FRIDAY, JANUARY 13, 2023

Well, hello and welcome to the Dividend Cafe I am today as I've been kind of telegraphing all week addressing the subject of Bernie Madoff, and it's an odd thing to address, and it really actually is. You'll soon see, doesn't have anything to do with Bernie Madoff. It's going to be about a broader investment point that I think is one of the most important and yet nearly impossible investment lessons for any mere mortal to ever understand and to ever fully comprehend. And I'm going to explain why I think that is.

But first, a little context as to why the name Bernie Madoff would even be in the lexicon of Dividend Cafe. This story, for those who don't know, I assume everybody watching or listening is familiar with the name. It's just complete societal, cultural, folklore by now that in late December, excuse me, 2008 and in December real Wall Street fixture by the name of Bernie Madoff had been arrested in what was soon known to be the largest discovered Ponzi scheme in history. And in the months and years that followed, there was quite a drama around a lot of it. So for obvious reasons, the sheer size of what has been called a 65 to 70 billion Ponzi scheme. It's a lot of money to 'Ponzi' and I'll explain what the real math that was in a moment. But also Bernie Madoff himself ended up dying in prison roughly about a decade later, but not before both of his sons tragically died, who were never charged with any crimes. In fact, they were the ones who turned him in. One of them died by taking his own life in circumstances you can imagine, related to the just awfulness of all that inspired in their family. And then the other died of cancer. And so there was a kind of just made for TV component to all of this. And in fact, a lot has been made for TV. There was, I think it was HBO fictional special with some A-listers. I mean Robert De Niro, Michelle Pfeiffer years ago. I remember watching a couple times and there's been other CNBC documentaries and other things. Number of books, I'm not aware of any books that came out that I didn't read, but there may have been but I've always kind of followed this story closely. There's a lot of, for my own reasons, there's certain elements to it that I don't know, I've never really thought made a lot of sense. And so it's an interesting deal and certainly historical in the world of Wall Street and finance that happens to be my life.

When I say fixture on Wall Street, he wasn't this fringe player. That's a big part of why the story was such a big deal. Bernie was at one point, the chairman of the board of the NASDAQ, he ran a legitimate business that what Madoff Securities, that was a huge market maker at trading firm that at one point was clearing nearly 10% of the trading volume was a huge market maker in the NASDAQ, which of course is over the counter exchange. And so he just had been a part of Wall Street through a lot of evolutions of trading and whatnot. But it was investment management business, that was where the Ponzi scheme was being held and administered. And one of the kind of unique elements historically is there was never a time that they were really investing client capital. Most of the time, Ponzi schemes start because they take in investor money, they invested, things aren't going well, they take in more investor money. Investors get mad, they're sending new investor money back to investors hoping to get more investor money and they're in a Ponzi. But it's all based on the fact that all things being equal, someone would like to not have to run a Ponzi because the investments would've been doing so well, and yet the investments don't do well and then they make bad decisions and steal and blah, blah, "Ponzi". Madoff was never buying assets. There's no evidence of any stock trades ever actually done. And so he was taking in real money, giving fake returns and then sending real money back. And obviously the only way to do so would be off of other people's real money. And he made it work for a very, very, very long time. And that's the essence of the controversy is how it wasn't discovered, how this is the part, a particular fascination to me is how the victims didn't know. Some of the investors made unbelievable profits and not fake profits on paper. Some made massive real profits had that money returned to them. So that's a part of the story a lot of people don't know. The total amount was suddenly a range of 18 billion. And so when we call it a '65 billion' by far, most of that money was fake money. It was money investors thought they had made on paper from the fake statements and from the Ponzi scheme, but that was not real. And so the real hard dollars were 18 billionish, and this is why they were able to recover about 80 something percent of the money investors had lost because it isn't like someone can go.... a Ponzi scheme's usually funding a lifestyle. And it was certainly funding the Madoff's lifestyle, but 18 billion is quite a lifestyle without, without buying a NBA team or nine. And so the yachts here and houses here that you recover all that stuff and then the money you can't ever recover is what gets spent along the way on just consumption. But most of the money, they're able to recover from investors people that had shared in the profits and they did clawbacks and there was one particular investor they got 7 billion back from. And so the whole thing is really quite fascinating.

