is our latest collection of questions and answers.

Question: *How did Madoff get away with what he did when he was supposed to be regulated by the SEC?* **Answer:** We don't really have all the answers on how he managed to pull off the alledged Ponzi Scheme yet, but what we believe is that he maintained "make-believe" accounts for each brokerage account he was supposed to be managing. As people turned over dollars, he created a new account for them but since it was his brokerage firm, he controlled what the accounts reflected. It appears that he didn't make investments, but pretended to make investments. It should have been caught in one of several ways. The first is through an audit by the SEC. He actually had two audits in recent years that obviously didn't do much good. Another is that he had independent auditors (accounting firm) that were supposed to verify his books (this was the 3 person firm). Another was Financial Industry Regulatory Association (FINRA) which is the Self Regulatory Organization that oversees the brokerage firms. We can certainly see how successful all these organizations were at identifying the fraud. Another part of this was that a very large percentage of his investors were outside of the US where laws are very different or were hedge funds that are non-regulated entities.

The red flags were all there: too consistent returns, a tiny auditing firm, no disclosed fees charged for management (we still aren't sure how he was supposed to be paid outside of stealing dollars), and no independent reporting. The bottom line is that everyone who did business with him needed to be asking more questions. We may see more of these types of scams as the dust settles.

Question: *Should we be worried about inflation anytime soon?* **Answer:** We believe that it will be at least nine months or longer before we will see inflation begin to pick up again. We are convinced that we will eventually face it because of all the dollars the US Government and other world governments are directing at the economy. Once demand begins to climb again, inflation won't be far behind. Since it is really difficult to predict exactly when we will go from being concerned about deflation to being concerned about inflation, we are starting to buy back into our PIMCO Commodities fund. This fund maintains exposure to commodities and to Inflation-Indexed Treasuries so it is a very good hedge against inflation. We will gradually rebuild our positions in this fund which we sold in most taxable accounts earlier in December. We sold it due to the fact that the fund was paying out a very large taxable gain.

Question: *When do you think it will be time to start adding dollars to the global real estate funds?* **Answer:** We are looking at beginning to add more dollars to real estate probably in January but not until we see more signs of stability in the economy. There is still weakness in the housing market and in the commercial real estate market. It will probably be summer or later before we see the housing market begin to recover value. Based on our current forecast, we will add to global real estate very gradually over the next few months with an objective of being fully allocated within the next 3 to 6 months depending on how quickly the economy begins to recover.

Question: *I noticed that you haven't been buying the international small cap fund. Do you put that in the* *same category as the emerging markets funds?* **Answer:** We do put this at one risk level less than emerging market funds. We will continue to hold making new investments in this area until we see more positives from international and emerging markets.

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Keep those questions coming in. If you are wondering about something, the odds are pretty good someone else may also be thinking about the same topic. When you ask—we get the chance to share it with others.

For those who have asked if you can forward our newsletters to others who are worried, please feel free. We put these together as a service to our clients but are very willing to share with others. We also keep them on our website if you would like to refer someone to it at **www.lassuswherley.com**.

Happy New Year and here's hoping that 2009 will be a very good year! Please let us know if you have any questions or concerns.

Diahann

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The Wall Street Journal Essay "Why We Keep Falling for Financial Scams"

Intelligent people have long been ruined by frauds. Psychologist Stephen Greenspan, who specializes in gullibility, explores why investors continue to be swindled -- and how he came to lose part of his savings to Bernard Madoff.

By Stephen Greenspan

There are few areas where skepticism is more important than how one invests one's life savings. Yet intelligent and educated people, some of them naïve about finance and others quite knowledgeable, have been ruined by schemes that turned out to be highly dubious and quite often fraudulent. The most dramatic example of this in American history is the recent announcement that Bernard Madoff, a highly regarded money manager and a former chairman of Nasdaq, has for years been running a very sophisticated Ponzi scheme, which by his own admission has defrauded wealthy investors, charities and other funds of at least $50 billion.

