Fooled by Ponzi (and Madoff)

How Bernard Madoff Made Off with My Money

BY STEPHEN GREENSPAN

THERE ARE FEW AREAS OF FUNCTIONING where skepticism is more important than how one invests one's life savings. Yet intelligent and educated people, some of them naïve about finance and others quite knowledgeable, have been ruined by schemes that turned out to be highly dubious and quite often fraudulent. The most dramatic example of this in American history is the recent announcement that Bernard Madoff, a highly-regarded hedge fund manager and a former president of NASDAQ, has for several years been running a very sophisticated Ponzi scheme which by his own admission has defrauded wealthy investors, charities and other funds, of at least 50 billion dollars.

In my new book *Annals of Gullibility*[1], I analyze the topic of financial scams, along with a great number of other forms of human gullibility, including war (the Trojan Horse), politics (WMDs in Iraq), relationships (sexual seduction), pathological science (cold fusion), religion (Christian Science), human services (Facilitated Communication), medical fads (homeopathy), etc. Although gullibility has long been of interest in works of fiction (Othello, Pinnochio), religious documents (Adam and Eve, Samson) and folk tales (Emperor's New Clothes, Little Riding Hood), it has been almost completely ignored by social scientists. There have been a few books that have focused on narrow aspects of gullibility, including Charles Mackey's classic 19th century book, *Extraordinary Popular Delusion and the Madness of Crowds* (most notably on investment follies such as Tulipimania, in which rich Dutch people traded their houses for one or two tulip bulbs).[2] In *Annals of Gullibility* I propose a multi-dimensional theory that would explain why so many people behave in a manner which exposes them to severe and predictable risks. This includes myself — I lost a good chunk of my retirement savings to Mr. Madoff, so I know of what I write on the most personal level.

Ponzi Schemes & Other Investment Manias & Frauds

Although my focus here is on Ponzi schemes, I shall also briefly address the topic of investment manias (such as the dot.com bubble) and other forms of financial fraud (such as various inheritance scams). That is because they all involve exploitation of investor gullibility and can all be explained by the same theoretical framework.

A Ponzi scheme is a fraud where invested money is pocketed by the schemer and investors who wish to redeem their money are actually paid out of proceeds from new

investors. As long as new investments are expanding at a healthy rate, the schemer is able to keep the fraud going. Once investments begin to contract, as through a run on the company, then the house of cards quickly collapses. That is what happened with the Madoff scam when too many investors — needing cash because of the general U.S. financial meltdown in late 2008 — tried to redeem their funds. Madoff could not meet these demands and the scam was exposed.

The scheme gets its name from Charles Ponzi,[3] an Italian immigrant to Boston, who in 1920 came up with the idea of promising huge returns (50% in 45 days) supposedly based on an arbitrage plan (buying in one market and selling in another) involving international postal reply coupons. The profits allegedly came from differences in exchange rates between the selling and the receiving country (where they could be cashed in). A craze ensued, and Ponzi pocketed many millions of dollars, most from poor and unsophisticated Italian immigrants in New England and New Jersey. The scheme collapsed when newspaper articles began to raise questions about it (pointing out, for example, that there were not nearly enough such coupons in circulation) and a run occurred.

The basic mechanism explaining the success of Ponzi schemes is the tendency of humans to model their actions (especially when dealing with matters they don't fully understand) on the behavior of other humans. This mechanism has been termed "irrational exuberance," a phrase attributed to former fed chairman Alan Greenspan (no relation), but actually coined by another economist, Robert J. Schiller in a book with that title. Schiller employs a social psychological explanation that he terms the "feedback loop theory of investor bubbles." Simply stated, the fact that so many people seem to be making big profits on the investment, and telling others about their good fortune, makes the investment seem safe and too good to pass up. In Schiller's words, the fact "that others have made a lot of money appears to many people as the most persuasive evidence in support of the investment story associated with the Ponzi scheme — evidence that outweighs even the most carefully reasoned argument against the story."[4]

In Schiller's view, all investment crazes, even ones that are not fraudulent, can be explained by this theory. Two modern examples of that phenomenon are the Japanese real estate bubble of the 1980s and the American dot.com bubble of the 1990s. Two 18th century predecessors were the Mississippi Mania in France and the South Sea Bubble in England (so much for the idea of human progress). In all of these cases, the thing that kept the mania going was the thought "when so many leading members of society believe in and seem to profit from a course of action, how can it possibly be risky or dangerous?"

