Angels and Demons

Highlighting the best and worst of the financial world

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ANGELS:

Investor Hall of Fame

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FOUNDER & PRINCIPAL

In the last few years, I have written about twenty white papers on a variety of financial and economic topics. I recently had a major "uh-oh" moment when I realized that I had written a number of times about investor behavior and mistakes but never about real people. I initially intended to write only about successful investors but decided that it would be much more interesting to chronicle the lives of both successful investors and rogues, hence the title *Angels and Demons.* To start on a positive note, let's take a look at the careers of some of history's greatest money managers.

There was a time when successful fund managers were the subject of admiring press with a few reaching something close to "rock star" status. In contrast, today's capital markets are dominated by high-speed computerized trading and passive vehicles that have now garnered more assets than their active competition. Other than perhaps Warren Buffett, can you name a famous current investor? The overall record of active management is disappointing, but there are and have been some truly talented investors who generated extraordinary returns for long periods. How did they do it? Do they share common traits or characteristics? What can we learn from them? In order to make amends for my not having focused on people, this paper profiles some of history's most successful investors and attempts to identify the key factors leading to their success.

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While there were many other candidates with excellent records, I very intentionally selected people who materially changed the practice of investment management. One conclusion is that there is no silver bullet or magic formula, and truly successful investors achieve their results using a variety of approaches and techniques.

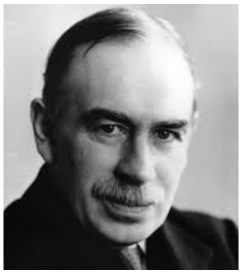
The Keys to Success

In order to get the most from the biographies that follow, here is a list of important traits of successful investors, and I believe you will find them present to some extent in each of the luminaries profiled. One caveat; this is my list and others might well substitute other characteristics they deem more important. In my opinion, outstanding investors have:

- A willingness to be different-to use new, creative, and unconventional approaches
- Courage-the ability to avoid paralysis and act during difficult periods
- Emotional stability-the ability to maintain equanimity
- Intense intellectual curiosity and the ability to think and act independently and imaginatively
- A competitive nature
- Self-confidence-but not arrogance
- The ability to learn from mistakes and move on
- Discipline supplemented by diligence and thoroughness
- Technical skills including financial and accounting acumen
- A well-refined investment philosophy, but equally important, the ability to adjust and adapt it over time

Of course, none of us is superhuman and most of these great investors had ups and downs to some extent during their careers. Nevertheless, each of them has left a major mark on the financial world.

JOHN MAYNARD KEYNES (1883-1946)



John Maynard Keynes was a British economist who developed what is known as Keynesian Economics which posits that governments should actively use monetary and fiscal policy to maximize employment and promote economic stability. Many of his recommendations were implemented by the Roosevelt administration as a means of emerging from the Great Depression but his theories fell out of favor from the 1970s through the early 2000s based on skepticism as to the effectiveness of governments in controlling the economy. However, his views regained popularity

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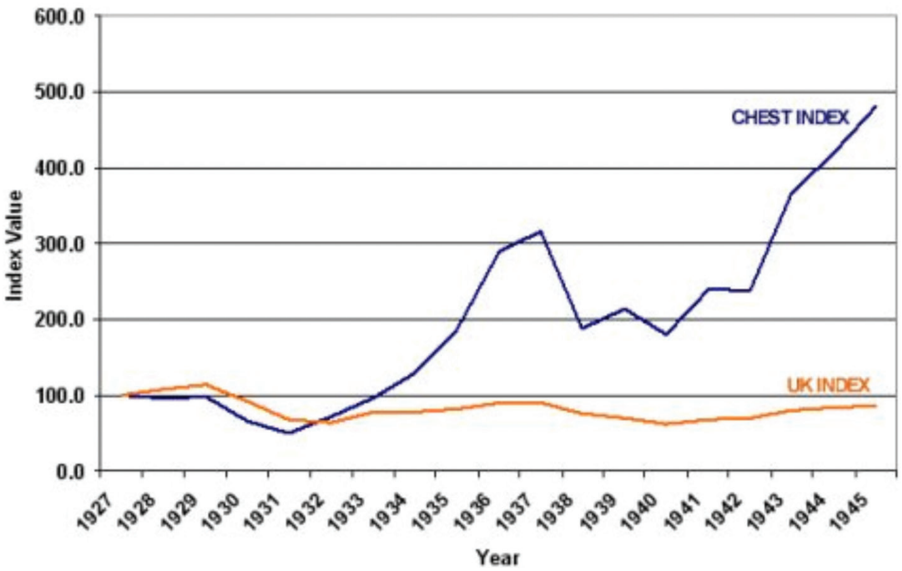
with the Global Financial Crisis of 2008-09 and form much of the basis of the current governmental response to the economic damage associated with Covid-19 virus.