Financial scams are just one of the many forms of human gullibility -- along with war (the Trojan Horse), politics (WMDs in Iraq), relationships (sexual seduction), pathological science (cold fusion) and medical fads. Although gullibility has long been of interest in works of fiction (Othello, Pinocchio), religious documents (Adam and Eve, Samson) and folk tales ("The Emperor's New Clothes," "Little Red Riding Hood"), it has been almost completely ignored by social scientists. A few books have focused on narrow aspects of gullibility, including Charles Mackey's classic 19th-century book, "Extraordinary Popular Delusion and the Madness of Crowds" -- most notably on investment follies such as Tulipmania, in which rich Dutch people traded their houses for one or two tulip bulbs. In my new book "Annals of Gullibility," based on my academic work in psychology, I propose a multidimensional theory that would explain why so many people behave in a manner that exposes them to severe and predictable risks. This includes myself: After I wrote my book, I lost a good chunk of my retirement savings to Mr. Madoff, so I know of what I write on the most personal level.

A Ponzi scheme is a fraud in which invested money is pocketed by the schemer and investors who wish to redeem their money are actually paid out of proceeds from new investors. As long as new investments are expanding at a healthy rate, the schemer is able to keep the fraud going. Once investments begin to contract, as through a run on the company, the house of cards quickly collapses. That is what apparently happened with the Madoff scam, when too many investors -- needing cash because of the general U.S. financial meltdown in late 2008 -- tried to redeem their funds. It seems Mr. Madoff could not meet these demands and the scam was exposed.

The scheme gets its name from Charles Ponzi, an Italian immigrant to Boston, who around 1920 came up with the idea of promising huge returns (50% in 45 days) supposedly based on an arbitrage plan (buying in one market and selling in another) involving international postal reply coupons. The profits allegedly came from differences in exchange rates between the selling and the receiving country, where they could be cashed in. A craze ensued, and Ponzi pocketed many millions of dollars, mostly from poor and unsophisticated Italian immigrants in New England and New Jersey. The scheme collapsed when newspaper articles began to raise questions about it (pointing out, for example, that there were not nearly enough such coupons in circulation) and a run occurred.

Another large-scale scandal that some have called a Ponzi scheme involved famed insurance market Lloyd's of London. In the 1980s, the company rapidly brought new investors, many from the U.S., into its formerly exclusive market. The attraction to these new investors, aside from the lure of good returns, was the chance to become a "name," a prestigious status which had been mainly limited to British aristocrats. These investors were often lured into the most risky and least productive syndicates, exposing them to huge liability and, in many cases, ruin.

The basic mechanism explaining the success of Ponzi schemes is the tendency of humans to model their actions -- especially when dealing with matters they don't fully understand -- on the behavior of other humans. This mechanism has been termed "irrational exuberance," a phrase often attributed to former Federal Reserve chairman Alan Greenspan (no relation), but actually coined by another economist, Robert J. Shiller, who later wrote a book with that title. Mr. Shiller employs a social psychological explanation that he terms the "feedback loop theory of investor bubbles." Simply stated, the fact that so many people seem to be making big profits on the investment, and telling others about their good fortune, makes the investment seem safe and too good to pass up.

In Mr. Shiller's view, all investment crazes, even ones that are not fraudulent, can be explained by this theory. Two modern examples of that phenomenon are the Japanese real-estate bubble of the 1980s and the American dot-com bubble of the 1990s. Two 18th -century predecessors were the Mississippi Mania in France and the South Sea Bubble in England (so much for the idea of human progress).

A form of investment fraud that has structural similarities to a Ponzi scheme is an inheritance scam, in which a purported heir to a huge fortune is asking for a short-term investment in order to clear up some legal difficulties involving the inheritance. In return for this short-term investment, the investor is promised enormous returns. The best-known modern version of this fraud involves use of the Internet, and is known as a "419 scam," so named because that is the penal code number covering the scam in Nigeria, the country from which many of these Internet messages originate. The 419 scam differs from a Ponzi scheme in that there is no social pressure brought by having friends who are getting rich. Instead, the only social pressure comes from an unknown correspondent, who undoubtedly is using an alias. Thus, in a 419 scam, other factors, such as psychopathology or extreme naïvete, likely explain the gullible behavior.

