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Investment Advisors LLC

The Madoff Scandal

History's Biggest Fraud: an unbelievable finish to a traumatic 2008

Executive Summary

As you all certainly know by now, what appears to be the largest Ponzi scheme in history has been discovered, and tens of billions of dollars appear to have been lost (the exact number is not at all clear). Sadly, it appears many nonprofits and charities have lost large amounts of money, in some cases needing to close altogether – a devastating blow to their good efforts and to the confidence of all in the financial markets at a time (2008 – need we say more?) when we could least afford it. We felt the urgent need to communicate with you about the issue, both to assure you that you are not at risk, and more generally to discuss the implications for investing and confidence.

First of all, our clients do not have exposure to Madoff. We have never recommended such a "black box" strategy totally lacking in transparency (and perhaps, it's fair to say, plausibility). None of the money managers or funds of funds we recommend to clients invested in Madoff either, a testament to their high due diligence standards. Naturally a number of clients have called to ask if they had any exposure to Madoff, and we were happy to say they did not.

The bigger issue, for those not directly affected by the fraud, is the overall investment issue – how can I trust anybody? How do I know my investments are safe and the information I get is real?

The facts as we know them so far

- Bernard L. Madoff Investment Securities LLC is now in liquidation, and the SIPC announced it is finding falsified records.
- Madoff himself admitted it is all gone, it was a fraud, and he expects to go to jail.
- This scandal has hit hard at some of the richest people in the world.
- British, French, Japanese and Spanish banks and funds said investments totaling billions of dollars could be wiped off their balance sheets.

- Top world financial groups and wealthy families were fooled by a classic pyramid investment fraud, where redemptions were apparently paid with new investor money.
- The very small local auditing firm that Madoff used, Friehling & Horowitz, is now the focus of a criminal probe by the district attorney in Rockland County, New York.
- Several large hedge funds and one hedge fund of funds company, Tremont, were victimized as well.
- Madoff apparently had little trouble from any of the regulatory agencies, despite the enormous size of his investments, his utter lack of transparency, and numerous red flags and complaints. Today the SEC's chief admitted "apparent multiple failures" to oversee the firm. Amazing. And Congress has announced an inquiry into the regulatory failure.
- On the other hand, many investors and hedge funds of funds steered clear of Madoff for reasons that appear obvious now.

Importance of straightforward due diligence

The consistent application of high standards, with no exceptions and no pursuit of free lunches – it's not rocket science, but it seems to run contrary to human nature. In the 1920's Charles Ponzi offered 40% returns obtained with some mystifying hocus pocus involving foreign exchange (you can check it out in Wikipedia). It worked, as silly as it sounds. People love a deal and seem willing to suspend common sense and good judgment when offered something special, especially if it is exclusive and yet "everybody is doing it."

The story of "The Emperor's New Clothes" never seemed so relevant. People observing the naked emperor were told that only the stupid and those unfit for their positions could not see the non-existent clothes. And so everyone pretended to see a beautiful suit until a young child ruined the game by blurting out the truth.

If you have no due diligence, no actual "suit of clothes" to see, what would make you invest in such a mysterious black box strategy? After all, he executed his own trades at his own firm, many senior people in his firm were relatives with obvious conflicts of interest, and his auditor was a tiny, virtually unknown firm. His statements were mystifying, even to the most sophisticated investors.

Well, the importance of reputation was cited as the reason to invest with Madoff by victims. Everyone else respected him, even venerated him. He was famous.

As many have learned to their sorrow, that is not a substitute for due diligence, but it worked for Madoff.

We called their office several years ago at a client's request, and got to experience the exclusivity and caché angle firsthand, without any real information, of course. I am reminded of "The Music Man," who responded to any questions about actual delivery of the goods by bursting into song and getting the whole town to sing along with him. *Oh well we got trouble, right here in River City…*

Didn't anyone see the problem?

Yes, certainly. One good example is a hedge fund of funds manager named Cadogan. They are in the Callan approved group of hedge funds of funds, and many of our clients are invested in one of their several funds (which include the UM Multi-Strategy Fund). Stuart Leaf, their CEO, summarizes it as follows:

"Should one allocate to a manager/strategy that has a phenomenal long-term track record, but where meaningful access to meaningful information is unavailable? As protectors of our clients' capital, we have always taken the path of foregone opportunities."