But I think that the essence of the story as financial media and as readers of books and then this brand new Netflix documentary, and I don't remember if I said that part of the beginning or not. I think I was about to and got distracted. That's the impetus for this right now is that there's a brand new four part documentary docu-series on Netflix that I watched with my wife last weekend. And so now there's a lot more people talking about it and it's a very well made piece and whatnot. There's a few things said in it that I don't agree with, but it tells a whole story and it's well done. And so here we are. But no, I did come away from it with a just profound realization about something that is related to the Bernie Madoff story that needs to be applied to all investors and all of you who are listening who haven't ever been Ponzi, who are, I would like to think

Lord willing, not going to be running a Ponzi just normal investors out there. What is the possible lesson from something like this Bernie Madoff drama that could apply to us? And that's what I want to talk about.

I was profoundly impacted by the fact that there's an unbelievable component to the story. Now people can talk about how the regulators not figure it out. There's a story written by Barons in 2001, seven years before Bernie was caught. There's an institutional hedge fund magazine in either '04 or '05, again several years before there was an SEC inquiry that could have and almost did shut it down as like '05 or '06. There's a lot of moments at which this thing seemed ready to crumble and just didn't. And so people understandably will say, "Gosh, how did the regulators not see, or how did the media not see or how did he get away with it?" But the question that really I think is more interesting is how did investors not see, and let's assume there may have been some investors who did see and at varying degrees didn't care. They were connected to it. They were getting some of the ill-gotten gains and had no incentive. They were sort of co-conspirators, if you will, even if they weren't the ones in the back office running the sham. That part has already been established, and that's one of the reasons that the court appointed trustee has been able to be so successful in recovering funds. However there's a psychology from others that's more innocuous, more innocent, less suspicious, not criminally tainted. That is what I want to talk about. It's fundamentally, a whole bunch of people believed that someone was generating massively better returns than anyone else for a long, long, long, long time with basically no downside ever. And they believed it because they wanted to believe it because it was utter nonsense and it's never going to be true. There was never a time. Now you say, "Well, hey, there was a year where someone did real well. What about you Bahnsen? Your dividend portfolio was up last year and market was down?" That's all well and good. There are periods of time where managers have a good time where markets do this or a manager does that. A certain portfolio strategy plays out a different way, and there's ebbs and flows, but everybody has periods of volatility and risk assets. And we're not talking about what this story had Madoff that people love the idea that he had four great months or four great years, but four great decades. I mean dear Lord, and not like he's really doing great and we're somehow getting 6% every year, and I'm sure there's some risk and there's some volatility, but it's all coming together. We end up averaging it at 5, 6, 7%. Now you're talking about mid-teen returns, and then when asked to explain the strategy, it's explained in a way that many other people do something similar, but they're not getting anywhere near the return. Come on. And so the real conclusion not to draw is not that a lot of the victims of the Ponzi were in on it because that's not true. There were people that did not know that, that believed they had the money and they were real victims. And then like we said, there's probably another category of people that were more nefarious, but what I'm referring to is, and if I remember correctly, back before we started our own firm, when I was still a managing director at Big Wall Street firm prior to this, I wrote a piece called *There's a Bernie Madoff on Every Corner*. And my point was not merely the fact that there's more charlatans out there, more crooks, more criminals, that's all true too. There's crooks criminals that have to be looked for, and there's a million ways to really, really mitigate oneself against those risks, to immunize oneself against those things.