Two historic versions of the inheritance fraud that are equal to the Madoff scandal in their widespread public success, and that relied equally on social feedback processes, occurred in France in the 1880s and 1890s, and in the American Midwest in the 1920s and 1930s. The French scam was perpetrated by a talented French hustler named Humbert, who claimed to be the heiress to the fortune of a rich American, Robert Henry Crawford, whose bequest reflected gratitude for her nursing him back to health after he suffered a heart attack on a train. The will had to be locked in a safe for a few years until Ms. Humbert's youngest sister was old enough to marry one of Crawford's nephews. In the meantime, leaders of French society were eager to get in on this deal, and their investments (including by one countess, who donated her chateau) made it possible for Ms. Humbert -- who milked the story for 20 years -- to live in a high style. Success of this fraud, which in France was described as "the greatest scandal of the century," was kept going by the fact that Ms. Humbert's father-in-law, a respected jurist and politician in France's Third Republic, publicly reassured investors.

The American version of the inheritance scam was perpetrated by a former Illinois farm boy named Oscar Hartzell. While Humbert's victims were a few dozen extremely wealthy and worldly French aristocrats, Hartzell swindled over 100,000 relatively unworldly farmers and shopkeepers throughout the American heartland. The basic claim was that the English seafarer Sir Francis Drake had died without any children, but that a will had been recently located. The heir to the estate, which was now said to be worth billions, was a Colonel Drexel Drake in London. As the colonel was about to marry his extremely wealthy niece, he wasn't interested in the estate, which needed some adjudication, and turned his interest over to Mr.

Hartzell, who now referred to himself as "Baron Buckland."

The Drake scheme became a social movement, known as "the Drakers" (later changed to "the Donators") and whole churches and groups of friends -- some of whom planned to found a utopian commune with the expected proceeds -- would gather to read the latest Hartzell letters from London. Mr. Hartzell was eventually indicted for fraud and brought to trial in Iowa, over great protest by his thousands of loyal investors. In a story about Mr. Hartzell in the New Yorker in 2002, Richard Rayner noted that what "had begun as a speculation had turned into a holy cause."

While social feedback loops are an obvious contributor to understanding the success of Ponzi and other mass financial manias, one also needs to look at factors located in the dupes themselves. There are four factors in my explanatory model, which can be used to understand acts of gullibility, but also other forms of what I term "foolish action." A foolish (or stupid) act is one in which someone goes ahead with a socially or physically risky behavior in spite of danger signs or unresolved questions. Gullibility is a sub-type of foolish action, which might be termed "induced-social." It is induced because it always occurs in the presence of pressure or deception by other people.

The four factors are situation, cognition, personality and emotion. Obviously, individuals differ in the weights affecting any given gullible act. While I believe that all four factors contributed to most decisions to invest in the Madoff scheme, in some cases personality should be given more weight while in other cases emotion should be given more weight, and so on. As mentioned, I was a participant -- and victim -- of the Madoff scam, and have a pretty good understanding of the factors that caused me to behave foolishly. So I shall use myself as a case study to illustrate how even a well-educated (I'm a college professor) and relatively intelligent person, and an expert on gullibility and financial scams to boot, could fall prey to a hustler such as Mr. Madoff.

Situations. Every gullible act occurs when an individual is presented with a social challenge that he has to solve. In the case of a financial decision, the challenge is typically whether to agree to an investment decision that is being presented to you as benign but may pose severe risks or otherwise not be in one's best interest. Assuming (as with the Madoff scam) that the decision to proceed would be a very risky and thus foolish act, a gullible behavior is more likely to occur if the social and other situational pressures are strong.

The Madoff scam had social feedback pressures that were very strong, almost rising to the level of the "Donators" cult around the Drake inheritance fraud. Newspaper reports described how wealthy retirees in Florida joined Mr. Madoff's country club for the sole reason of having an opportunity to meet him socially and be invited to invest directly with him. Most of these investors, as well as Mr. Madoff's sales representatives, were Jewish. The fact that Mr. Madoff was a prominent Jewish philanthropist was undoubtedly another situational contributor.

