

From FAMILY WEALTH REPORT

Families first: Trust, process and the Madoff case

Charles Lowenhaupt - 16 December 2008

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Just as the ultra-wealthy were starting to get over the shock of how their banks let them down, along comes the Madoff fraud scandal. **Bernard Madoff**, a respected figure in high-wealth circles, has admitted running a \$50-billion Ponzi scheme, according to the **SEC**.

One hears of *individuals* entrusting \$1 billion or more to Madoff's care. As a result entire family fortunes have vanished overnight. Charities that invested with him are cutting back drastically; some may even close.

That way madness

And so, once again, the world is forced to contemplate *trust*, the bedrock of all relationships. And many will conclude that Madoff's alleged fraud proves you can't trust anyone. Here, after all, was a giant of the industry -- a man, supposedly, of particular integrity -- who was trusted implicitly by clients, colleagues and peers alike.

Madoff's investment program was a "black box" with no transparency. To be sure, investors could take their money out any time. In fact, investors who expressed discomfort at not knowing the details of the program were invited to withdraw and invest elsewhere. In addition, the difficulty of becoming an investor with Madoff's firm -- apparently many were turned away -- enhanced his reputation for integrity and his investors' overall sense of trust.

But does the fact that these investors misplaced their trust in Madoff really mean you can't trust anyone?

No it doesn't. We can't lead our lives without trust. We confer trust when we enter a hospital, when we board a jet, when we drive on our streets. And we can't have an investment portfolio without trust. We have to trust the custodian, the exchanges, the currencies and the rules of the market. Managing a portfolio without the aid of a trusted advisor requires an immersion in the details of investment management that would leave most people with little time or energy to enjoy their wealth. Without trust, all that's left is a sense of distrust so prevalent, so all-encompassing as to approach full-blown paranoia.

Shunning that dismal outcome, the lesson of Madoff's demise is that trust must be linked, inextricably, to *proper process*. What we call "fiduciary process" or "industry



best practices" go hand in glove with trust. And trust, backed by sound and responsible process, can give us ease of mind.

Trust and process

We trust those we consider to have integrity. The challenge is that integrity is easy to feign. Many believed that Madoff had integrity.

Trust, meanwhile, is notoriously subjective. I can quite legitimately trust someone you don't trust because it's something that's *felt*; it defies objective measure.

So, if we can't evaluate genuine integrity, and if we need to trust an advisor, how can we avoid another Madoff debacle?

I think we can start by building, and adhering to, objective and neutral systems and processes that are applied as the foundation of our investment policy just as they are imposed on our trustees and foundation directors, and on our ERISA fiduciaries.



Then we can afford to rely on our subjective trust in advisors and institutions. If someone we deem trustworthy can't -- or chooses not to -- work within these systems and processes, we can cheerfully continue to trust that person. But we should look for investment counsel elsewhere.

Those who bring proper process to bear on the management of their investments *don't* lose everything because a single investment advisory collapses. As more of the facts of the Madoff case come to light, I think people will be shocked to learn that so many investors threw overboard so many fundamental fiduciary checks-and-balances because of their blind trust in one man.

Even without much detail, it's easy to see a glaring lack of process -- fiduciary and best practices -- by many of those who seem to have lost so much to Madoff. Fiduciary standards dictate that there be separate custody from management, so that our investment assets are certified as held by an institution not beholden to the manager. Bookkeeping and accounting should be independent of the custodian so that there are checks and balances on facts. Additionally, any investment platform should be comprehensible -- not just transparent, but also *understandable* so we can evaluate that it is consistent with our investment policy and that it complies with its mandate. And of course diversification of *managers* is a vital element of portfolio diversification -- particularly when it comes to large portfolios and managers who employ "alternative" styles.

Ponzi world

The information we are learning about the investors in Madoff's funds suggests that there was trust without process.

Where does all of this leave us with respect to most hedge funds and structured products? Well, we can go ahead and assume that the managers of these products are trustworthy, but unless they provide separate custody, separate accounting, transparency and comprehensibility, we shouldn't entrust to them much more than a relatively small proportion of our investment portfolio. And our involvement should always be part of a diversified portfolio of strategies and managers.

A responsible trusted advisor insists that his clients follow sound fiduciary practices -- or, if he isn't strictly speaking a fiduciary, sound best practices. He doesn't say, "Don't use Bernie's fund because you shouldn't trust him." Rather, he accepts his client's faith in Bernie, but explains that trustees of trusts and managers of charitable foundations must follow fiduciary practices. He might even agree that Bernie seems like a wonderful guy, but point out that the client needs an investment steward who meets strict fiduciary guidelines. "If a trust or foundation cannot use him, should you?" is a relevant and responsible query.



Madoff is said to have described his operation as a Ponzi scheme. That means he took the principal stakes of new investors to pay out old investors. Yet these days we frequently hear of hedge funds mounting "capital campaigns" so they can raise money needed to redeem those who want out, and funds that have "gated" because they can't meet redemption requests. The only thing separating hedge funds from Ponzi schemes is a fine and fragile barrier of integrity. So integrity, trust and best practices must be foundational as any investor builds a portfolio containing those funds.

We can't let fallout from the Madoff case create a world in which distrust is the standard. In these very uncertain times, wealthy investors need to be encouraged to find and stay loyal to financial-service providers they trust; indeed, we all do. But to be effective, we must, as absolute prerequisites to any investment program we use, put in place systems and processes reflecting sound fiduciary practices. -FWR

The illustrations for this column are details from a Japanese woodblock print in the Charles A. Lowenhaupt Collection.

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