**ELLIOTT ASSET MANAGEMENT**

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**January 8, 2008 Commentary**

# Elliott Asset Management had Nothing Invested With Madoff

***And, more importantly:***

1. ***Why didn't we invest when the fund beat the indexes for more than a decade?***
2. ***Can EAM embezzle funds like Madoff did?***
3. ***What can we learn from this recent catastrophe?***

I have had several people call me to ask me if we had any investments with the recently disgraced fund. Thank you or the questions because it made me realize there were probably others who also had this same question!

## Why didn't we invest in Madoff's (or any other) celebrated hedge fund?

For many of you it should come as no surprise we didn't invest a dime in Madoff's hedge fund. Not only did we not have any money invested with Madoff , but we continue to have no money invested in *any* hedge fund, whatsoever.

I have been writing for quite awhile that I believe most hedge funds to be too expensive, too secretive, and built on flawed assumptions. In October I sent out a newsletter entitled "A Thousand Popping Hedge Funds," where I explained why I felt a lot of hedge funds were going to run into serious trouble. I argued that, even without fraud, it is probable a hedge fund can "outperform" for many years, but the regular over-performance is built on dubious assumptions. I compare investing in some of these funds to buying all the spots on a roulette wheel except for one. You can make money like clockwork, but eventually you come out a loser.

For more discussion on this topic please see the enclosed, previously released, newsletter "A Thousand Popping Hedge Funds."

## What prevents EAM from committing the same fraud as Madoff?

In short: a lot! Though no amount of regulation or precaution can completely eliminate all possibilities for fraud altogether, most experts would agree the type of fraud Madoff perpetrated is almost impossible under EAM's business plan and procedures.

**Key difference #1:** *Investments in hedge funds.* Madoff invested his client's funds into a hedge fund**.** As we elaborated on in "A Thousand Popping Hedge Funds", a hedge fund is typically a secretive investment fund where clients often do not even know where their money is invested! Additionally investors must generally "lock up" their investments for extended periods of time.

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**Key difference #2:** *Active regulation.* Our clients accounts fall under the regulatory di authorities for both registered investment advisors and independent broker dealers. Thus our client accounts are subject to a double layer of regulation (not that I expect you to have much faith in the regulatory system right now!). Both EAM and your broker dealer are subject to spot audits – and one can assume the broker handling your account also takes extra care monitoring investment advisor decisions to avoid potential liability. Madoff's client accounts were not with independent broker dealers – they were all mixed together in his hedge fund.

**Key difference #3:** *Separately managed accounts.* Investors with Madoff did not have separately managed accounts for clients to access through an independent broker dealer. The nature of a hedge fund is that all assets are pooled and all clients have the same investments in the same proportion. We have deliberately asked your broker dealer (whether it be Scottrade, BrokersXpress, or Interactive Brokers) to continue to allow our clients direct access their accounts to receive information and confirmations/verification directly from the broker.

**Key difference #4:** *Control and possession of investment funds.* Madoff controlled the investment funds he invested his client money into. This is key. When EAM clients write a check to invest under our management they make checks out to an individually owned and separate brokerage account in their names only. EAM never takes possession of any funds or securities at any time. Those investing with Madoff made out their checks to Madoff's hedge fund which, due to the secretive nature of hedge funds, he was able to fabricate results and produce fictitious account statements.

**Key difference #5:** *Madoff produced his own account statements.* Investors felt confident each quarter as they received a professional-looking customized account statement from Madoff's firm. Regulation enables EAM to produce a similar statement. Even though we believe that producing customized account statements would be a great marketing tool for our business we believe existing client security and assurance from continuing to have statements issued directly from the broker are more important. Between a client's ability to call or log in to their separate brokerage accounts and the statements the broker issues directly to them our clients know where their money is at all times.

Finally each account we manage is protected by insurance policies from the SIPC, a government insurance program like the FDIC is for banks, and additional policies issued by major insurers. These policies protects client accounts from insolvency or fraud. $30 million per account is the minimum aggregate insurance any of the broker-dealers we use provide.

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## So what can we learn from the Madoff fraud?

**Take home message #1:** *Don't focus strictly on historical performance.* In fact if things look extremely good then ask even more questions! This is the same lesson investors have failed to learn from all of the bubbles and investment manias of the recent past: real estate, tech stocks, Chinese stocks/emerging markets, oil/commodities, and whatever happens next (I suggest treasury bonds). Don't assume because something has been going up in value that it is a good investment (and conversely if an investment has recently performed poorly don't assume it *won't* be a good investment in the future).

