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In this Issue

THE MADOFF DISTRACTION

Frederick W. Rosenberg, J.D.[1]

I. VICTIMS ALL

Today, Wall Street is breathing sighs of relief in part because the $50 billion Madoff distraction, the media darling of financial disasters, has moved the spotlight away from ordinary investors - who've collectively seen trillions in savings turn to vapor - to fixate on losses suffered by a relatively few wealthy investors swindled in an affinity fraud.[2]

Since the mid 1990s, public investors - those ordinary working people and retirees whose life savings have been sucked into the financial maelstrom - have been systematically victimized by what can only be characterized as a Ponzi market that finally went nuclear in 2008, devastating the lives and hopes of millions. The responsibility for this investor catastrophe rests squarely on the financial services industry, its sales representatives, managers and quasi-professionals who have consistently misled investors about their professed ability to control portfolio losses in any meaningful manner. Worse, they have negligently if not recklessly kept investors in the dark about the overwhelming problems associated with systemic risk.

1. Frederick Rosenberg obtained his JD from George Washington University in 1971 with an emphasis on business planning. He founded an NASD member firm in 1981 in Washington DC and was a Series 24 principal and Series 4 registered options principal. Today he has over 30 years business and legal experience as claimant's counsel, chief financial officer, private equity underwriter, foreclosed commercial real estate asset manager, and bank risk auditor. He has qualified as an expert in federal and state courts and in NASD arbitrations, has written chapters for PLI's arbitration course books and articles for the Piaba Bar Journal, and has been a speaker at the Piaba Annual Meeting and a faculty member of the Practicing Law Institute program on securities arbitration.

2. NY Times reported on March 12th, 2009, that in the last quarter of 2008 Americans had lost $5.1 Trillion and $11 Trillion over all for 2008 (and that leaves out 2009). Vikas Bajaj, *Household Wealth Falls By Trillions*, N.Y. TIMES, March 12, 2009, http://www.nytimes.com/ 2009/03/13/business/economy/13wealth.html.

SYSTEMIC RISK

Under normal market conditions, negative events generally occur randomly and most often are offset by non-correlated events moving in a positive direction. This is the rationale for diversification. But, when negative events begin to occur in concert, they become correlated and their combined negative effect is amplified across the entire economy.

Systemic risk - the risk of a catastrophic collapse of the financial system - by definition is non-diversifiable. In a systemic meltdown, the interconnection and interdependence of large financial companies through complex financial dealings such as credit default swaps, overnight lending, underwriting, and loan participations, means that the failure of just one can set off a chain reaction of failures that jeopardize the entire financial system, exactly what happened in 2008. "Too Big to Fail!" became the bailout mantra, as insolvent of companies like AIG and Citicorp could not go down without all of their counterparties toppling like dominoes. In short, the sources of systemic risk are the financial companies and counterparties themselves. That is exactly the problem.

The collapse in housing prices in 2006 and 2007 led to a collapse in mortgage backed securities, which when marked-to-market caused insolvencies and capital impairments that triggered a credit crunch. Financial derivatives used to hedge the risks of assets of dubious if not unknowable value contributed to gross instability if not outright failure of premiere commercial, banking, insurance and investment companies and their counter-parties. Without credit, retail sales foundered in all sectors. Unemployment ballooned with the uncertainty brought about by frozen credit markets and declining retail sales that further stressed the economy.

For investors, the economic collapse in 2007 and 2008 cascaded across all investment sectors and asset classes, leaving them scratching their heads upon reviewing their monthly statements. Years of savings evaporated amid conflicted recommendations to ride out the crisis. We've all heard the financial clichés:

- Diversify
- You can't time the market so ride out the storm
- Allocate your portfolio in various sectors
- Be a long term investor.

But, over the past decade and two market crashes, this advice has proven disastrous to many. Still, the vast majority of investors, brokers and investment advisers appear blind to that fact.

Advice to public investors to *stay the course and diversify* proved catastrophic in 2008. Such advice negligently ignored the economic turmoil driving the markets every day in favor of strategies based upon the historical analyses of financial markets that resemble contemporary markets in name only. Given that most investors are incapable of efficient hedging against catastrophe, the only advice to protect one's investments during a systemic crisis is to tactically rebalance and ride out the storm in cash, savings bonds or other instruments with strong credit backing and little market risk.

Over the past decade and with increasing frequency in recent years economists, research universities and government entities like the Treasury Department, the Federal Reserve and White House have been holding conferences and delivering papers about Systemic Risk, how to control it and how to regulate the systems to maintain efficiency in the economy. A word search for "systemic risk" on Google will illustrate the depth and pervasiveness of those concerns. Yet, despite deep concerns, the retail brokerage and financial services industry simply ignored systemic risk to persist with portfolio strategies based not upon what was actually driving the markets, but solely upon an individual investor's investment profile and a near religious adherence to the portfolio theories popularized in recent years.

