Duck tales

*One does not have to be a detective, or even a financial expert, to spot financial institutions that **may** prove insolvent, or worse, with the passage of time. As the saying goes, if it looks like a duck, if it waddles like a duck and if it quacks like a duck, it must be a duck.*

The financial world has been in a state of turmoil after the recent financial and investment scandals. The collapse of seemingly rock-solid institutions, billion-dollar swindles and hoaxes are everywhere. It seems there is a new case every day.

The "talking heads" of the world have naturally taken up on this. Calls for stricter regulation are a constant, which is quite understandable. Nobody likes to see "innocent" people suffer at the hands of unscrupulous financiers.

But one has to be a realist also. These rackets and hustles are as old as humanity itself and have been going on since Ug sold Og the "magic stone" that made fire. Regardless of how much effort is put into controlling or supervising everything, there will always be a loophole somewhere that a rip-off artist can wiggle himself through. There is a proverb in Spanish "Hecha la ley, hecha la trampa" (or Italian "fatta la legge, trovato l'inganno) which is something like "where there's a law, there's a loophole." Scams will continue regardless of the regulatory hurdles thrown at them. They'll morph or mutate, much as pathological bacteria do when facing an antibiotic attack.

One must also face up the fact that if you are on this planet long enough, you will become a direct or indirect victim of one of these frauds. Sooner or later, it will happen. It can be from being confident, trusting, naïve, greedy or careless. Or simply stupid. But it will happen. We've all been "taken" at some point. If not in a monetary deception, who hasn't been deceived by a 'friend," relative or "significant other?" It's human nature. Gall will usually trump incredulity and skepticism. When one thinks "he/she couldn't have," well they could…and then some.

How can you protect yourself? How does one avoid being the victim of the next Madoff, DMG, La Vuelta, Gumi or Banco Latino?

First off, one must realize that nothing is safe or sacred. There is a risk and margin of error in everything, and in financial issues, even more so. The rubber stamp of the CNV, SEC, FDIC or an auditor or the "word" of a friend or partner are all relative. Nothing is safe or "sure." Madoff duped the SEC, Enron had its way with "Arthur Anderson," and recently Saytam, a large Indian company, tricked the powerful auditing firm of PriceWaterhouseCoopers.

Everything is relative and everything can be a lie. However, unless you wish to live like a hermit there is no modern life without risks. The goal is to assume the risks that you think you can manage and do your best to keep them under control. In business (and why not?..in love also!), if you don't bet you can't win and if you don't play you can never win.

Another thing many can't grasp is why these scams aren't uncovered. The truth is that most of them are "found out" all by themselves or when the circumstances make it obvious. Madoff could have continued forever had he not faced fund redemptions with which he couldn't comply. Pyramid schemes collapse when they run out of marks. And it's not just because the participants are happy while they are collecting profits. It's that a good scam is really hard to detect and almost impossible to uncover without inside help.

Being "almost sure" is usually "not enough." How do you blow the whistle when you're "almost sure"? It's preferable to not get involved and the skeptic will keep it to himself. Frankly, what does a whistle blower have to gain? So normally he'll back away from the suspicious deal and leave things as they were.

With financial institutions, it is twice as touchy. A suspicion can be considered a "destabilizing rumor" and on certain occasions (though less often than one thinks), an unfounded rumor can turn into a self-fulfilling prophecy. Yours truly still recalls when an extract from a report about Banco Mercantil was taken out of context and splattered on the front page of a newspaper, generating a mini-run on the bank. The bank survived obviously (it was structurally sound…a fact also stated in the report), but the affair left a bad aftertaste. The analysis was correct and the quote was word for word, but a third party maliciously manipulated it.

Back to how to protect yourself. The best scam antidote is common sense or what is called the "Duck Theory." The Duck Theory states quite simply that: if it "quacks" like a duck, if it walks like a duck and it has a bill like a duck…IT'S A DUCK!

The only way to be 99.99% sure that it's a duck is to extract its DNA and analyze it and even then there is margin for error. I respect Heisenberg; there is no absolute certainty.

So what does a financial duck look like? Its traits are many and varied, but here are a few:

1. It's too good (to be true)

I still recall that Gumi (a pyramid scheme in Bolivar in the '90s) would pay 20% monthly interest on deposits. DMG (Colombia) offered to fully recharge members' prepaid cards after six months for free. Madoff didn't make any claims, but he had a track record of producing returns that consistently outpaced the market, without the volatility (risk) that usually goes with it. Banco Latino's rates were far higher than the rest of the banks'…and so on.

There's usually something very attractive or juicy being offered or else no one would get in. The catch is that it can be too attractive. The most successful schemes, such as Madoff's, straddle the "limit of reasonability," and that allows them to survive for a long time.