Keynes is widely known as an economist, but his prowess as an investor has received considerably less fanfare. While he lost the majority of his personal capital in 1920 and again in 1929, he bounced back each time amassing a fortune at his death that equates to approximately $30 million in today's dollars including an extensive art and manuscript collection. To his credit, he achieved his wealth despite very significant philanthropy. Keynes personally invested actively in stocks, currencies, and commodities making him the equivalent of a modern macro hedge fund manager. More important, he managed capital for several insurance companies as well as the endowment of King's College Cambridge, the discretionary portion of which he nicknamed The Chest. The following chart portrays the performance of The Chest from 1927 to 1946 as compared to a UK stock index. While spotty data produce somewhat different results in the various studies of the endowment's returns, the King's College Fund outperformed the broad equity market by 7-10% per annum during his tenure.

CHEST FUND PERFORMANCE 1927 TO 1946



As was true of all of the Oxbridge College endowments, the King's College Fund was almost entirely invested in agricultural real estate when Keynes assumed control in 1924. His first significant act was to sell roughly one third of the real estate holdings and reinvest the proceeds in equities. This was highly controversial, and the other colleges at Oxford and Cambridge did not follow suit waiting until after the Second War to change their investment policies. Therefore, some consider Keynes the first significant institutional investor in equities.

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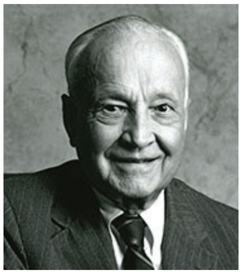
Given his training in macroeconomics, his initial approach to managing the endowment relied primarily on switching between equities, bonds and cash; in other words, market timing. However, he failed to anticipate the stock market Crash of 1929 leading to considerable self-reflection and a dramatic change in investment strategy. From that point forward, he focused on bottom-up stock selection based on deep understanding of a small number of industries and companies and his assessment of a company's intrinsic worth. He said "I get more and more convinced that the right method in investment is to put fairly large sums into enterprises which one thinks one knows something about and in the management of which one thoroughly believes." He gravitated toward low portfolio turnover and concentrated positions in small and medium size companies, "value" stocks, and stocks with high dividends; all selection criteria that were made famous by Ben Graham and Warren Buffett and later confirmed by academic studies by Nobel Prize winner Gene Fama and others. Notably, in a move that was decades ahead of its time, he invested as much as seventy-five percent of the College equity portfolio in non-UK stocks at various times. As was the case with his personal portfolio, The King's College endowment performed poorly for several periods, but Keynes persisted in his approach ultimately resulting in superb cumulative results.

After reviewing my list of the characteristics of successful investors, note that Keynes:

- Veered significantly from prevailing endowment management practice by investing in equities
- Demonstrated courage, self-awareness, and emotional maturity by dramatically changing his basic investment approach
- Suffered major reversals but stayed in the fight creating both personal and institutional wealth

SIR JOHN MARKS TEMPLETON (1912-2008)



John Templeton hailed from Winchester, Tennessee and was educated at Yale University and Balliol College, Oxford which he attended on a Rhodes Scholarship. He took a job on Wall Street in 1937, and two years later, borrowed $10,000 to invest in 104 stocks that were selling for less than $1 per share. They produced an average profit of 400% providing a nest egg that allowed him to form his own firm in 1940. In 1954, he launched the Templeton Growth Fund that he managed until 1992 when his firm was sold to Franklin Investments. At that time, the various Templeton Funds had $13 billion under management. Following the sale, he retired to devote the remainder of his life to philanthropy that ultimately exceeded $1 billion. Templeton was a very religious man and one of his legacies is the Templeton Prize that rewards people who have "improved the interaction between spirituality and the modern world."

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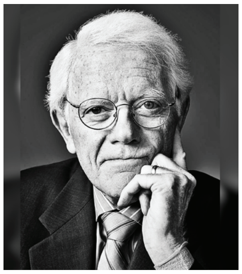
In 1999, Money Magazine called him "arguably the greatest global stock picker of the century." During the thirty-eight years that he managed the Templeton Growth Fund, it returned 15% per annum net of fees as compared to an 11% return on the S&P 500.