A non-social factor that contributed to a gullible investment decision was, paradoxically, that Mr. Madoff promised modest rather than spectacular gains. Sophisticated investors would have been highly suspicious of a promise of gains as spectacular as those promised decades earlier by Charles Ponzi. A big part of Mr. Madoff's success came from his apparent recognition that wealthy investors were looking for small but steady returns, high enough to be attractive but not so high as to arouse suspicion. This was certainly one of the things that attracted me to the Madoff scheme, as I was looking for a non-volatile investment that would enable me to preserve and gradually build wealth in down as well as up markets.

Another situational factor that pulled me in was the fact that I, along with most Madoff investors (except for the super-rich), did not invest directly with Mr. Madoff, but went through one of 15 "feeder" hedge funds that then turned all of their assets over to Mr. Madoff to manage. In fact, I am not certain if Mr. Madoff's name was even mentioned (and certainly, I would not have recognized it) when I was considering investing in the ($3 billion) "Rye Prime Bond Fund" that was part of the respected Tremont family of funds, which is itself a subsidiary of insurance giant Mass Mutual Life. I was dealing with some very reputable financial firms, a fact that created the strong impression that this investment had been well-researched and posed acceptable risks.

I made the decision to invest in the Rye fund when I was visiting my sister and brother-in-law in Boca Raton, Fla., and met a close friend of theirs who is a financial adviser and was authorized to sign people up to participate in the Rye (Madoff-managed) fund. I genuinely liked and trusted this man, and was persuaded by the fact that he had put all of his own (very substantial) assets in the fund, and had even refinanced his house and placed all of the proceeds in the fund. I later met many friends of my sister who were participating in the fund. The very successful experience they had over a period of several years convinced me that I would be foolish not to take advantage of this opportunity. My belief in the wisdom of this course of action was so strong that when a skeptical (and financially savvy) friend back in Colorado warned me against the investment, I chalked the warning up to his sometime tendency towards knee-jerk cynicism.

Cognition. Gullibility can be considered a form of stupidity, so it is safe to assume that deficiencies in knowledge and/or clear thinking often are implicated in a gullible act. By terming this factor "cognition" rather than "intelligence," I mean to indicate that anyone can have a high IQ and still prove gullible, in any situation. There is a large amount of literature, by scholars such as Michael Shermer and Massimo Piattelli-Palmarini, that show how often people of average and above-average intelligence fail to use their intelligence fully or efficiently when addressing everyday decisions. In his book "Who Is Rational? Studies of Individual Differences in Reasoning," Keith Stanovich makes a distinction between intelligence (the possession of cognitive schemas) and rationality (the actual application of those schemas). The "pump" that drives irrational decisions (many of them gullible), according to Mr. Stanovich, is the use of intuitive, impulsive and non-reflective cognitive styles, often driven by emotion.

In my own case, the decision to invest in the Rye fund reflected both my profound ignorance of finance, and my somewhat lazy unwillingness to remedy that ignorance. To get around my lack of financial knowledge and my lazy cognitive style around finance, I had come up with the heuristic (or mental shorthand) of identifying more financially knowledgeable advisers and trusting in their judgment and recommendations. This heuristic had worked for me in the past and I had no reason to doubt that it would work for me in this case.

The real mystery in the Madoff story is not how naïve individual investors such as myself would think the investment safe, but how the risks and warning signs could have been ignored by so many financially knowledgeable people, including the highly compensated executives who ran the various feeder funds that kept the Madoff ship afloat. The partial answer is that Madoff's investment algorithm (along with other aspects of his organization) was a closely guarded secret that was difficult to penetrate, and it's also likely (as in all cases of gullibility) that strong affective and self-deception processes were at work. In other words, they had too good a thing going to entertain the idea that it might all be about to crumble.

Personality. Gullibility is sometimes equated with trust, but the late psychologist Julian Rotter showed that not all highly trusting people are gullible. The key to survival in a world filled with fakers (Mr. Madoff) or unintended misleaders who were themselves gulls (my adviser and the managers of the Rye fund) is to know when to be trusting and when not to be. I happen to be a highly trusting person who also doesn't like to say "no" (such as to a sales person who had given me an hour or two of his time). The need to be a nice guy who always says "yes" is, unfortunately, not usually a good basis for making a decision that could jeopardize one's financial security. In my own case, trust and niceness were also accompanied by an occasional tendency toward risk-taking and impulsive decision-making, personality traits that can also get one in trouble.