A form of investment fraud that has structural similarities to a Ponzi scheme is an inheritance scam, in which a purported heir to a huge fortune is asking for a short-term

investment in order to clear up some legal difficulties involving the inheritance. In return for this short-term investment, the investor is promised enormous returns. The best-known modern version of this fraud involves use of the internet, and is known as a “419 scam,” so named because that is the penal code number covering the scam in Nigeria, the country from which most of these internet messages originate. The 419 scam differs from a Ponzi scheme in that there is no social pressure brought by having friends who are getting rich. Instead, the only social pressure comes from an unknown correspondent, who undoubtedly is using an alias. Thus, in a 419 scam, other factors, such as psychopathology or extreme naïvete, likely explain the gullible behavior, as seen in a profile of such a highly-trusting victim, nicknamed “the perfect mark,” by Mitchell Zuckoff.[5]

Two historic versions of the inheritance fraud that are equal to the Madoff scandal in their widespread public success, and that relied equally on social feedback processes, occurred in France in the 1880s and 1890s, and in the American Midwest in the 1920s and 1930s. The French scam was perpetrated by a talented French hustler named Therese Humbert, who claimed to be the heir to the fortune of a rich American, Robert Henry Crawford, whose bequest reflected gratitude for her nursing him back to health after he suffered a heart attack on a train. The will had to be locked in a safe for a few years until Humbert’s youngest sister was old enough to marry one of Crawford’s nephews. In the meantime, leaders of French society were eager to get in on this deal, and their investments (including by one countess, who donated her chateau) made it possible for Humbert — who milked this thing for 20 years — to live in a high style. Success of this fraud, which in France was described as “the greatest scandal of the century” was kept going by the fact that Humbert’s father-in-law was a respected jurist and politician in France’s Third Republic and he publicly reassured investors, who included the cream of French society.[6]

The American version of the inheritance scam was perpetrated by a former Illinois farm boy named Oscar Hartzell. While Therese Humbert’s victims were a few dozen extremely wealthy and worldly French aristocrats, Hartzell swindled over 100,000 relatively unworldly farmers and shopkeepers throughout the American heartland. The basic claim — as described by Jay Robert Nash[7] and Richard Rayner[8] — was that the English seafarer, Sir Francis Drake, had died without any children, but that a will had been recently located (in one version, in a church belfry). The heir to the estate, which was now said to be worth billions (from compounding of the value of loot accumulated when Drake was a privateer plundering the Spanish Main), was a colonel Drexel Drake in London. As the colonel was about to marry his extremely wealthy niece, he wasn’t interested in the estate, which needed some adjudication, and turned his interest over to Hartzell, who now referred to himself as “Baron Buckland.” The Drake scheme became a social movement, known as “the Drakers” (later changed to “the Donators”) and whole churches and groups of friends — some of whom planned to found a utopian commune with the expected proceeds — would gather to read the

latest Hartzell letters from London. Hartzell was eventually indicted for fraud and brought to trial in Iowa, over great protest by his thousands of loyal investors. Rayner noted that what "had begun as a speculation had turned into a holy cause."

A Multidimensional Theory of Investment & Other Forms of Gullibility

While social feedback loops are an obvious contributor to understanding the success of Ponzi and other mass financial manias, one needs to also look at factors located in the dupes themselves that might help to explain why they fell prey to the social pressure while others did not. There are four factors in my explanatory model, which can be used to understand acts of gullibility but also other forms of what I term "foolish action."[9] A foolish (or stupid) act is one where someone goes ahead with a socially or physically risky behavior in spite of danger signs, or unresolved questions, which should have been a source of concern for the actor. Gullibility is a sub-type of foolish action, which might be termed "induced-social." It is induced because it always occurs in the presence of pressure or deception by one or more other people. Social foolishness can also take a non-induced form, as when someone tells a very inappropriate joke that causes a job interview or sales meeting to end unsuccessfully. Foolishness can also take a "practical" (physical) form, as when someone lights up a cigarette in a closed car with a gas can in the back seat and ends up incinerating himself. As noted, the same four factors can be used to explain all foolish acts, but in the remainder of this paper I shall use them to explain Ponzi schemes, particularly the Madoff debacle.

The four factors are *situation*, *cognition*, *personality* and *emotion*. Obviously, individuals differ in the weights affecting any given gullible act. While I believe that all four factors contributed to most decisions to invest in the Madoff scheme, in some cases personality should be given more weight while in other cases emotion should be given more weight, and so on. As mentioned, I was a participant — and victim — of the Madoff scam, and have a pretty good understanding of the factors that caused me to behave foolishly. So I shall use myself as a case study to illustrate how even a well-educated (I'm a college professor) and relatively intelligent person, and an expert on gullibility and financial scams to boot, could fall prey to a hustler such as Madoff.