Templeton is best known as a pioneer in global investing. In particular, he began researching companies in Japan in the late 1950s and subsequently invested as much as one-half of the fund in Japanese equities capturing Japan's economic boom of the 1970s and 1980s. He was a classic value investor in that he purchased "cheap" stocks using a variety of valuation metrics including his favorite, price to replacement cost. Consistent with his value orientation, Templeton was also very much a contrarian publicly predicting a bull market in 1982 when various publications proclaimed the "death of equities." Although he had retired from full time fund management, he recommended to friends and family that they short a number of technology stocks in 1999, just in time to capture the bursting of the Dot-Com Bubble. In order to avoid paying taxes that would diminish his potential philanthropy, he renounced his U.S. citizenship in 1964 and moved to the Bahamas. Interestingly, this move was very consistent with his investment philosophy of rising above the day-to-day noise and turmoil of Wall Street thereby fostering perspective and independent thought. His humility is best demonstrated by his statement that "an investor who has all of the answers doesn't even understand all the questions."

Again referring to my list of the characteristics of great investors, Templeton:

- Embarked on global investing at a time when most U.S. portfolios were entirely invested in domestic securities
- Consistently followed a classic "value" approach based on a blend of quantitative metrics and judgment which he deemed his strongest personal asset
- Had the courage and strength to buck prevailing sentiment and act decisively
- Lived frugally and independently, both of which contributed to his global perspective and clear thinking

PETER LYNCH (1944-



At the beginning of this paper, I mentioned that some fund managers achieved "rock star" status based on their performance and media savvy. Well, Peter Lynch was arguably the brightest star in the investment firmament during his era. While attending Boston College, Lynch used his savings to purchase 100 shares of Flying Tiger Airlines at $8 per share. The stock rose to $80 helping him finance an MBA from the Wharton School which he received in 1968. He joined Fidelity in 1969 as a stock analyst and then served as its Director of Research from 1974 to 1977.

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In 1977, Lynch was asked to manage the relatively obscure Magellan Fund that held assets of only $18 million. When he retired thirteen years later at age 46, Magellan Fund assets had risen to $14 billion. Since retiring, Lynch has devoted himself to philanthropy and writing including three best-selling investment books.

The track record of the Magellan Fund during his tenure is truly extraordinary generating an annualized return of 29.2%, double the 15% return on the S&P 500. The Fund outperformed the S&P in eleven of the thirteen years of his management. A great deal of research suggests that smaller mutual funds tend to outperform their larger competitors which makes his record all the more remarkable given that the mammoth size of the Magellan Fund necessitated as many as one thousand stock positions.

Lynch's investment approach was similar to those of both Keynes and Templeton in some ways but also differed materially in important respects. First, as was the case with both of them, he did not operate with an overarching economic strategy but instead focused on research-intensive selection of individual stocks. Similarly, he had a global perspective in that the Magellan Fund was initially invested in U.S. stocks but gradually diversified internationally. On the other hand, both Keynes and Templeton were true value investors whereas Lynch's strategy was more adaptive and growth oriented. He developed an approach that is widely used today called "growth at a reasonable price" or GARP which allows a fund manager to buy more expensive stocks as long as their earnings growth rate justifies the higher valuation. To make this judgment, he developed a metric known as the PEG ratio that compares the P/E of a given company to its expected earnings growth rate.

Lynch is best known for advocating a strategy that he called "invest in what you know," and to illustrate this approach, he frequently cited one of his most successful stock selections which was Dunkin Donuts. He became interested in the stock as a daily consumer of their coffee. In his books, Lynch urged investors to walk through malls looking for interesting products and concepts and noting the stores that were capturing a large amount of foot traffic. His strategy is best captured by his simple exhortation to "know what you own and why you own it."

Once again, let's refer back to the characteristics of great investors. Lynch:

- Developed a distinctive investment style that he implemented consistently
- Was flexible and adaptive not confining his portfolio to a single type of stock or geography
- Was very thorough relying on deep research
- Was highly imaginative with a particular ability to perceive major consumer and technology trends

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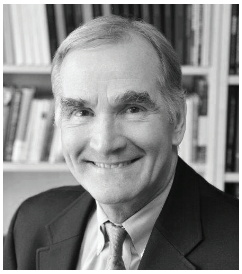
DAVID SWENSEN (1954-



David Swensen grew up in Wisconsin and attended the University of Wisconsin-River Falls before earning a PHD in economics at Yale where he was a student of future Nobel Laureate James Tobin. He spent five years on Wall Street at Salomon Brothers and Lehman Brothers where he engineered the first swap transaction, a financial technique that is now very widely used with outstanding notional value today of more than $300 trillion. In 1985, David was persuaded to return to Yale as its Chief Investment Officer (taking an 80% pay cut), a position that he still holds after thirty-five years. In contrast to our three previous honorees, Swensen and his team do not select individual securities but parcel out the endowment fund to outside investment managers. Therefore, his skills lie in determining an optimal allocation of assets among the various investment categories and then selecting and monitoring managers in each asset class.

