

From FAMILY WEALTH REPORT

Families first: Preventing the next catastrophe

Charles Lowenhaupt - 13 February 2009



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The word I'm getting from financial hubs like New York, Hong Kong and Geneva is that **Bernard Madoff's** investors were mainly "unsophisticated" and "naïve," a group of people that didn't understand finance and investing and in some cases at least might qualify as out and out "dopes."

If we are to guard against the likelihood of fraud occurring on such a grand scale again, it's important to recognize that this characterization of Madoff's victims as rubes is inaccurate. I know several giants of Wall Street, great investors with fine track records, who hired Madoff to invest for them. Smart, competent lawyers in New York helped their clients invest in Madoff. So there are plenty of shrewd and savvy people -- "captains" of their respective industries -- who were burned by Bernie. Even the **SEC** appears to have been snowed.

The emerging dogma that only the naïve invested with Madoff has the effect of preparing the ground for future Madoffs because it sends the message that investors can rely on their wit and intuition to know who is really good and trustworthy and who is not. If self-proclaimed shrewdness and sophistication is deemed sufficient armor to keep fraudsters at bay, I'm afraid these very sharpies will find themselves particularly easy prey for the next Madoff or Ponzi who comes along. After all, as these would-be sophisticates are out searching for the best and brightest manager with the best and brightest strategy, the best and brightest crooks will have concocted ways to bilk elite investors without throwing up the "red flags" Madoff had hoisted.



Process as antidote

Stubborn, dogged adherence to sound wealth-management principles is rarely found in the sharpest and savviest whiz kids, who believe a structured process is for the financially challenged; nevertheless, the most effective protection against fraud is disciplined process.

Chesley Sullenberger, the **U.S. Airways** pilot who crash-landed his plane in the Hudson recently, is a good model for investors. . He is not the brilliant stunt pilot who could flip the plane through breathtaking acrobatics, and no one describes his heroism as "outwitting disaster." Instead he was experienced and disciplined. He knew all the rules and followed them carefully (as one of his crew said later, "we just performed our jobs" during the crisis). By adhering to process and systems with discipline, he and his crew saved lives.

Too many in the investment industry say that process is fine for the less capable, but not for themselves. An acquaintance of mine who runs hedge funds is a perfect example. He tells me that simple and reasonable rules are a good idea for the inexperienced. However, he himself can "smell" fraud and move agilely and sublimely through the complexities of derivatives and hedges. He and his peers have no need for simple and commonsense process; that's for the "little guy."

I say again: this attitude is what keeps the Madoffs of this world in business.

Process and principles

To understand how the damage from Madoff might have been mitigated, let's look at what might have happened if process had been in place -- precisely the kind of process set out in the recently issued **Principles of Private Wealth Management** articulated by **Don Trone** and me.

- If all trustees had followed best fiduciary practices (Principle 3), neither charitable foundations nor private trusts would have invested a disproportionate share of their principal, if any, in Madoff.
- If each portfolio were diversified "as completely as practical" (Principle 5), no investor would have lost the bulk of his wealth to Madoff.
- With "clear, disciplined and objective process for selecting" managers (Principle 8), would Madoff ever have been selected as a manager?
- If every manager were required to have "strategy and style which could be easily understood" (Principle 9), the opaqueness of Madoff's strategy would have kept him out of any portfolio.
- And requiring that custody be separate from management (Principle 10), would have left Madoff without a platform from which to commit his fraud.

Each of those principles is simple, plain and clear. None requires an MBA to understand or to follow it. Yet, each alone would have insulated the investor from the devastation Madoff inflicted.

Believing that only "dopes" fell for Madoff, that they were all "unsophisticated" and "naïve," leaves the "shrewd" investor utterly unprotected and without the support necessary for evaluating each opportunity objectively. Disciplined process will be embraced by wise investors -- whether they style themselves shrewd or naïve -- because it insulates against fraud and protects in times of crisis. -FWR

The illustration for this column is a detail from a Japanese woodblock print in the Charles A. Lowenhaupt Collection.

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