**Take home message #2:** *If someone appears to be a "guru" question very carefully before drinking the elixir.* Many stock brokers made a fortune off pushing tech stocks and real estate brokers pushing properties to clients even though it was later abundantly clear that most had no idea what they were doing. They were trusted because of recent things they invested in did well (most likely by luck). Abby Cohen gained notoriety for being "right" that tech stocks would continue their dizzying climb (based on flawed logic and luck ended in a crash, loss of her fame, and the financial destruction of countless investors. This lesson has failed to have been learned by most even though it repeats itself over time. In fact, investors are susceptible to going from one fad to the next. Don't do it! Parenthetically, this is the most important service EAM aims to provide to our clients (thus our strong stance against real estate investing several years ago and our similar stand against sub-prime and option-arm mortgages)

**Take home message #3:** *Understand your investments and resist believing in magic!* There is no formula that will assure success in any investment market. Anyone peddling a system or product claiming otherwise is likely selling snake oil. It is almost statistically impossible to have out-performance every year without any periods of under-performance. Even the best investors in the world will still have investments that are big losers and have periods of time where the average person does better than them – but great investors measure their success over *decades*, not year-to-year. For instance, Warren Buffet's Berkshire Hathaway stock fell by well over 50% this past year (versus the average US stock declining by about 45% over the same time). Several of his individual stock investments fell in excess of 75%. Invest in something or with someone because you *understand* the investments and they make sense, not because they promise you magic, have fancy formulas you can not understand (or can't see like hedge funds), or had great returns the last few quarters or years.

What are the fanciest investments you can think of that have complex formulas that seemed like "sure" ways to beat the market last year? I would put them in this order: 1) Mortgage backed securities (the root of most of our current problems). 2) Hedge funds

and 3) Annuities. I would also guess some of you may placed emerging markets and commodities/oil on your list. Usually when something is a "sure thing" and seems "safe" it is a surefire way to lose your shirt!

**Take Home Message #4:** *Live within your means and save for the future!* This is the most important lesson of all.

I have extensively written about how I felt the world (and the US, in particular) had become an almost "lottery economy." Most have been looking for the next get rich quick scheme and not focusing as much as we should on producing goods or services of value. Over these past few years I have often mourned about having to reject many clients because they thought they had money to invest when, in fact, they were a heartbeat away from financial catastrophe.

Especially in Southern California, I met many families of modest means who wanted me to aggressively invest amounts far exceeding their net worth because they expected – and needed – consistent double digit returns on borrowed money to pay their debt burden while continuing to fund lifestyles far exceeding their means. When I would proposed budgeting and belt-tightening before I could consider accepting any assets to invest they would cringe. "I *need my Lexus SUV,*" they would say. "It is safer" or "we go camping (once a year)." No amount of research or logic I could present on the relative cost or safety of their vehicles could get one soul to budge. And many of these families chose not to use our services because they would rather pay someone for bad advice so they can continue to live in a fantasy land. An ugly reality is fast approaching for many of them.

The way most people make money is through hard work, sacrifice, and saving. Why is it that many immigrant groups move in one generation from working class to affluent in one generation – even without formal education? Why is it the typical American family saves nothing from our paychecks as the typical Chinese family saves 20% of their income even though their lifestyles are far more spartan than ours? It is not magic why the Chinese economy will continue to grow through these tough times faster than ours have recently in the best of times!

Most of us Americans have been starry-eyed for too long as we continued on in our destructive spending ways. Our investments helped propagate our believe we could continue to outspend and live better lifestyles through returns on borrowed money. Most Americans likely found a broker, hedge fund, or annuity salesman all too happy to point out that China stocks returned 70% the previous year and commodities are on a perpetual upswing into the stratosphere – promising those huge, all but certain, returns would make investors rich even as they paid out sized commissions and fees for bad advice. I hope that America has learned her lesson on both spending and investing. As I stated in an

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earlier newsletter (also enclosed), that a serious and painful recession may be "just what the doctor ordered" to help wake everyone up to reality. Let's hope this bad tasting medicine works!

Finally I want to thank those of you who took my advice in October and November when I sent out my first plea in years for common investors to start being more aggressive with investing again. I believe the corporate bonds, municipal bonds and preferred stock we picked up will prove to be good investments over time; so-far, so-good! It is nice to know some of my advice is implemented, especially after being frustrated at saving virtually no one from the destruction from the implosion of the real estate bubble and tech stock bubble despite passionately arguing against both!

As always feel free to write or call if you have any questions or if you want to discuss any of the points brought up in this newsletter. And feel free to share what you have read with your friends and family.

Wishing you a Happy New Year (while living below your means!),

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