During Swensen's tenure, the Yale Endowment has grown from $1 billion to $30.3 billion earning an annualized return of 12% over the past thirty years. For multiple periods, Yale's return ranks number one in the Cambridge Associates universe of endowment performance. Because of this outstanding growth, the endowment now supplies 34% of Yale's operating revenue. While most components of the portfolio have outperformed relevant benchmarks, the most striking statistic is the 241% annualized return on Yale's venture capital portfolio over the past ten years. One of Swensen's important legacies is that his protégées have served as Chief Investment Officers of a number of endowments and foundations including Princeton, the Carnegie Endowment, the Rockefeller Foundation, and MIT.

While other institutions were beginning to follow similar approaches, Swensen is generally credited with developing the "endowment model" of investing that is characterized by heavy orientation toward equity-like investments, diversification, and extensive use of non-traditional investment categories. When he arrived at Yale in 1985, seventy-five percent of the fund was invested in U.S. stocks, bonds, and cash. Today, the fund is structured as follows:

Absolute Return Strategies	23.0%
U.S. Equities	2.75
Non-U.S. Equities	13.75
Leverage Buyouts	16.5
Natural Resources	5.5
Real Estate	10.0
Venture Capital	21.5
Cash and Fixed Income	7.0
Total Portfolio	100%

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As you will note, only 23.5% of the portfolio is invested in stocks and bonds with the remainder allocated to a variety of "alternative", and in many cases, illiquid assets.

While Swensen and his team do not pick securities, their approach to selecting managers draws many parallels to the techniques ascribed to the other three honorees. They rely on very rigorous, research driven due-diligence to identify firms that seem to have an enduring edge over the competition. They avoid "black box" investment approaches in favor of strategies in which they clearly understand the decision making process of the manager. They focus on the soft factors including the motivation of a firm's principals, the division of economics within the firm, and team dynamics. And, they view their relationships with managers as a partnership rather than a vendor-client dynamic.

They view their relationships with managers as a partnership rather than a vendor-client dynamic.

So, back to my list of the characteristics of great investors. Swensen:

- Had the courage and intellect to move the Yale endowment away from a conventional structure to a very non-traditional asset allocation
- Invests in highly specialized asset categories requiring patience and unusual expertise thereby generating extraordinary returns
- Developed a team characterized by discipline, and thorough, in-depth research
- Has developed a reputation as a good partner, in some ways a "brand," that gains Yale access to premier investment vehicles that are not available to others

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Common Threads

Each of these individuals developed a personal style of investing based on his philosophical bent and assessment of his own skills. And, while they practiced their craft at different times and in different venues, there are very powerful themes that are common to all of them. First, each had a global orientation and was willing to look for opportunities wherever they could be found. Second, each of their approaches was based on careful, in-depth research that was implemented in an organized and disciplined manner. None of them was susceptible to fads and every investment conformed to very specific criteria and was consistent with a well-articulated strategy. Third, all four were innovators who were very willing to reject conventional wisdom; they fundamentally changed the practice of investment management. Fourth, while operating with core beliefs and principles, each evolved his approach to conform to changing circumstances. It is important to point out that this evolution in every case resulted from careful introspection and not reaction to the latest market gyrations. Finally, all four were very altruistic and philanthropic viewing their careers as providing the means to give back.

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"In the end, how your investments behave is much less important than how you behave."

— BEN GRAHAM

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DEMONS:
A Rogues' Gallery

So now you've read about the lives and careers of four of history's most successful investors. All four were innovative, independent thinkers who materially changed the practice of investment management.

Now I'll turn to examine the other side of the coin, some of the financial world's worst villains. Their stories are fascinating, but there are also lessons we can learn that should decrease the chance of being a victim of the next scheme that comes along. As Willie Sutton indicated, there will always be nefarious behavior when you combine money with people of questionable character.

"I rob banks, because that's where the money is."