The growth of the financial services industry began in earnest during the 1990s and was rooted in the demise of pension plans (defined benefit plans) and the rise of self-directed 401Ks (defined contribution plans). For the first time in modern history, ordinary and unsophisticated individuals found themselves in control of 100% of their retirement assets without any safety net or guidance, making them targets for the burgeoning financial services salesmen eager to promote equities as the vehicle for building wealth. Trillions of dollars flowed into mutual funds, brokerages and investment managers, whose principal investment recommendations for a diversified portfolio over-concentrated in high risk equities were rationalized by questionable conclusions drawn primarily from mathematical analyses of the past markets from past eras.

Unfortunately, over the past 15 years, too many financial services professionals, brokers, financial planners and investment advisers grew fat selling and allegedly managing investments without any concrete understanding of the risks they promised to control. Worse, they uniformly claimed credit for the appreciation occurring during rising markets while disclaiming liability for their failures when the markets reversed. Furthermore, the income, bonuses and wealth of these self-professed experts are actually correlated directly with their success in preventing ordinary investors from exiting high risk markets. Welcome to the Hotel California![3]

3. "You can check out anytime you want, but you can never leave." EAGLES, *Hotel California*, *on* HOTEL CALIFORNIA (Asylum Records, 1976).

Why did the very brokers who promoted market investments to excess during the boom of the 1990s fail during the bust of the 2000s to recommend a retreat to safer harbors? Amazingly, not a single brokerage or advisory firm of consequence ever sent out a general warning advising investors to substantially reduce market exposure as the economy imploded. In fact, most brokerages still maintain their model portfolio allocations to this very day.

The facts are crystal clear: public investors were simply kept in the dark by those whose profits, fees and commissions derived explicitly from keeping them fully invested even as disaster consumed their savings. Ironically, even after a decade of unmitigated failures, many of these self-styled professionals are still in denial about their ability to control portfolio risk through their "set it and forget it" strategies and mathematical projections. Many advisers today are even claiming victim status at the hands of Wall Street's financial alchemists whose alphabet soup of concoctions by every measurement make the Madoff scam seem amateurish if not picayune.

SUSPENSION OF DISBELIEF

The real tragedy in the events of 2008 lies not with the affluent, powerful and high profile victims of the Madoff scam (i.e., those whose tragic fall can best be explained by Coleridge's aesthetic theory of "the suspension of disbelief," the willingness to accept the impossible as true). Rather, the tragedy of 2008 lies with the millions of unsophisticated and trusting public investors left without recourse while our Government - whose job it is to protect its citizens - allocates their tax dollars to bail out the greed-driven institutions that orchestrated the economic collapse in the first place.

While the how and why of the Madoff scam are slowly coming to light, there is a clear explanation why financial service companies ignored systemic risk. A general recommendation to reduce exposure to market risk, and equities in particular, was likely to pull the house down upon themselves. With trillions of dollars under the management of seriously conflicted companies and individuals generating enormous fees, any recommendation to exit the markets would have emptied their trough. In short, public investors were trapped if not actually deceived into holding onto their investments over months of market declines under the rationale of diversification and the questionable logic of using historical analyses as a basis for forecasting future market performance without regard to the existing economic realities.

On the institutional and investment banking side of the industry, the repeal of Glass Steagall, along with reduced regulation, the relaxation of capital requirements in 2004, and extraordinary fee generation, stimulated a gluttonous appetite for financial instruments of incomprehensible risk like Collateralized Mortgage Obligations, Credit Default Swaps, Auction Rate Securities, Derivatives and a host of arcane concoctions that generated enormous profits from the leakage off the financial trash heap, an alchemy of disaster.

Paralleling the Madoff catastrophe, during the last decade, new money poured into financial service companies from investors unwary of how their savings became the essential feedstock that Wall Street required to perpetuate its excesses. Diversification and portfolio strategies recommended to public investors at a time when blood cascaded down Wall Street proved no barrier against loss at all and were flat out wrong. It is no coincidence that public investors were cajoled by sales-trained registered representatives into standing pat amidst the worst systemic collapse in history.

Those in control, who understood systemic risk, failed to disabuse their representatives of the erroneous conclusion that there were no market conditions too risky for public investors so long as the portfolio was balanced and their life expectancy exceeded 15 years. The Madoff scandal may be good press and great story telling, but it pales in importance and magnitude to the catastrophe that befell innocent investors negligently - if not recklessly - kept in the dark about the risk in their portfolios while being advised to adopt strategies that all but assured disaster under existing market conditions.

