MV Capital Management Thought Content Series: Markets in Crisis

Of Mice and Managers

January 7, 2009

As investors, we love to believe in market wizards who hold the secret to making serious money. In fact there is no such secret, but admitting it is like abandoning a childhood faith.
-Jane Bryant Quinn, Washington Post 12/21/2008

There is no secret ingredient.
-Mr. Ping, "Kung Fu Panda" 2008

The best laid plans of mice and men often go awry.
-John Steinbeck "Of Mice and Men" 1934

2008 was a terrible year for investors even before Bernard L. Madoff took over the December headlines, crowding out dismal reports on employment, consumer spending and housing prices with his epic, shameful and sorrowful tale of fraud. Those who had already come to terms with the fact of their portfolios being down by 20% or more for the calendar year now had to wonder if it may be even worse: maybe we've lost everything! At MVCM we moved quickly to reassure our clients that indeed none of them had any exposure to the Madoff crowd. As reassuring as it was for our clients to hear that, the Madoff scandal has been a source of great dismay. As professional practitioners of investment management we – and the vast majority of our colleagues in the profession – take our responsibility as fiduciaries extremely seriously. The money with which we are entrusted builds futures – a child's rewarding education, a couple's comfortable retirement, a foundation's contribution to breakthrough medical research, a hospital's means to improve its ability to treat and cure patients. The cost of investment management gone wrong – of a Madoff event – is real, it is painful and it is not adequately measured by a mere percentage loss – it is dreams shattered, hope extinguished, lives not saved.

This is not a cheerful note on which to start the New Year. Perhaps we should simply move on, putting the demons of 2008 to rest and hoping for a better year to come, cheering on what has been a relatively strong performance in the stock market for the last week or so and willing it to become a year-long trend. We are as ready as anyone for a bit of good news. But there is more to the Madoff story than the isolated fact of one corrupt money manager – a story that is worth exploring behind the sensational headlines. For us at MVCM it is a story that goes directly to why our philosophy and approach to this business is what it is. We think this is something our clients should know – because how we manage money and the specific discipline by which we endeavor to avoid ensnarement in the likes of the Madoffs of the world is of clear and present importance.

Investing: the science and the emotion

First, there is the highly uncomfortable fact that the scandal was as far reaching as it was – that so many purportedly smart, sophisticated investors were charmed by the snake oil and in many cases – astonishingly enough – entrusted all or a significantly large percentage of their assets to this charming, seemingly larger than life individual. Here after all is a profession – investment management – that according to the financial journals and academic research papers is all about arcane mathematics and conceptually challenging economic notions like marginal utility, rational allocation and the coefficient of correlation. An investment manager's presentation on the relative merits of the Black-Litterman allocation model versus the classic Markowitz mean-variance approach may put a client to sleep, but at

least that client should sleep soundly, knowing that somehow the alphabet soup of alphas and betas and deltas and r-squareds connotes time-tested, prudent ways for her money to be managed.

And yet here are real-life investment decisions, involving billions upon billions of dollars, where all that science is tossed out the window with a dismissive wave in favor of…what? Of being "in" on a "can't miss" opportunity. Of being the beneficiary of the guy with the "superior knowledge" or the "secret ingredient." That's not science. That's the rule of cocktail party emotion, the arguably biological impulse for position in a social hierarchy, and it clearly plays an outsized role in this supposedly scientific business.

Honestly, the argument against a Madoff-style investment is pretty easy to grasp: it is the Rule of No Free Lunch. This is a simple rule. In the universe of investment choices there are investments that are considered to be virtually risk-free: US Treasury securities and virtually nothing else. They don't pay much (in fact right now they pay about as close to nothing as you can get) but they will ensure that your principal capital is safe and sound. Everything else involves risk. The more return you want to earn in the long run, the more willing you have to be to see your assets lurch up and down in the short term, with the potential for loss of principal. This is axiomatic. Rational investors should know this – but then along comes a Madoff with his track record of apparently outperforming the market year in and year out, and ration gives way to emotion. "This one's different" say those supposedly in the know. "These guys, they're onto something." And the guru speaks in a wise and charming manner, and plays delightful melodies on his Pan pipes, and his legions of believers follow him over the cliff, and the track record turns out to have been an illusion, the end.

The failure of mechanisms

At MVCM we have long told clients a single simple truth: our job is to manage with patience and discipline as an antidote to their emotions of fear and greed. We are all emotional beings, and as such anyone is susceptible to the Siren songs of the Madoffs and their ilk. It certainly is not surprising that numerous clients were charmed by the promise of the Free Lunch. What is to us much more surprising is how the basic mechanisms set up to protect investors failed. They failed at the government regulatory level – the SEC had plenty of cause to take investigative actions over a number of years and failed to do so. And they also failed at the self-regulatory level of due diligence. It seems that money managers and advisors forgot what this word means. "Due diligence" is one of those charming phrases from our storied past – the wise Judge Putnam ruling on the necessity of "prudence" and "discretion" in the *Amory vs. Harvard College* ruling of the early 19th century. This established the standard for managing other people's money with no less care than one would manage one's own – the cardinal rule of investment management, as absolutely critical today as it was 200 years ago. And where were these standards when they mattered? Madoff's funds did not employ a trusted third-party institution to hold custody of the funds at arm's length. His external accounting firm – entrusted with keeping the books in compliance with the regulations – was a rinky-dink three-person operation in northern Long Island. These were particularly egregious red flags but there were others. A simple due diligence questionnaire, for which any investment advisor or manager is expected to have a template, would have uncovered these oddities. That they went unchallenged and unremarked on for so many years by so many participants is breathtaking in its contempt for the most elemental of professional responsibilities.

