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Don't Ask, Don't Tell: Bernie Madoff is so secretive, he even asks his investors to keep mum

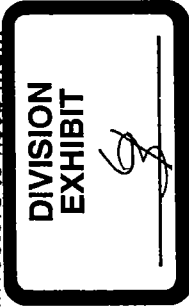
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Two years ago, at a hedge-fund conference in New York, attendees were asked to name some of their favorite and most-respected hedge-fund managers. Neither George Soros nor Julian Robertson merited a single mention. But one manager received lavish praise: Bernard Madoff.

Folks on Wall Street know **Bernie Madoff** well. His brokerage firm, Madoff Securities, helped kick-start the Nasdaq Stock Market in the early 1970s and is now one of the top three market makers in Nasdaq stocks. Madoff Securities is also the third-largest firm matching buyers and sellers of New York Stock Exchange-listed securities. Charles Schwab, Fidelity Investments and a slew of discount brokerages all send trades through Madoff.

But what few on the Street know is that **Bernie Madoff** also manages more than \$6 billion for wealthy individuals. That's enough to rank Madoff's operation among the world's five largest hedge funds, according to a May 2001 report in MAR Hedge, a trade publication.

What's more, these private accounts, have produced compound average annual returns of 15% for more than a decade. Remarkably, some of the larger, billion-dollar Madoff-run funds have never had a down year.

When Barron's asked Madoff how he accomplishes this, he says, "It's a proprietary strategy. I can't go into it in great detail."

Nor were the firms that market Madoff's funds forthcoming. "It's a private fund. And so our inclination has been not to discuss its returns," says Jeffrey Tucker, partner and co-founder of Fairfield Greenwich, a New York City-based hedge-fund marketer. "Why Barron's would have any interest in this fund I don't know." One of Fairfield Greenwich's most sought-after funds is Fairfield Sentry Limited. Managed by **Bernie Madoff**, Fairfield Sentry has assets of \$3.3 billion.

One of Madoff's hedge-fund offering memorandums describes his strategy this way: "Typically, a position will consist of the ownership of 30-35 S&P 100 stocks, most correlated to that index, the sale of out-of-the-money calls on the index and the purchase of out-of-the-money puts on the index. The sale of the calls is designed to increase the rate of return, while allowing upward movement of the stock portfolio to the strike price of the calls. The puts, funded in large part by the sale of the calls, limit the portfolio's downside."

Among options traders, that's known as the "split-strike conversion" strategy. In layman's terms, it means Madoff invests primarily in the largest stocks in the S&P 100 index -- names like General Electric, Intel and Coca-Cola. At the same time, he buys and sells options against those stocks. For example, Madoff might purchase shares of GE and sell a call option on a comparable number of shares -- that is, an option to buy the shares at a fixed price at a future date. At the same time, he would buy a put option on the stock, which gives him the right to sell shares at a fixed price at a future date.

The strategy, in effect, creates a boundary on a stock, limiting its upside while at the same time protecting against a sharp decline in the share price. When done correctly, this so-called market-neutral strategy produces positive returns no matter which way the market goes.

Using this split-strike conversion strategy, the Fairfield Sentry Limited fund has had only four down months since inception in 1989. In 1990, Fairfield Sentry was up 27%. In the ensuing decade, it returned no less than 11% in any year, and sometimes as high as 18%. Last year, Fairfield Sentry returned 11.55% and so far in 2001, the fund is up 3.52%.

Why would Madoff Securities do this? Because, in having access to such a huge capital base, it can make much larger bets -- with very little risk -- than it could otherwise. It works like this: Madoff Securities stands in the middle of a tremendous river of orders, which means that its traders have advance knowledge, if only by a few seconds, of what the big customers in the market are buying and selling. And by hopping on the bandwagon, the market maker effectively locks in profits. As such, throwing a little cash back to the hedge funds would be no big deal. And the funds' consistent returns, in turn, attract more capital.

When Barron's ran that scenario by Madoff, he dismissed it as "ridiculous."

Still, some on Wall Street remain skeptical about how Madoff achieves such stunning, double-digit returns using options alone. Three option strategists for major investment banks told Barron's they couldn't understand how Madoff churns out such numbers using this strategy. Adds a former Madoff investor: "Anybody who's a seasoned hedge-fund investor knows the split-strike conversion is not the whole story. To take it at face value is a bit naive."

Madoff dismisses such skepticism. "Whoever tried to reverse-engineer [the strategy], he didn't do a good job. If he did, these numbers would not be unusual."

Adding further mystery to Madoff's motives is the fact that he charges no fees for his money management services. Indeed, while fund marketers like Fairfield Greenwich rake off a 1.5% from investors, none of that goes back to Madoff. Nor does he charge a fee on money he manages in private accounts? Why not? "We're perfectly happy to just earn commissions on the trades," he says.

The lessons of Long-Term Capital Management's collapse are that investors need, or should want, transparency in their money manager's investment strategy. But Madoff's investors rave about his performance -- even though they don't understand how he does it. "Even knowledgeable people can't really tell you what he's doing," one very satisfied investor told Barron's. "People who have all the trade confirms and statements still can't define it very well. The only thing I know is that he's often in cash" when volatility levels get extreme. This investor declined to be quoted by name. Why? Because Madoff politely requests that his investors not reveal that he runs their money.

"What Madoff told us was, 'If you invest with me, you must never tell anyone that you're invested with me. It's no one's business what goes on here,'" says an investment manager who took over a pool of assets that included an investment in a Madoff fund. "When he couldn't explain [to my satisfaction] how they were up or down in a particular month," he added, "I pulled the money out."

For investors who aren't put off by such secrecy, there are a few ways to get into Madoff funds. Fairfield and Kingate Management both market funds that are managed by Madoff. Tremont Advisers, a publicly traded hedge-fund advisory firm offers Madoff-managed funds.

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