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Lessons remain for quant genius who helped expose Madoff

Dan diBartolomeo helped prove Bernie Madoff was a fraud. He says the collapse of Archegos Capital shows professionals still fall for things too good to be true.

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The death of fraudster Bernie Madoff in a US prison this week quickly prompted the question that's always hung over his $25 billion fraud: why didn't anyone twigthat his purported returns were too good be true?

But one of the men who helped expose Madoff's crimes says the recent implosionof Archegos Capital shows even the smartest people in the market are falling for returns that look brilliant – until they aren't.

Bernie Madoff's fraud went undetected for about 15 years. **The New York Times**

Dan diBartolomeo, president and founder of influential risk management analytics provider Northfield Information Services, is based in Boston; ironically his office sits just 500 metres from the former home of Charles Ponzi, the namesake for investing scams that generate returns for earlier investors with money taken from later investors.

Northfield has a reputation for solving difficult problems in financial markets and in March 1999 a client named Harry Markopolos, then chief investment officer at Rampart Investment Management, came to diBartolomeo with a puzzle.

A fund manager using a similar strategy to Markopolos' was delivering staggering results. How was he doing it?

DiBartolomeo was given only a few pieces of the puzzle about the entity Markopolos called Manager B, including a marketing document describing Madoff's split/strike strategy and monthly performance numbers going back seven years.

Within a few hours, diBartolomeo knew the manager was either a genius, doing something illegal like front-running his clients, or a fraud. By the end of the day, he'd run the numbers – there was a one in 200,000 chance Manager B was legitimate.

Dan diBartolomeo's number-crunching helped expose fraudster Bernie Madoff. **David Rowe**

DiBartolomeo handed his findings and moved on. But Markopolos used Northfield'snumbers to appeal to the Securities and Exchange Commission to take action on Madoff.

DiBartolomeo learned who Manager B was at Christmas in 2004, but it wasn't untilMadoff's arrest in December 2008 that he joined the dots and subsequently became a minor celebrity for a few days.

Speaking this week, diBartolomeo says he doubts the great lesson of Madoff's fraudhas been learnt.

"Financial markets are 'hand of man' rather than 'hand of God', so any amount ofpurported success in the past is only a very weak indication of the likelihood of success in the future.

"The situation with Madoff was a bit like being a wine grower in Pompeii ahead of the volcanic eruption of 79 AD. The soil was excellent and town was lively, but residents obviously knew the volcano was active, so the expectation of an indefinitefuture of prosperity was simply too good to be true."

Before things went pear-shaped

The failure to recognise what's too good to be true still happens and diBartolomeosays professionals who should know better are not immune.

The collapse of Archegos, which has cost Credit Suisse and Nomura over $US6billion ($8 billion) in failed margin calls, is a perfect example.

One of the stocks involved in that collapse was US media giant Viacom, which diBartolomeo says provides a neat example of why Archegos' prime brokers shouldhave been worried long before things went pear-shaped.

The stock was about $US100 on March 22, up 733 per cent from a year earlier, in a market that was up 70 per cent. That can happen, but Northfield's fundamental model data showed Viacom had a beta (measure of volatility) of 1.81 with a specific risk of 8.33 per month or 29 per cent per annum, suggesting Viacom's expectedreturn over that period would have been 127 per cent.

The chances of Viacom delivering the return it did in a reasonably efficient market is basically zero, diBartolomeo says – which is a pretty good description of too goodto be true.

"I am confident that the brokers financing Archegos were making excellent profits – until they weren't."