Probing Question: How do Ponzi Schemes work?

July 2 2009, By Solmaz Barazesh

Imagine the shock, the horror, and the sheer panic that would come with learning that the financial plan you'd sunk your life savings into was a sham, the financial experts you trusted were crooks, and all your money was gone.

Thousands of investors experienced that nightmare scenario in December 2008, when Bernard "Bernie" Madoff, CEO of the prominent Wall Street firm Bernard L. Madoff Investment Securities LLC, confessed that the asset management arm of his firm was "a total lie," as he put it. An estimated $65 billion of investors' money vaporized in the financial fraud that experts call a Ponzi Scheme. So how does such a scheme work, and how did Madoff trick so many people?

The Ponzi premise is simple, said Ed Ketz, an associate professor of accounting at Penn State. Ponzi victims -- typically those without in-depth knowledge of financial jargon -- are lured by the promise of fantastic returns on their money. Impressive-sounding terms such as "hedge futures trading," "high-yield investment programs," and "offshore investment" are bandied about, but in reality, the dividends paid to investors don't come from prudent analysis of the markets. Instead, Ponzi payouts come from the cash deposited by other investors.

"It's a charade to get new investments to feed the previous investors and further enrich the person carrying out the scam," Ketz said.

As long as new investors continue to inject cash, existing investors receive their dividends and have no reason to suspect foul play. However, when the economy slows down, the scam unravels, Ketz said. New investors stop investing and old investors want to withdraw their funds; that's when people realize there is nothing to withdraw.

Madoff apparently began his scheme in the 1990s. He claimed then to have devised a proprietary investment strategy he called “split-strike conversion,” when, in fact, he was simply depositing his clients' money into his Chase Manhattan account.

The Ponzi ruse isn't a new idea. This type of financial fraud is named for Charles Ponzi, a “confidence trickster” (the origin of the phrase con man) who fleeced New England investors in the 1920s. Before that, a similar scam was outlined in Charles Dickens' 1857 novel, "Little Dorrit."

So, if the Ponzi Scheme has been around for so long, why do people still fall for it?

It's all about trust and the potent lure of easy money, Ketz said. Madoff's investors thought they were being allowed access to lucrative investment secrets.

“People, even smart people, can be fooled by such schemes because they are drawn in by those who seem smart and experienced,” he said.

Plus, there is the added thrill of seeing an investment grow quickly, at least on paper.

“People commit to a Ponzi Scheme because they want to be winners. Earning money steadily by hard work seems so pedestrian compared to the temptation to get rich quick,” Ketz said. “A lack of clarity about the workings of an investment plan should be an immediate red flag.

Investors should be skeptical if fund managers say things like ‘you wouldn’t understand’ or ‘that’s private information.’ Those types of claims are attempts to deceive.”

To avoid scams, he suggests, learn exactly how an investment plan works.

“Warren Buffet is one of the world’s most successful investors, and he has often said that he does not invest in anything he does not fully understand. Those who follow his advice will not fall prey to a Ponzi Scheme.”

Source: By Solmaz Barazesh, Research/Penn State

Citation: Probing Question: How do Ponzi Schemes work? (2009, July 2) retrieved 19 April 2024 from https://phys.org/news/2009-07-probing-ponzi-schemes.html

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