Emotion. Emotion enters into virtually every gullible act. In the case of investment in a Ponzi scheme, the emotion that motivates gullible behavior is excitement at the prospect of increasing and protecting one's wealth. In some individuals, this undoubtedly takes the form of greed, but I think that truly greedy individuals would likely not have been interested in the slow but steady returns posted by the Madoff-run funds.

In my case, I was excited not by the prospect of striking it rich but by the prospect of having found an investment that promised me the opportunity to build and maintain enough wealth to have a secure and happy retirement. My sister, a big victim of the scam, put it well when she wrote in an email that "I suppose it was greed on some level. I could have bought CDs or municipal bonds and played it safer for less returns. The problem today is there doesn't seem to be a whole lot one can rely on, so you gravitate toward the thing that in your experience has been the safest. I know somebody who put all his money in Freddie Macs and Fannie Maes. After the fact he said he knew the government would bail them out if anything happened. Lucky or smart? He's a retired securities attorney. I should have followed his lead, but what did I know?"

I suspect that one reason why psychologists and other social scientists have avoided studying gullibility is because it is affected by so many factors, and is so context-dependent that it is impossible to predict whether and under what circumstances a person will behave gullibly. A related problem is that the most catastrophic examples of gullibility (such as losing one's life savings in a scam) are low-frequency behaviors that may only happen once or twice in one's lifetime. While as a rule I tend to be a skeptic about claims that seem too good to be true, the chance to invest in a Madoff-run fund was one case where a host of factors -- situational, cognitive, personality and emotional -- came together to cause me to put my critical faculties on the shelf.

Skepticism is generally discussed as protection against beliefs (UFOs) or practices (feng shui) that are irrational but not necessarily harmful. Occasionally, one runs across a situation where skepticism can help you to avoid a disaster as major as losing one's life (being sucked into a crime) or one's life savings (being suckered into a risky investment). Survival in the world requires one to be able to recognize, analyze, and escape from those highly dangerous situations.

So should one feel pity or blame toward those who were insufficiently skeptical about Mr. Madoff and his scheme? A problem here is that the lie perpetrated by Mr. Madoff was not all that obvious or easy to recognize. Virtually 100% of the people who turned their hard-earned money (or charity endowments) over to Mr. Madoff would have had a good laugh if contacted by someone pitching a Nigerian inheritance investment or the chance to buy Florida swampland. Being non-gullible ultimately boils down to an ability to recognize hidden social (or in this case, economic) risks, but some risks are more hidden and, thus, trickier to recognize than others. Very few people possess the knowledge or inclination to perform an in-depth analysis of every investment opportunity they are considering. It is for this reason that we rely on others to help make such decisions, whether it be an adviser we consider competent or the fund managers who are supposed to oversee the investment.

I think it would be too easy to say that a skeptical person would and should have avoided investing in a Madoff fund. The big mistake here was in throwing all caution to the wind, as in the stories of many people (some quite elderly) who invested every last dollar with Mr. Madoff or one of his feeder funds. Such blind faith in one person, or investment scheme, has something of a religious quality to it, not unlike the continued faith that many of the Drakers continued to have in Oscar Hartzell even after the fraudulent nature of his scheme began to become very evident. So the skeptical course of action would have been not to avoid a Madoff investment entirely but to ensure that one maintained a sufficient safety net in the event (however low a probability it might have seemed) that Mr. Madoff turned out to be not the Messiah but Satan. As I avoided drinking a full glass of Madoff Kool-Aid -- I had invested 30% of my retirement savings in the fund -- maybe I'm not as lacking in wisdom as I thought.

Stephen Greenspan is emeritus professor of educational psychology at the University of Connecticut and author of the 2009 "Annals of Gullibility." A longer version of this essay appeared at skeptic.com and will be in Skeptic magazine in early 2009.