– WILLIE SUTTON

"Corruption, embezzlement, fraud, these are all characteristics which exist everywhere. It is regrettably the way human nature functions, whether we like it or not. What successful economies do is keep it to a minimum. No one has ever eliminated any of that stuff."

— ALAN GREENSPAN

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A Catalogue of Financial Crimes

While a little research turns up a huge number of financial misdeeds throughout the last century, it turns out that most are repetitive; they fall into a modest number of categories and each new generation of bad actors executes some variation on an oft-used technique. The biographies that follow will be a little clearer with a basic understanding of several forms of financial skullduggery. There are three particularly common shenanigans and then a handful of minor but equally reprehensible techniques.

The first is insider trading that the SEC defines as "the buying or selling of a security on the basis of material, non-public information about that security." Illegal insider trading also includes tipping others when one possesses such information. Among the better-known perps of insider trading are Martha Stewart, Michael Milken, Jeff Skilling, Marty Siegel, Dennis Levine, and Raj Rajaratnam. The history of insider trading laws is actually interesting in that it was legal until banned by the Securities Exchange Act of 1934. Enforcement of that Act was initially the responsibility of the first Chair of the SEC, Joseph P. Kennedy, who reputedly made his fortune using inside information and other questionable trading techniques that he then outlawed upon assuming the SEC role. You should also know that members of Congress were allowed to use privileged information until the passage of the Stock Act (Stop Trading on Congressional Knowledge Act) in 2012. It now prohibits members and employees from using private information derived from their official positions for personal benefit. Currently, an investigation of Senator Richard Burr of North Carolina is underway in relation to his stock sales following a Congressional briefing early in the coronavirus pandemic.

The most famous swindle is the Ponzi scheme. Charles Ponzi carried out his fraud in the 1920's, but Charles Dickens had actually described this technique in his novel Martin Chuzzlewit in 1844. The first well-documented schemes were carried out in 1869 and 1872 by two women, Adele Spitzeder in Germany and Sarah Howe in the U.S. The perpetrator of a Ponzi scheme promises high and unachievable returns in order to attract investors, and then uses the contributions of later investors to make payments to the earlier investors and to himself. Ponzi schemes inevitably collapse when there are not enough new investors to meet interest payments and redemption requests. However, these schemes can go on for an extended period because investors are lulled into a false sense of security by fraudulent accounting statements indicating high returns and growing account values. Additionally, the perpetrator attempts to display that all is well by promptly meeting redemption requests, as long as they are not too large. In some cases, there are no underlying assets but Ponzi schemes can also develop when legitimate investment funds fail to achieve return expectations. Aside from Mr. Ponzi himself, the most famous Ponzi scheme promoter is Bernie Madoff who is serving a one hundred and fifty year prison sentence. A number of sophisticated investors have been victims of

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these frauds demonstrating the difficulty in overcoming the prospects of high returns promised by a slick operator.

The final major type of fraud is carried out by corporate managements who “cook the books” in order to overstate a company’s financial performance in an attempt to boost the stock price. These schemes can involve recording fake or backdated revenues, hiding debt and losses in “special purpose” entities, capitalizing rather than expensing costs to overstate earnings, outright theft of funds, and a variety of other capers. Well-documented examples of corporate fraud include Waste Management, Enron, WorldCom, Tyco, and Lehman Brothers.

In addition to these main categories, there are numerous other shady investment techniques. For example, there have been “pools” in which a small group of people join forces to manipulate the price of a stock, “cornering the market” in order to drive up the price artificially, “parking” securities in order to disguise true ownership, the sale of fraudulent securities, and “pump and dump” schemes. These activities are banned by the SEC Act of 1934 and subsequent legislation, but continue to resurface periodically. For example, an announcement on Sept. 29, 2020 indicated that fifteen traders at J.P. Morgan had caused losses of more than $300 million to other participants in the U.S. Treasury and precious metals markets through market manipulation. The bank accepted responsibility and agreed to a $920 million fine.

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Rogues

It was difficult to select the characters to profile because there have been hundreds of financial miscreants over the past century. Books such as **The Wizard of Lies** and **The Smartest Guys in the Room** document the stories of Bernie Madoff and Jeff Skilling of Enron fame, so I will focus on somewhat lesser known scoundrels. I have chosen one for each of the three major types of misdeeds discussed above, and then briefly refer to several more cases that make an interesting and somewhat surprising statement regarding many of the people who engage in financial fraud. One very interesting aside is that very few major financial scams are perpetrated by women. For many years, this was attributable to the small number of women in senior financial positions, but that is no longer the case. The low incidence of financial crimes attributable to women is consistent with data on other categories that show that only 15-30% of crimes are committed by women despite their representing just under 51% of the population.