2. It can do what no one else can

Finance is a lot simpler than most people are led to believe (we analysts must appear to be important). Most things can be explained with simple arithmetic. When the numbers or the explanations become too complex…beware!

What was Gumi doing that enabled it to pay 20% a month? The whispered answer was that it was financing drug traffickers.

Not true! Frankly, why would traffickers need to finance their operations at those loan shark rates? Drug lords had the opposite problem, tons of cash to launder. It was all a lie of course; Gumi was a simple pyramid scheme.

Enron, in its day, was into innovative and "exotic" businesses. They even had supposedly established a trading market for "bandwidth." Their financial statements were almost impossible to decipher and there was good reason for that. They were a lie.

More recently, Madoff's hedge funds would rack up extremely consistent monthly gains, which were far above the market average. It didn't seem that strange; there are people who are very good at the investing game. But they were a bit too large and too consistent. Everyone gets tripped up once in a while. Not Bernie. Quite a few people thought he operated with insider information…and that's why they invested with him!

3. There are few people (or only one person) overseeing everything

It is suspected that Madoff operated alone or with a small group of collaborators. His auditor was a personal firm that worked out of a storefront office in New York. His multi billion-dollar hedge fund operated on a secret floor manned by only 19 people.

In the Barings scandal (1995), trader Nick Leeson managed to be able to execute his trades and control how and when they were booked. He lost a billion dollars and "broke the bank" before anyone found out. A similar story emerged in 2008, when Jerome Kurviel lost five million euros for Société Général. The point is that lies and secrets are best kept when few people are involved.

4. Few incentives for whistle blowers

Madoff was a philanthropist and a NASD director. His client list was a "who's who" of the rich and famous. His detractors and those who suspected his activities weren't "kosher" were considered envious of his success.

Who was going to uncover the mess? The SEC? Based on what? Madoff sent all the information legally required of him and signed by his auditor. The SEC (not unlike the Venezuelan CNV) doesn't conduct audits itself; it just makes sure that somebody does.

At one point, 22,000 people worked for Enron and they were all really busy. But the company overvalued assets at offshore affiliates (aside from other accounting tricks) and was one big house of cards. Who was going to risk their job and career, trying to discover and denounce the truth?

A case study

Thank you for bearing with me up until this point. Your patience is about to be rewarded. Here is a case study: a duck "possibility" or better stated, something that could be a duck.

And a "live" one, to boot.

A friend contacted me recently to ask about an offshore bank where he had deposited part of his savings. Not a great amount in the large scheme of things, but an important sum for him. I promised I would take a look at the "animal." Fortunately, there was information about the bank on the Internet, along with its audited financial statements.

This is a bank that operates on a small Caribbean island, inhabited by less than 100,000 people. Roughly, a population the size of Altagracia de Orituco.

What is being offered?

The bank offered (still offers) high interest rates on CDs. Up until recently the rate was about 7.5% on a one-year deposit. That compares quite favorably with 4-5% that U.S. banks were paying in the best case scenario, and recently rates have fallen below 3%. My friend told me that its rates had always been that high.

This has been an extremely successful strategy for the bank, at least as far as deposit growth is concerned. The bank's deposits have grown from $624 million in 1999 to over $8.4 billion at year-end 2008. That's an average compound growth rate of 34%!

Now, **that** is unusual. Very aggressive deposit growth is usually a "red flag" for banks. It's difficult to invest such a deluge of money efficiently. It also indicates that something may be "too attractive."

Oops…I think I saw a feather!

How does the bank operate? What does it do with the money?

The bank operates on a quite unique business model. It basically takes deposits from investors all around the world mainly in the form of time deposits. But it doesn't make loans (technically, a depositor can take out a loan with his/her own CD as collateral, but that's all). It has practically no service revenue.

Only 75 people actually work for the bank on the island, but it captures deposits through a global network of independent affiliated "advisors" who receive a commission for delivering deposits to the bank (a high one…1.5% per annum).

In order to make money, the bank invests in the capital markets. Stocks, Bonds, Hedge Funds, Precious Metals and currencies. Those are really fascinating things that go up and down and deliver great profits sometimes, not so much on other occasions, and at times (not few, especially recently) go down in value as well.

You may be inclined to say: "lots of banks do that." Not so. The so-called "investment banks (of which there are few left), have several other businesses which generate revenue, such as underwriting, mergers and acquisitions, brokerage and asset management. Yes, they have trading divisions, but the fee-based businesses generate a stable flow of income that (usually) allows them to weather the ups and downs of the trading business.

Commercial or retail banks will also "invest" money as part of their strategy. But these are usually arbitrage situations. For example, if a bank can receive deposits from the public at 2% and use them to buy government paper with a 4% yield and a similar maturity, it is a low risk strategy which banks will execute quite gladly.

But that's not their main business. Normally banks will pay little, charge a lot and still have a hard time making money on the margin. They make their profits with service charges.