Situations

Every gullible act occurs in a particular micro-context, in which an individual is presented with a social challenge that he has to solve. In the case of a financial decision, the challenge is typically whether to agree to an investment decision that is being presented to you as benign but that may pose severe risks or otherwise not be in one's best interest. Assuming (as with the Madoff scam) that the decision to proceed would be a very risky and thus foolish act, a gullible behavior is more likely to occur if the social and other situational pressures are strong

and less likely to occur if the social and other situational pressures are weak, or balanced by countervailing pressures (such as having wise heads around to warn you against taking the plunge).

The Madoff scam had social feedback pressures that were very strong, almost rising to the level of the "Donators" cult around the Drake inheritance fraud. A December 15, 2008 *New York Times* article described how wealthy retirees in Florida joined Madoff's country club for the sole reason of having an opportunity to meet him socially and be invited to invest directly with him.[10] Most of these investors, as well as Madoff's sales representatives, were Jewish, and it appears that the Madoff scheme was seen as a safe haven for well-off Jews to park their nest eggs. The fact that Madoff was a prominent Jewish philanthropist was undoubtedly another situational contributor, as it likely was seen as highly unlikely that such a person would be scamming fellow Jews (which included many prominent Jewish charities, some of them now forced to close their doors).

A non-social situational aspect that contributed to a gullible investment decision was, paradoxically, that Madoff promised modest rather than spectacular gains. Sophisticated investors would have been highly suspicious of a promise of gains as spectacular as those promised almost 100 years earlier by Charles Ponzi. Thus, a big part of Madoff's success came from his recognition that wealthy investors were looking for small but steady returns, high enough to be attractive but not so high as to arouse suspicion. This was certainly one of the things that attracted me to the Madoff scheme, as I was looking for a non-volatile investment that would enable me to preserve and gradually build wealth in down as well as up markets.

Another situational factor that pulled me in was the fact that I, along with most Madoff investors (except for the super-rich) did not invest directly with Madoff but went through one of 15 "feeder" hedge funds that then turned all of their assets over to Madoff to manage. In fact, I am not certain if Madoff's name was even mentioned (and certainly, I would not have recognized it) when I was considering investing in the (three billion dollar) "Rye Prime Bond Fund" that was part of the respected Tremont family of funds, which is itself a subsidiary of insurance giant Mass Mutual Life. Thus, I was dealing with some very reputable financial firms, which created the strong impression that this investment had been well-researched and posed acceptable risks.

The micro social context in which I made the decision to invest in the Rye fund came about when I was visiting my sister and brother-in-law in Boca Raton, Florida and met a close friend of theirs who is a financial adviser who was authorized to sign people up to participate in the Rye (Madoff-managed) fund. I genuinely liked and trusted this man, and was persuaded by his claim that he had put all of his own (very substantial) assets in the fund, and

had even refinanced his house and placed all of the proceeds in the fund. I later met many friends of my sister who were participating in the fund. The very successful experience they had over a period of several years convinced me that I would be foolish *not* to take advantage of this opportunity. My belief in the wisdom of this course of action was so strong that when a skeptical (and financially savvy) friend back in Colorado warned me against the investment, I chalked the warning up to his sometime tendency towards knee-jerk cynicism.

Cognition

Gullibility can be considered a form of stupidity, so it is safe to assume that deficiencies in knowledge and/or clear thinking often are implicated in a gullible act. By terming this factor "cognition" rather than intelligence, I mean to indicate that one can have a high IQ and still prove gullible. There is a large literature, by scholars such as Michael Shermer[11] and Massimo Piattelli-Palmarini[12] that show how often people of average and above-average intelligence fail to use their intelligence fully or efficiently when addressing everyday decisions. Keith Stanovich makes a distinction between intelligence (the possession of cognitive schemas) and rationality (the actual application of those schemas).[13] The "pump" that drives irrational decisions (many of them gullible), according to Stanovich, is the use of intuitive, impulsive and non-reflective cognitive styles, often driven by emotion.

In my own case, the decision to invest in the Rye fund reflected both my profound ignorance of finance, and my somewhat lazy unwillingness to remedy that ignorance. To get around my lack of financial knowledge and my lazy cognitive style around finance, I had come up with the heuristic of identifying more financially knowledgeable advisers and trusting in their judgment and recommendations. This heuristic had worked for me in the past and I had no reason to doubt that it would work for me in this case.