IVAN BOESKY (1937-

Ivan Boesky hailed from Detroit where his immigrant parents owned several delicatessens. Despite never finishing college, he managed to get a law degree, and at the age of 25, married Seema Silberstein who was the daughter of a wealthy real estate magnate. Boesky worked for several brokerage firms in New York before starting Ivan Boesky and Company in 1975 using funds supplied by his in-laws. The firm's primary strategy was merger arbitrage in which an investor buys the stocks of companies that are acquisition targets. The lowest risk version of that strategy calls for purchasing shares only after the announcement of a transaction, whereas the more aggressive variety involves speculating on potential acquisition candidates. Boesky seemed to have an uncanny knack for identifying potential takeovers and often established very large stock positions only days before an announcement. By the early 1980's, his net worth was in excess of $200 million and he and his wife were highly visible in New York social and charitable circles.

It turns out that Boesky had a vast network of sources who illegally provided him inside information on upcoming transactions. One of them was Dennis Levine, an investment banker at Drexel Burnham who had been trading on inside information for years in an offshore account at Bank

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Leu in the Bahamas. Several of the Bank's employees copied Levine's trades for their own accounts which were held primarily at Merrill Lynch. Seeing the terrific profits the bank employees were earning, their brokers at Merrill began to implement the same trades for themselves leading to an investigation by Merrill which then informed the SEC. The trail led back to Levine who was arrested in May of 1986. He agreed to cooperate and immediately implicated Boesky who also agreed to be an informant. Beginning in September of 1986, Boesky assisted in a number of wiretaps and taped conversations in which fourteen individuals at five different brokerage firms were implicated including Michael Milken at Drexel Burnham which was forced into bankruptcy in February of 1990. The most striking aspect of this saga was the large number of people involved and the incredibly brazen behavior of highly visible individuals such as Boesky and Milken. James B. Stewart chronicles this fascinating slice of financial history in his book **Den of Thieves**.

Boesky's cooperation with the government resulted in relatively lenient treatment in that he received a sentence of three years in prison of which he served twenty-two months. He was also banned from the securities industry for life and fined $100 million. Several months prior to being charged and pleading guilty, he was the graduation speaker at Berkeley where he said: "Greed is all right, by the way. I want you to know that. I think greed is healthy. You can be greedy and still feel good about yourself." Boesky and this statement were the model for Gordon Gekko in the movie Wall Street. Today, he lives quietly in La Jolla, California on the $23 million settlement that he received from his wealthy wife upon their divorce in 1991.

"Greed is all right, by the way. I want you to know that. I think greed is healthy. You can be greedy and still feel good about yourself."

— IVAN BOESKY

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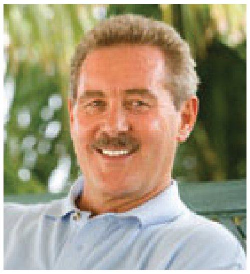
ROBERT ALLEN STANFORD (1950-



Allen Stanford grew up in a middle class family in Mexia, Texas and graduated from Baylor University in 1974. His first foray into the business world was a gym that failed, but he apparently went on to achieve some success in purchasing distressed real estate in Texas. In the 1980's, he moved to Antigua where he started Stanford International Bank (SIB) that issued Certificates of Deposit (CDs) that were sold to investors by affiliated brokerage arms based in a number of countries. The CDs carried above market interest rates that should have raised a red flag, but investors were assured they were backed by very high quality, liquid assets managed by skilled professionals. For example, SIB was paying 4.5% in early 2009 as compared to the 2% rate offered by U.S. banks. While regulators were apparently suspicious of SIB's high and consistent returns as early as 1997, they took no action until February of 2009 when the FBI and SEC raided Stanford's offices in Houston and Memphis. The subsequent investigation determined that Stanford had been conducting a Ponzi scheme for at least twenty years. He was arrested in June of 2009 and convicted in March of 2012.

Stanford had siphoned off approximately $5 billion of the $7 billion in outstanding CDs to fund his other failing businesses, real estate purchases, and an incredibly lavish lifestyle that included six airplanes and multiple residences. As occurs in all Ponzi Schemes, he used the proceeds of new CD sales to pay earlier investors who redeemed. In order to sustain the scheme, his internal accountants vastly inflated the value of the firm's assets and Stanford bribed both his external auditors and the Antiguan regulator. There were also suggestions of money laundering and various types of political intrigue.