The correlated disasters suffered in every sector of the economy in 2008, the blind arrogance of bonus driven investment bankers and executives, the credit rating agencies paid to bless risky instruments, and the laissez-faire oversight by ideologically disinterested regulators led to a predictable catastrophe of historic proportion. It doesn't take an Agatha Christie to figure out the complicity if not conspiracy of every entity responsible for this "Murder on the Systemic Express." More than one suspect had a motive.

II. PUBLIC INVESTOR CLAIMS

Arbitrators will be faced in coming years with claims from public investors arising out of the turmoil experienced between the end of 2007 and the present. Many arbitrators, victims too of their own brokers' misguided advice, are more likely to be empathetic to those claims. In evaluating such cases, arbitrators - if they are to identify causation - will need to look beyond mere structural and suitability arguments to focus on the duties and disclosure of those selling their market expertise. I've enumerated below several identifiable areas that should rightly be considered.

1. Broker Training

From 2000 to the present and particularly in recent years, the issue and impact of systemic risk has dominated the economic and financial press. For financial advisors counseling investors about risk, a failure to identify, understand and explain systemic risk and its consequences likely amounts to recklessness in most cases. In short, the one risk that a customer does not assume is that his broker doesn't know what he's talking about.

2. Portfolio Theories and Indexes

Portfolio theorists and indexers generally ignore current market conditions under assumptions that over the long term markets are rational and that a portfolio constructed around historical performance measurements will average out, (regress to the mean).

In contrast, most active managers rely on market fundamentals to value assets and control the timing of purchases and sales. Typically, actively managed funds also impose guidelines that limit exposure to sector concentration regardless of the makeup of the index they're benchmarked to. This often means that active managers will likely underperform the index, especially during bubbles such as technology in 2000 and more recently, in the financial sector. In short, return is only one consideration when selecting a benchmark; the other considerations are weighting and volatility. Balancing risk and return generally leads to lower but more stable performance when measured by long term returns.

All portfolio theories and indexing strategies necessarily require human intervention to contain catastrophic short term losses. If there are no market conditions under which a broker will advise tactical rebalancing, then the client needs to be advised that he or she will be on their own during market declines. Brokers *absolutely need to disclose and explain* to investors whether or not they actually have a methodology or strategy for controlling portfolio declines beyond merely advising investors to stay the course, especially during periods of systemic turmoil when risk is amplified.

3. Risk Creep

Furthermore, portfolios and indexes are rarely static. Arbitrators, therefore, must also consider Risk Creep - the fact that that indexes and portfolios actually wander across a wide spectrum of volatilities as measured by standard deviation. Market cap weighted indexes like the SP500 and the portfolios benchmarked to them, often become over-concentrated in the hottest sectors and underweighted in conservative sectors with predictable effect on risk and volatility.

For example, when tech grew to 35% of the SP500 in 2000, up from 15%, the standard deviation of the index blew past 21, a level equal to the normal Russell 2000. During much of 2008, the 30-day trailing standard deviation of the S&P500 (which normally ranges between a standard deviation of 10 and 20), actually ranged between 35 to 75 for much of the year, mirroring the VIX, the volatility index that blew past 80 at one point, exceeding by 3 times the normal risk of small cap index. Consequently, in 2008, a broker's advice to stay the course in portfolios benchmarked to the S&P500 meant that investors were unknowingly saddled with two to four times the expected risk, far in excess of what was authorized and approved in their New Account Forms.

Arguably, brokers who recommend portfolio strategies and diversification must actually monitor the risk characteristics of the portfolios they recommend to provide full and complete disclosure. Given the probability of a systemic meltdown and the excessive volatility arising from the uncertainty of 2008, investors should generally have been advised to adopt safe-harbor strategies that substantially reduced market exposure by moving to cash and investment grade bonds.

4. The Point of Non-Recovery

The risk to most investors is not that their portfolio declines to zero, but rather that it rapidly declines in value to the point where its sustainability and capacity to achieve the customer's objectives is a practical impossibility over all relevant periods. A portfolio may be sustainable under normal market conditions with a 15% decline but be unsustainable following a 30% decline and having a strategy that controls losses between those points is essential. Consequently, it is critical for portfolio investors to know both the point of non-recovery and the point of sustainability so that protective measures can be implemented and understood by the client.

It is simply negligent to advise investors to stay the course when the conditions of recovery require a lifetime of 1999 repeats. The asymmetry in this equation is also obvious. Portfolios that can go up 400% may suffer losses over time, but once a portfolio declines 40%-60% its ability to recover under normal markets becomes problematic.

5. Beware Market Timing

Market Timing is a trading strategy that attempts to beat the market over the long term through in-and-out trading. But Tactical Rebalancing, such as shifting one's portfolio to lower risk sectors and cash in times of turmoil clearly is not Market Timing. Rather, it is a preferred and acceptable defensive measure to control risk albeit with potentially lower upside.