And one of the biggest ways to mitigate against the risk is to already know that those things these people are selling cannot be true. That there is no risk, no volatility, and everything is going so much better than everyone else in the world all the time. This is naturally what humans want to believe, and I use analogies of food a lot, partially because I love food so much, and even though I really do love exercise, I wish that I could stay fit the way I want to without having to control diet, without having to exercise. The fact of the matter is that exercise is a pretty good analogy because most of us intuitively know that there is a certain sacrifice one gets for the reward of fitness and that type of stuff and health and whatnot, and the notion of a risk-free superlative returns. We have a whole industry that has been set up around we're here to lower your volatility and increase your return, and this is a very elementary rule of corporate finance that no, you're not. What you do could be exchanging the risk. We want to lower your what's called beta systematic market risk and replace it with something more non systematic, more idiosyncratic. We're going to have less market beta risk, but in exchange we're going to have more execution risk or manager risk or inflation risk or interest rate risk or currency risk. There's a number of different risks in financial markets, and there are things one can do and in fact should do by the way, from an asset allocation standpoint diversification of risks to try to make sure that one is adding more risk to a portfolio that has it to get a certain addition of return, that those risks are diversified from one another. That's the whole essence of modern portfolio theory. It isn't to go with one thing with risk, one thing without risk, it's to have different risks and therefore you create a different return environment but hopefully can do so within a volatility that's comfortable to an investor. The notion that one is saying, I have to choose between risk or no risk, but then I don't have to make a trade off to the return. Now of course, someone can pull it off. Someone can be a really good manager, someone can have a good year, someone can get lucky. My point is that they were still risk. There was execution risk for the manager. There was viewpoint risk. They could have had a thesis that could have been wrong, and then from their viewpoint, even if it was right, they could have been wrong in the way they executed it or had timing problems or execution problems or unforeseen other variables that enter the fray.

None of these things are bad. All investors deal with it. What I am talking to you about today is the belief that you don't have to be subjected to it. That somehow there exist, these returns of that nature that are above and beyond risk regardless of which risk we're describing. That is the great con, I get that most people are not actually taking people's money. Most people don't have the sophistication scale, and by the way, just the pathology probably clinical narcissism and perhaps sociopathic tendencies that someone like a Madoff would've had at that level to just live that way and perform that is just sickening, of course. But at the most benign level, that guy you meet at the bar who says, "Oh yeah, there's no risk. We're clipping 10%. It's great, blah, blah, blah," that that's a Madoff like mentality, and if you believe it and you invest in it because of the hope in this really high return without any trade off of risk, then you become a Madoff like investor, and it happens all the time, sometimes not very sophisticated or educated or intelligent investors, and it's sometimes people who most certainly you would think intellectually would know better but why could it happen to both? Because they're both human and humans want to believe all sorts of nonsense. That's what makes us human in a lot of ways, is the fact that our emotions and our hopes can get the better of our reason and our rational faculties.

So I'm on planet Earth along with 51 other colleagues and friends and partners of mine that also wear the uniform of the Bahnsen Group. We're here for the purpose of telling you that what Bernie was selling was a lie before he ever took money, before he ever Ponzi'ed anyone, before he ever printed a fake statement, Bernie's first lie was what he was selling, not his inability to deliver it. The lie was that it could even exist because it can't, doesn't never has, it never will, and all such ideas. There's something, one of my mentors in the business, a guy by the name of Nick Murray has said many, many times, and I want to quote it for you all. "Fundamentally, investors don't really want safety. They want the illusion of safety. The people are willing to do a lot of psychological gamesmanship and mental coverup to fool themselves into believing that they have a certain safety level they don't have."

This is the great crime of the Bernie Madoff moment is the mentality out there that wants to believe something can exist, that this is the thing that must be fought against, must be resisted, an acceptance of various risks, of various volatilities of those things in exchange for a result that is necessary to a financial objective that's appropriate to a given investor specific and customized situation. All of those things can and should be done. It's what we do. It's a lot of great wealth managers do, but what no Great Wealth Manager does is lie by telling the Bernie Madoff lie, not the Bernie Madoff theft, the Bernie Madoff lie, which is that one can have this sort of perfect environment of high return and absolutely no risk or downside. It's not the way the world works. I think a lot of you who are listening are adults and I think you know it, but it's not always something that we remember in those emotional moments, and it's something I felt would be an important lesson to reinforce in the Dividend Cafe today.

With that said, thank you for listening. Thank you for watching. Have a wonderful weekend. Our DC Today will be off on Monday along with the markets and along with banks and along with our offices in honor Martin Luther King Day, and we'll be back with a very long and special DC Today on Tuesday. Thanks for listening.

FRIDAY, JANUARY 13, 2023