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Stanford received a 110-year sentence that he is serving in the US Penitentiary in Coleman, Florida. Sadly, more than 18,000 investors were defrauded including a large number of older individuals who had entrusted their retirement funds to SIB. To date, investors have only received about five cents of every dollar lost in the scheme. Stanford contends that his operation was entirely legitimate and only failed because overzealous U.S. regulators shut it down without cause. He also suggests that all of the underlying assets were real but are no longer recoverable because they have "fallen into the hands of corrupt bankers and legislators." This is the second largest Ponzi scheme after Bernie Madoff's fraud in which the net loss was approximately $17 billion, 75% of which has been recovered. Both promoters offered above average and consistent returns that should remind us of the old adage "if it seems too good to be true, it is."

BARRY MINKOW (1966-

I have saved the best for last in that Barry Minkow was guilty of all three of the major financial crimes I outlined at the outset: insider trading, a Ponzi scheme, and corporate accounting fraud. And, there was much more!

In 1982, at age 16, Minkow started a carpet cleaning company in his parent's garage in California called ZZZZBest. (Pronounced Zee Best) While a legitimate business, it was undercapitalized and perennially short of operating capital which Minkow addressed by resorting to check kiting, stealing and selling his grandmother's jewelry, staging break-ins at his own office, and placing fraudulent charges on customers' credit cards. Next, he started an insurance restoration business that was a sham from the outset. In order to get financial support for this new business from investors and banks, he forged documents showing non-existent projects and revenues, engaged in additional check-kiting schemes, and factored non-existent accounts receivable. In classic Ponzi scheme fashion, new inflows provided the promised return to earlier lenders and investors.

In 1986, he took ZZZZBest public on the NASDAQ having supplied the accountants who did very questionable due-diligence on the firm with false documents, tours of fake offices and restoration projects, and so on. By 1987, the stock was selling at $18 per share valuing Minkow's stake at $100 million. With backing from Mike Milken and Drexel Burnham, he then embarked on a merger

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with KeyServ which was Sear's authorized carpet cleaner, and twice the size of ZZZZBest. At the eleventh-hour, one of the customers who Minkow had defrauded in his early years related her experience to the LA Times which published a story setting off a chain of events in which the merger was cancelled, the banks called ZZZZBest's loans, Ernst & Whinney resigned as the firm's auditors, and the company filed for Chapter 11 bankruptcy. In addition to the aforementioned crimes, the subsequent government investigation turned up evidence of laundering of drug profits and ties to organized crime.

Minkow was indicted in January of 1988, found guilty of all charges, and sentenced in March of 1989 to 25 years in prison and $26 million in restitution. In total, investors and lenders are believed to have lost approximately $100 million in the scam.

However, there is much more to the story! While in prison, he became a born-again Christian, and upon his release in 1995, became the pastor of a church in California. On the side, he started a for-profit company called the Fraud Discovery Institute in which he identified and published reports on publicly traded companies that he viewed as Ponzi schemes or similar frauds. As it turned out, he was shorting the stocks of these companies prior to releasing his reports in what is known as a "short and distort" scheme. Moreover, he was using church funds and property to conduct his outside business. One of his targets was the homebuilder Lennar, which fought back vigorously resulting in an investigation by the government and guilty plea by Minkow in 2011 to insider trading. He was sentenced to five years in prison and ordered to pay restitution to Lennar of $584 million. Unbelievably, the story still isn't over!

On the side, he started a for-profit company called the Fraud Discovery Institute in which he identified and published reports on publicly traded companies that he viewed as Ponzi schemes or similar frauds.

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In January of 2014, he pleaded guilty to embezzling church funds, charging unauthorized expenses on church credit cards, swindling church members, and defrauding the IRS. For this last batch of crimes, he received another five-year sentence to be served after the insider-trading sentence, and was ordered to pay $3.4 million in restitution. Minkow was released from prison in 2019 and now reportedly lives in a small town in Tennessee. However, he remains liable for restitution that some believe could approach a billion dollars with interest. Wow, you couldn't make up this story!

Why?