The Towneley Study[4] logically concludes that market timing is a practical impossibility over the long term. Tables A and B of the Towneley Study[5] confirm that missing all the best months over a protracted period (decades) reduces returns substantially. However, the study also shows that missing the worst months increases returns proportionately more and remarkably, the study also demonstrates that missing both the best and worst months produces returns that actually exceed "staying the course" over the long term. Furthermore, Table A illustrates that the consequence of missing the single best month is only a 44 basis point reduction in return, while missing the three best months, if that were the outcome, only reduced long term returns by only 1.24%, from 10.04% to 8.8%. This is still an excellent return.

Towneley's numbers suggest that getting out of the market entirely during periods of extreme turmoil may be preferable to the alternative of a 20% to 60% decline in current portfolio value. Unfortunately, the investor, who should be made aware of all these facts, is typically given only half-truth warnings against missing all the best months over a lifetime, a most unlikely probability.

4. H. Nejat Seyhun, *Stock Market Extremes and Portfolio Performance 1926-2004,* Towneley Capital Management, Inc. (2005), http://www.towneley.com/pdf/MT%20Study %2004.pdf.
5. Seyhun, *supra* note 4, at 11.

6. The Bear Stearns Market: Do as I say, not as I do!

In August 2008, one month before the Lehman Brothers failure and AIG bailouts, the Counterparty Risk Management Policy Group III (CRMPGIII) issued a report to the Treasury Secretary on systemic risk, stemming from the Bear Stearns failure in April 2008. The Management Group,[6] consisting of many of the top risk managers of the major financial industry leaders and brokerages, commenced its report with the following paragraph:

> Dear Secretary Paulson and Governor Draghi:
>
> On behalf of CRMPG III we are pleased to convey to you our Report entitled "Containing Systemic Risk: The Road to Reform." As the title of the Report suggests, the Policy Group considers the financial crisis of 2007 and 2008 to be the most severe we have experienced in the postwar period. While this turn of events had multiple causes and contributing factors, the root cause of financial market excesses on both the upside and the downside of the cycle is collective human behavior – unbridled optimism on the upside and fear – bordering on panic – on the downside. As history tells us in unmistakable terms, it is virtually impossible to anticipate when optimism gives rise to fear or fear gives rise to optimism. The last twelve months have been no exception to this sobering reality.[7]

CRMPG III is important reading because it fully reveals that *by April 2008 at the latest,* the financial services industry at its highest levels well understood the potential disastrous consequences of a systemic collapse. CRMPG II, which was issued three years earlier, warned mightily about the consequences of uncontrolled growth in CDO's and other gimmicky financial instruments.

The April 2008 Bear Stearns failure quantified for the counterparties the magnitude of the risks they had first identified as early as 2005. Left with vast exposure to the collateral markets, the major financial institutions began a mad dash to exit their web of financial entanglements. Meanwhile, as these financial giants strove desperately to exit their positions, not one offered an

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6. CRMPG III members at the time the report was released are listed at http://www.crmpolicygroup.org/docs/CRMPG-III-Exhibit-I.pdf and http://www.crmpolicygroup.org/docs/CRMPG-III-Exhibit-II.pdf.

7. Transmittal letter from CRMPG III to Henry M. Paulson, Jr. and Mario Draghi (August 6, 2008), http://www.crmpolicygroup.org/docs/CRMPG-III-Transmittal-Letter.pdf.

instruction, warning, or advisory to their retail brokers and customers of the potential impact of "the worst financial crisis in post war America."

III. CONCLUSION – FOR NOW

There was a broad chasm between those institutions heading for the doors and their customers whom they advised to be patient in the misplaced assertion that long term market recovery is adequate reason to accept short term catastrophe under actual market conditions. If there is one thing we need to take away from this disaster it is that there is no formula, equation or portfolio allocation theory that does not require the exercise of good judgment to avoid riding the wave over the falls.

Arbitrators must also seriously consider the question: "Is there ever a time when the market is simply too risky for small investors?" Historical volatility failed to predict 2008's black swan[8] meltdown while portfolio theories based on rational markets have succumbed to reality. Sure, we will all benefit from a rising market in the next decade, but without the leverage and exotic financial instruments, the market recovery may take a very long time, certainly longer than the recovery from the 2001 collapse that took five years to reach breakeven under the previous regime.

8. "Black Swans" represent unanticipated catastrophic events and are the subject of Dr. Nassim's writings which argue that black swans occur with greater frequency and severity than predicted by bell curve simulations using standard deviation alone as a proxy for risk. See NASSIM NICHOLAS TALEB, THE BLACK SWAN -THE IMPACT OF THE HIGHLY IMPROBABLE (2007); and NASSIM NICHOLAS TALEB, FOOLED BY RANDOMNESS: THE HIDDEN ROLE OF CHANCE IN LIFE AND IN THE MARKETS (2008).