Madoff rip-off shattered trust, changed investment behavior

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Notorious financier Bernie Madoff bilked more than 10,000 investors out of billions of dollars in the 1990s and 2000s in the largest financial fraud in U.S. history. But the effect of Madoff's elaborate Ponzi scheme

rippled far beyond his direct victims.

For the first time, a Cornell University researcher and his colleagues have quantified just how much the rip-off cost the financial industry.

After the fraud was discovered, people who knew Madoff's victims or who lived in areas where victims were concentrated lost trust in the financial system and dramatically changed their investment behavior, according to a new Cornell study recently published in *The Review of Financial Studies*.

The investors yanked $363 billion from the financial advisers they had entrusted with it - even though many of those advisers had nothing to do with Madoff - and stashed a significant portion into safe assets such as bank deposits.

"People lost trust in these advisers. Everybody just ran," said Scott Yonker, co-author of the study, assistant professor of applied economics and management.

The $363 billion in investment withdrawals is nearly 20 times the $17 billion in restitution the courts ordered Madoff to pay his investors, Yonker said. "That's a pretty big effect. The withdrawals were so hefty in some areas that some investment firms ended up shutting their doors and going out of business," he said.

Investment firms with clients in regions that were affected by the fraud were over 40 percent more likely to close than firms in a control group. Those who had the ability to steal from their clients lost more of their clients' business. In contrast, advisers who were able to build more trust with their clients, such as by offering personalized financial planning, had fewer withdrawals.

From the 1990s through the late 2000s, Madoff deposited his clients' money into his personal bank account, rather than invest it and generate steady returns as his clients had expected. When his clients wanted to liquidate their investments for cash, he dipped into the bank account to fund their requests.

The Securities and Exchange Commission investigated Madoff several times. But it only discovered the fraud when Madoff's sons turned him in, in 2008.

Yonker and his colleagues used court documents to identify the names and addresses of more than 10,000 victims, who were concentrated in the Northeast, parts of California and around Miami. The team also compared that information with the assets managed by nearly 4,000 investment advisers and deposits in 97,000 branches of banks in 20,600 ZIP codes.

Crunching that data, the researchers showed investors' trust in Madoff - and their friends' and neighbors' subsequent distrust of the financial system - spread by word of mouth. The key? Madoff targeted elderly, wealthy Jewish investors in what is known as an affinity Ponzi scheme.

"These schemers basically take advantage of some commonality in their background. In this case, Madoff was Jewish and his clients were Jewish," Yonker said. Religion is the second-most common source of this affinity link in Ponzi schemes, after family and friends, he added.

The loss of trust was strongest in areas that were home to both Madoff victims and a large number of the affinity group. "It propagated through this social network," Yonker said.

Even four years after the fraud was revealed, the researchers found no evidence that investors had reversed their withdrawals from the stock

market.

"We show the importance of trust in investors' allocation decisions," Yonker said. "At the macro level, economic growth critically depends on the efficient allocation of capital.

"Capital flows stemming from distrust in intermediaries instead of the underlying investment opportunities can potentially lead to suboptimal allocations," he added.

Provided by Cornell University

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