I want to briefly mention a couple of other individuals convicted of financial crimes and then raise an interesting question. Richard Whitney was educated at Groton and Harvard before embarking on a career on Wall Street that led to his serving as President of the New York Stock Exchange from 1930 to 1935. In 1938, he was convicted of embezzling from the Stock Exchange as well as the New York Yacht Club and given a sentence of five to ten years in Sing Sing Prison. Whitney was released in 1941, and while he ultimately made restitution of all the embezzled funds, his Wall Street career and reputation were ruined. Martha Stewart is a highly successful author, businesswoman, television personality, and writer whose net worth had crossed a billion dollars in 1999 with the IPO of Martha Stewart Living Omnimedia. Yet, in 2001, she sold her shares of ImClone stock based on inside information in order to avoid a $45,000 loss! She was convicted of insider trading and received a five-month jail sentence in addition to fines of approximately $200,000. Finally, Rajat Gupta was the CEO of McKinsey and Company and a director of Goldman Sachs, Procter and Gamble, and American Airlines. In 2012, he was convicted on three counts of securities fraud and one count of conspiracy related to his leaking inside information to hedge fund manager Raj Rajaratnam who was also convicted. Gupta received a two-year sentence and a fine of $5 million.

With the exception of Barry Minkow, all of the characters mentioned in this paper had substantial incomes, strong career trajectories, positions of authority and trust, notable reputations, and in most cases, significant net worth. Yet, they chose to commit crimes. Why?

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In 2016, Harvard Business School Professor Eugene Soltes published **Why They Do It-Inside the Mind of the White-Collar Criminal**. He interviewed eighty former corporate executives and financiers who had been convicted of a wide variety of crimes in order to try to understand their motivations, mindset at the time of their crime, and reflections on their experience given the benefit of the passage of time. Perhaps his most surprising observation is that most of their crimes did not represent carefully thought out, well-planned schemes. Instead, most really didn't think about the consequences of their actions and instead simply made a decision in the course of their day to day lives that set them on an irreversible and destructive course.

While not excusing their actions in any way, Soltes found that their environment contributed to or enabled poor choices. Specifically:

- In financial frauds, there is frequently distance between the perpetrator and the victim that makes rationalization easier. For example, in insider trading, the victim is unfamiliar and abstract.
- There is frequently a time gap between the commission of a financial crime and the realization of its impact.
- Pressure to achieve Wall Street expectations on sales and earnings combined with the structure of many compensation schemes creates an environment in which it is easy to succumb to expediency. The definition of success in much of the corporate world is the stock price and any effort to increase it is often praised and rewarded.
- Because white-collar crime is common, there is a sense that "everyone is doing it." Or, "what I did is not nearly as bad as what others are doing."
- Many of the perpetrators viewed their job as problem solving, even if the solution crossed the line.
- Many executives lack exposure to opposing points of view or what Soltes calls uncomfortable dissonance.
- In a global world, perpetrators are frequently not subject to the shame traditionally imposed by close-knit communities.

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On the other hand, Soltes identified a number of basic character flaws that are evident in the behavior of many of the people he interviewed. Perpetrators:

- Tend to have little empathy and a lack of self-control.
- Are extremely capable of self-deception and rationalization.
- Have a strong sense of invincibility.
- Are very capable of delusion.
- Rely on intuition rather than careful reasoning.

After reviewing this list of characteristics and circumstances, it is interesting to reread the biographies presented above and make an attempt to diagnose the critical issues in each case.

Protecting Yourself

There is very little one can do to be insulated from insider trading or corporate accounting fraud, but there are a number of things to watch for and steps to take to protect assets from scammers. Public vehicles such as mutual funds and ETFs are subject to considerable scrutiny and elaborate controls so they should be of little concern. The more problematic areas are less regulated asset categories such as hedge funds and other partnership vehicles. While their parent firm is likely to make good on any problem, even brokers and insurance sales representatives at reputable firms occasionally engage in Ponzi schemes, embezzlement, and other frauds.

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DIVERSIFIED TRUST

The most important overall recommendation that we can make: ***know with whom you are dealing!*** However, some specific suggestions are as follows:

- Be wary of firms that cannot explain their investment strategy in relatively simple and understandable terms.
- Be wary of a track record with unusually high and/or consistent returns.
- Make sure that your assets are held at a reputable, financially strong custodian or depository.
- Only invest with funds that use world class service providers including auditors, administrators, etc.
- Insist on documentation of insurance, bonding, etc.
- And once a relationship is established, monitor your statements for unusual activity, unexplained withdrawals, etc.

Most corporate and financial executives are hard-working people of integrity, and as we saw in the Angels section, there have been some truly extraordinary investors who also possessed admirable personal characteristics. However, there will always be bad apples. So, we should attempt to learn as much as we can from the exemplary investors but also take personal responsibility for our financial well-being by doing careful due-diligence on financial service partners and maintaining a reasonable level of vigilance over time.

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