The best-laid plans…

So here is a tale of emotion getting the better of reason and the failure of mechanisms to protect those they are meant to serve. Is that all of it? We think there is one more related aspect that is worth thinking about. Because, as we noted earlier, this was not just a tale of a few bad apples. The most sobering part of the regulatory and diligence failures cited above is that they were systemic – and that they were by no means limited to the malfeasance of one individual in one situation.

The Madoff scandal was different from other disasters of the 2007-08 market crisis only by a matter of degree. His $50 billion Ponzi scheme was flagrantly illegal, which cannot be said of the $62 trillion credit default swap market or the other toxic securities that poisoned the well of our credit markets last year. But the trajectory of those securities relied on exactly the same ingredients that let Madoff flourish for as long as he did: the triumph of emotion over reason, the systemic failure of regulators to regulate the market and of competing institutions to regulate themselves, and an institutional culture that not only condoned this status quo but encouraged and indeed pressured all its participants to conform to it.

Here is what we mean by that third point. There is a risk in the investment business that is seldom discussed in polite company and never shows up on those analytical risk-return graphs so beloved of investment analysts. It is called career risk. Simply put, people in this business are hired and fired on the basis of a number of factors – but how they perform in the short term relative to other competitors is often a significant part of that equation. In particular the competition for managing really big money – institutions and large family offices for example – is intensely focused around the delivery of a few basis points more return than the next guy – often using ridiculously short time periods for measurement where there is no statistical significance whatsoever. Aspiring managers find themselves needing to show these institutions' investment committees and their array of consultants that they possess that elusive secret ingredient – that has been the driving impulse behind a lot of those really bad synthetic credit derivatives, for example. It would be considered career suicide not to do this, particularly when an "everyone else is doing it" mentality flourishes.

In our opinion this, more than anything else, explains why so much Madoff exposure found its way into the so-called fund-of-funds market – portfolios of diverse hedge funds managed by professional fund managers. Madoff should have never made it past the successive evaluative screens and processes onto any such fund's approved list. It is not that these fund-of-fund managers were malevolent or that they were knowingly abetting Madoff's crimes – they simply looked the other way in the hope of cashing in on that too-fabulous run of luck. They competed hard for those institutional accounts that wanted to be in on the secret sauce, whose investment committees and chief investment officers yearned to preen as "king of the hill" among the gala dinner set. In so doing these managers' best laid plans, to paraphrase John Steinbeck, got all messed up.

Where we stand

To avoid the temptations of the Madoffs and their ilk it is necessary to understand why they exist, to acknowledge the very real susceptibility we all have to falling prey to them, to acknowledge that sometimes resisting them can have negative short-term effects on one's business and career prospects, but to remain absolutely confident that in the long run it will always turn out the same way – the Madoffs will soar Icarus-like towards the sun, they will fall spectacularly, there will be much weeping and gnashing of teeth, and the No Free Lunch rule will remain inviolate.

It helps to have a coherent philosophy that serves as a counterweight to the manifold temptations of whatever the special sauce of the day is. At MVCM our philosophy is grounded in the idea that there is no single right answer. There are competing "wisdoms" out there in the market – ideas and approaches that have been tested and validated over time, and sometimes some of these work better while at other times other wisdoms have their day in the sun. Our job is to distill the chaos of these competing ideas into coherent strategies and tactics for managing portfolios according to the specific return objectives and risk tolerance levels of our clients, using the characteristics of return, risk and correlation to achieve prudently diversified portfolios.

That is no more exciting than it sounds. If there is someone out there touting some sexy new "secret ingredient" chances are you won't hear about it from us. And you may indeed fall asleep during our

portfolio presentations. We have in the past and will no doubt continue to lose some new business opportunities to competitors who push hard and wow the decision-makers with the tales of their secret ingredient. And that's okay – because the clients who *do* give us the honor of managing their money will know where we stand, will know that we will never make promises on which we cannot deliver, and will trust in our fidelity to a process grounded solely in their interests. Maybe in the wake of Madoff boring will come into fashion again – or maybe not. Either way, we intend to continue practicing our business according to our philosophy, from morning to evening every day, in the interests of doing the right thing by our clients to put them in the position to win. That will not change.

With warm regards,

Masood Vojdani
President

Katrina Lamb, CFA
Senior Investment Analyst

MVCM 2009 0001
DOFU: January 2009

MV Capital Management, Inc.
4520 East West Highway, Suite 400
Bethesda, MD 20814
www.mvfgroup.com
(301) 656-6545 tel
(301) 656-2722 fax

Investment Advisory Services offered through MV Capital Management, Inc., a Registered Investment Advisor. Securities offered through Purshe Kaplan Sterling Investments, Inc., headquartered at 18 Corporate Woods Blvd., Albany, NY 12211, Securities Dealer, Member FINRA/SIPC. Insurance offered through MV Financial Group, Inc. MV Financial Group, Inc. and MV Capital Management, Inc. are independently owned and operated.

This email and any attachments are intended only for the use of the individual addressed and may contain privileged and confidential information that is exempt from disclosure. If you are not the intended recipient, you are hereby notified that dissemination, distribution, retransmission or copying of this communication is prohibited. If you have received this communication in error, please destroy it and notify us immediately.