We have attached the Cadogan letter. It is succinct and outlines the issues well. We see the issues exactly the same way. When you invest, you must have transparency, accountability, independent verification, controls and safeguards. Even with hedge funds and private equity, you can have SEC registration and a Big Four audit. And your hedge fund of funds manager can diversify and monitor carefully; you can check. It is not rocket science, just hard work and discipline.

What does this mean to you?

The bottom line is that you can follow a well-defined prudent process and be assured that your investments are what you believe them to be. Obviously this year we have experienced tremendous volatility, but our clients – like all prudent investors - can look at what the market has done, asset class by asset class, and compare the performance of their managers and overall portfolio to those results. They can be confident that they are invested as they expected to be, per their asset allocation, and they have independent verification of their asset values (e.g., from Schwab) and proper safeguards against fraud and theft.

You can invest with confidence. A business-like approach, with independent checks and balances, audits and controls, provides a great deal of protection against this kind of fraud. It might not be glamorous, it might even appear academic or dull, but it really is the right way to go. It is what we have always believed and practiced, because it is best for you and for us.

Best Regards,

Roger C. Hewins III

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President

December 12, 2008

Dear Investors,

In response to the recent news regarding Bernard L. Madoff, we are writing to assure you that ***none of Cadogan's funds or managed accounts currently have or have had any investments in the Madoff funds.***

Over the years Cadogan has fielded more questions from clients and other industry professionals regarding the Madoff funds and their strategies than on any other hedge fund manager. Madoff has always been a showcase example of the 'black box' investment dilemma – Should one allocate to a manager/strategy that has a phenomenal long-term track record, but where meaningful access to meaningful information is unavailable? As protectors of our clients' capital, we have always taken the path of foregone opportunities.

Nevertheless, given the interest surrounding Madoff, Cadogan has on many occasions discussed his funds and we have also conducted due diligence on them. Madoff has been a well-known pioneer in 'off-exchange' trading and, over many years, has developed a sizeable investment management business. Some of these accounts have been carried as brokerage accounts; others, apparently much larger, were managed in an investment advisory entity. The purported strategy was "split-strike conversions"; this involves buying a stock, selling a call and buying a put simultaneously. This strategy is well-established, well-understood and highly competitive. The trades create a range of possible outcomes in which the maximum possible gain and loss can be calculated. The return on any individual split-strike conversion depends upon the path of the shares during the options' lives, the relative prices of the options, any dividends received, together with financing and execution costs. A very large book of such trades requires great record-keeping and execution and involves considerable analytical and logistical complexities. Although we felt we could understand the strategy and trading as explained, we were never able to reach a sufficient level of comfort that either all the complexities were being properly handled or that Madoff and his team could generate a volatility-adjusted return stream so much better than those of the competition, with such consistency and such enormous size. That intellectual mismatch, as well as a lack of sufficient effective transparency from the Madoff funds prohibited Cadogan from ever considering an investment in them.

Over the years, many market participants, including Cadogan, have been highly skeptical of Madoff, citing among other things:

- the competitive difficulties of the space;
- the apparent mismatch between Madoff's supposed AUM and the size of the options market which would need to accommodate this capital;
- the immense implied net revenues given the estimated AUM and the reported results;
- the extraordinary complexity and opacity of the Madoff investment vehicles;

- the lack of any spin-off of senior personnel over the years; and,

- the smoothness of returns relative to other traders in the area.

At present, the only thing which is clear is that everything is completely foggy! From initial reports, many things remain unclear, including but not limited to the following:

- ✓ how much actual trading was done by the Madoff vehicles;
- ✓ how great the losses might be;
- ✓ who will be left holding which losses;
- ✓ which positions were real and which fictitious;
- ✓ what the market implications might be beyond the initial loss of capital to investors in the funds;
- ✓ the level of involvement of Madoff's broker/dealer and the independent and interactive (with the funds) issues these might entail;
- ✓ how this will involve the Exchanges and various regulators; and,
- ✓ the impact on entities investing in or distributing Madoff funds.

It may well be months before many of these questions are answered and many years before the inevitable tangle of litigation clears up. At Cadogan, we frequently use the aphorism: "If it's too good to be true, it's too good to be true." Sometimes we might be wrong and miss a phenomenal opportunity; however, in our business, where protection of capital is paramount, we must accept such foregone profits to avoid potential losses we cannot quantify or handicap. At times like this, we are particularly thankful for having kept things simple.

Like everyone else, we must wait to see how this situation evolves. Please do not hesitate to contact us, however, if you have any questions now or as the situation unrolls.

As always, thank you for your ongoing support.

Cadogan Management, LLC