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Management Lessons From Bernie Madoff

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You have no doubt heard and read numerous bits of information about Bernie Madoff's infamous $50bn Ponzi scheme. It is really quite surprising how large, how widespread, and for how long (perhaps up to 30 years) this dubious investment scheme lasted. Or is it? You see the "marketing strategy" that Bernie Madoff exploited so well was leveraging the inherent weakness of people's use of emotions. More specifically, the dangerous use of emotional thought to make key strategic decisions when the downside risk is very large. Think this doesn't apply to business management? Think this doesn't apply to you? Read on and see if you are right.

The Ponzi Scheme

As a quick background, the Ponzi scheme was named after Charles Ponzi, an Italian who immigrated to the US in 1903 and was subsequently jailed for his version of the scheme in 1920. A Ponzi scheme essentially operates by using newly received investment dollars to pay "returns" to existing investors above that which is normally achievable in the free market. This means that you need a steady supply of new investors in order to continue paying "returns" to the growing number of existing ones. These schemes eventually collapse when enough new investors cannot be acquired to continue paying "returns". When the existing investors notice the sudden lack of returns they begin investigating why. At that point it is too late. Everyone typically loses everything. One key differentiator that Bernie Madoff utilized in his scheme was the use of a broad, but "exclusive' network of individuals who trusted each other due to long standing relationships. They, in affect, sold each other on the Madoff scheme, which is why Madoff's "marketing strategy" was so successful. Madoff also positioned his scheme as "exclusive", meaning that many considered themselves lucky to even have a chance to participate.

Management Lessons

So, what lessons can business managers learn from Bernie Madoff's Ponzi scheme?

- Networking is a double edge sword: It had been drilled into our heads repeatedly that networking is the best and most effective solution to solve almost any business or personal challenge. Like most commonly accepted "rules" this one is basically true in most circumstances.

Some caveats:

- Networking can limit your scope. You only know so many people. Usually the people closest in your circle of contacts are the ones who think most like you. If you are looking for new or creative ways to solve an issue, looking outside your network can be very beneficial. There are many effective ways to screen and background check people outside of your network. Don't be lazy.

- Networking does not replace due diligence. Just because your good business buddy Joe recommends that new marketing executive, don't throw due diligence out the window. Many of Madoff's victims stated that they didn't press for normal background information because they didn't want to "insult" their network introduction and possibly lose out on the opportunity. Madoff capitalized on this and so do others. Remember Ronald Reagan's phrase during the nuclear arms treaty negotiations with the USSR. "Trust, but verify".

- Hiring an expert does not mean abdicating responsibility. When managing a company there are times when it is necessary to hire an expert to assist with an issue or opportunity. This may include attorneys, CPA's, management consultants, etc. This also includes hiring key employees. This does not mean, however, you can then abdicate all responsibility to that individual and move on to other things. Instead you should:

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- Get educated. Any expert (or employee) you hire should be willing to provide some basic level of education in the service they are providing. If they refuse, find someone else. You don't need to be an expert in all areas but you should always be expanding your knowledge base and understand what is being done on your behalf. Then monitor it.

- Always perform the due diligence. No matter who refers you to the expert, check references and interview the person as you would a stranger. Many of Madoff's clients didn't have the time for this either. Guess what their spending their time on now?

- If it sounds too good to be true it is. Ever interview a candidate who sounded just great. They had all the right answers. Then you ask them the classic question, "What was one of your biggest business mistakes and what did you learn from it". Problem is they didn't make any mistakes. How did that person work out?

- Take personal responsibility for your life and your business. This is more important now than ever. I recently read a headline in the Boston Globe newspaper that shocked me. "Middle class sits helplessly by and watches retirement savings evaporate". What? Why would anybody sit helplessly by and watch their retirement evaporate? Would you do the same with your business? Get active. Get educated. Get involved and make a decision. Several of Madoff's clients had suspicions and never followed up on them. If you are paralyzed with fear get help to move forward.

- There is no inherent fairness doctrine in business. Justice is driven by competition not by law. Therefore, you need to look out for your own best interests both personally and professionally. Martha Stewart did jail time for a $60K inside trade. Bernie Madoff is still living in a $7M downtown Manhattan condominium. His only restriction is that he needs to be home each night by 7:00 PM. Enough said.

- Out of crisis come the biggest opportunities. Most people follow a herd mentality during a crisis. Just look at the stock market. Virtually every US company regardless of quality of management or earnings has been dumped. Does this make sense? Crises like these are like a forest fire, a painful but necessary periodic cleansing of the environment. Remember out of every forest fire comes new growth and a healthier forest which will flourish for the next hundred years. The species that flourish will be the ones that learn to adapt to the new environment the quickest.

More Important Now Than Ever

I had a conversation with a relative over the Holidays about work and the current economy. He went on about how nervous I must be working for my own consulting firm in a time like this. He has worked for a major investment firm for 15 years. I pointed out that we actually had a lot in common but that my employment risk was actually quite a bit lower than his. My points were:

- We are both employees at will.
- We are both paid on a consistent basis based upon our ability to continue providing a service that someone else deems worth the cost.
- The security of our incomes is based on the health of our respective companies.
- I run my company so I will always know its health and can take immediate and unilateral action to address any risks and/or adapt to any changes to the business or its market.
- You rely on somebody else to do that for you and hope they are good at it.
- That is not how the new forest is growing and I have already begun to adapt.
- Have you?