The real mystery in the Madoff story is not how naïve individual investors such as myself would think the investment safe, but how the risks and warning signs could have been ignored by so many financially knowledgeable people, ranging from the adviser who sold me and my sister (and himself) on the investment, to the highly compensated executives who ran the various feeder funds that kept the Madoff ship afloat. The partial answer is that Madoff's investment algorithm (along with other aspects of his organization) was a closely guarded secret difficult to penetrate, and partly (as in all cases of gullibility) that strong affective and self-deception processes were at work. In other words, they had too good a thing going, for themselves and their clients, to entertain the idea that it might all be about to crumble.

Personality

Gullibility is sometimes equated with trust, but the late psychologist Julian Rotter showed that not all highly trusting people are gullible.[14] The key to survival in a world filled with fakers (Madoff) or unintended misleaders who were themselves gulls (my adviser and the managers of the Rye fund) is to know when to be trusting and when not to be. I happen to be a highly trusting person who also doesn't like to say "no" (such as to a sales person who had given me an hour or two of his time). The need to be a nice guy who always says "yes" is, unfortunately, not usually a good basis for making a decision that could jeopardize one's financial security. In my own case, trust and niceness were also accompanied by an occasional tendency towards risk-taking and impulsive decision-making, personality traits that can also get one in trouble.

Emotion

Emotion enters into virtually every gullible act. In the case of investment in a Ponzi scheme, the emotion that motivates gullible behavior is a strong wish to increase and protect one's wealth. In some individuals, this undoubtedly takes the form of greed, but I think that truly greedy individuals would likely not have been interested in the slow but steady returns posted by the Madoff-run funds. I know that in my case, I was excited not by the prospect of striking it rich but by the prospect of having found an investment that promised me the opportunity to build and maintain enough wealth to have a secure and happy retirement. My sister, a big victim of the scam, put it well when she wrote that "I suppose it was greed on some level. I could have bought CDs or municipal bonds and played it safer for less returns. The problem today is there doesn't seem to be a whole lot one can rely on, so you gravitate towards the thing that in your experience has been the safest. I know somebody who put all his money in Freddie Macs and Fannie Maes. After the fact he said he knew the government would bail them out if anything happened. Lucky or smart? He's a retired securities attorney. I should have followed his lead, but what did I know?"[15]

Conclusion

I suspect that one reason why psychologists and other social scientists have avoided studying gullibility is because it is affected by so many factors, and is so micro-context dependent that it is impossible to predict whether and under what circumstances a person will behave gullibly. A related problem is that the most catastrophic examples of gullibility (such as losing one's life savings in a scam) are low frequency behaviors that may only happen once or twice in one's lifetime. While as a rule I tend to be a skeptic about claims that seem too good to be true, the chance to invest in a Madoff-run fund was one case where a host of factors — situational, cognitive, personality and emotional — came together to cause me to put my critical faculties on the shelf.

Skepticism is generally discussed as protection against beliefs (UFOs) or practices (Feng Shui) that are irrational but not necessarily harmful. Occasionally, one runs across a situation where skepticism can help you to avoid a disaster as major as losing one's life (being sucked into a crime) or one's life savings (being suckered into a risky investment). Survival in the world requires one to be able to recognize, analyze, and escape from those highly dangerous situations.

So should one feel pity or blame towards those who were insufficiently skeptical about Madoff and his scheme? A problem here is that the lie perpetrated by Madoff was not all that obvious or easy to recognize (in fact, it is very likely that Madoff's operation was legitimate initially but took the Ponzi route when he began to suffer losses that he was too proud to acknowledge). Virtually 100% of the people who turned their hard-earned money (or charity endowments) over to Madoff would have had a good laugh if contacted by someone pitching a Nigerian inheritance investment or the chance to buy Florida swampland. Being non-gullible ultimately boils down to an ability to recognize hidden social (or in this case, economic) risks, but some risks are more hidden and, thus, trickier to recognize than others. Very few people possess the knowledge or inclination to perform an in-depth analysis of every investment opportunity they are considering. It is for this reason that we rely on others to help make such decisions, whether it be an adviser we consider competent or the fund managers who are supposed to oversee the investment.

I think it would be too easy to say that a skeptical person would and should have avoided investing in a Madoff fund. The big mistake here was in throwing all caution to the wind, as in the stories of many people (some quite elderly) who invested every last dollar with Madoff or one of his feeder funds. Such blind faith in one person, or investment scheme, has something of a religious quality to it, not unlike the continued faith that many of the "Drakers" continued to have in Oscar Hartzell even after the fraudulent nature of his scheme began to become very evident. So the skeptical course of action would have been not to avoid a Madoff investment entirely but to ensure that one maintained a sufficient safety net in the event (however low a probability it might have seemed) that Madoff turned out to be not the Messiah but Satan. As I avoided drinking a full glass of Madoff Kool-aid, maybe I'm not as lacking in wisdom as I thought.

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