Back to our bank, which according to its financial statements, as of the end of 2007, was 42% invested in stocks, 20% in fixed income (bonds), 25% in hedge funds and 13% in precious metals. That is a relatively typical allocation for this bank and over

PORTFOLIO RETURNS

Year	Overall Portfolio	Stocks	Hedge Funds	Precious Metals	S&P Index
2003	14.4%	N/A	N/A	N/A	26.4%
2004	11.5%	8.2%	16.9%	12.3%	9.0%
2005	10.3%	8.8%	21.6%	9.3%	3.0%
2006	11.0%	11.7%	25.1%	14.9%	12.8%
2007	11.4%	8.2%	25.0%	15.0%	3.8%
2008	6.0%	N/A	N/A	N/A	-38.4%

the last few years it has gone from a low of 27% in stocks (2004) to a high of 60% in 2006. Nothing to see here, right?

How about this? The return on the portfolio over the last years: 2003: 14.4%, 2004: 11.5%, 2005: 10.3%, 2006: 11.0%, 2007: 11.4%. Can you see a pattern emerging? One of consistency.

Considering only the stock portfolio, the returns were: 2004: 8.2%, 2005: 8.8%, 2006: 11.7%, 2007: 8.2%. Nothing out of the ordinary, right?

Consider the returns on the S&P 500 the same years: 2004: 9%, 2005: 3%, 2006: 12.8%, 2007: 3.8% (we'll talk about 2008 later). The bank did quite a bit better than average.

As for other categories, they report a 22% average annual profit on their hedge funds and 12% on precious metals. Not bad at all.

This could seem quite "normal" for someone who is not in the investment world, but these performance figures are very, very good. The last few years have been incredibly challenging for investing in most of these categories. In the ´80s or ´90s, returns of this magnitude could be considered "normal." Since 2000, however, they are on the "limit of the credible universe."

I really would like to know which stocks, bonds, funds and metals these folks have invested in to achieve such returns.

Unfortunately, that is something they don't reveal. As an investor, I love to "toot my own horn" when I get something right. The bank doesn't. One could argue that their portfolio is made up of private companies, not publicly traded ones. There is some of that in the group of companies mentioned to be associated with the bank, but it´s not clear if those positions are in this portfolio. Anyway, that private equity portfolio includes stock in a resort developer, three motion pictures, a golf club manufacturer, a golf course, an auction house and a restaurant in Memphis. These are small companies which could not represent a large portion of the bank's assets and frankly looking at their nature, look more to be a millionaire's "toys" than investments.

Back to our case study. Even if everything that this institution publishes and states is 100% true (apologies to Heisenberg), a "depositor" at this bank is effectively lending it money so the bank can then go out and play the markets with that money (the bank has $16 in deposits for each dollar of equity). That fact alone is somewhat unsettling. Fortunately, the bank has consistently achieved above-average results in all its investment categories.

That is, they have done what few (or no) others can.

What's that? I think I heard a "quack."

Who manages and controls this animal?

As stated above, the bank has 75 employees on the island. But a small group manages it. There is mention of an investment committee, but the members of the committee are not named. A few years ago there was an actual investment manager or VP; now the position appears to be vacant. There is one board member, an 85-year-old cattle rancher and used car dealership owner who has the title of "Investments," so one can presume that he advises some about that.

The management team and board has basically been the same for many years. There is no mention of any special investment technology or strategy that can account for the results obtained so far. That is, unless you count "long-term, hands-on and globally diversified" as a strategy and not just a catch phrase. An $8 billion portfolio is not easy to manage, at least not efficiently (to which the Barings and Société Général traders can attest).

Without further information, we must assume that the administrators are extraordinary beings.

What about the stockholders? There is only one. He has the title of Chairman of the Board and doesn't appear to have management responsibilities at the bank.

Auditors? Well, yes, the financial statements of the bank are audited. The auditor is a local (island) firm. The principal is a 72-year-old gentleman who has been auditing the bank for many years (at least ten). PriceWaterhouseCoopers and KPMG have offices on the island, and it is a good internal control practice to change auditors every few years, but the bank prefers to stick with its trusted firm.

The banking authorities which supervise the bank are those from the island. The same island with the population similar to Altagracia de Orituco. The bank does not take institutional deposits or deposits from other banks. This is not necessarily a bad thing, but corporate depositors would be expected to do some due diligence on the bank before committing their money.

Hmm. This animal walks in a very peculiar way. Like a waddle.

So why hasn't anyone noticed or said anything?

There isn't really an interest in drawing attention to this case. The depositors are not likely to suspect and much less say anything. Does anyone really read those financial statements that are lying around in bank offices? The local authorities prefer to leave these people alone. If the bank goes elsewhere, who is going to build schools and maintain the roads and gardens? The bank plays an important social role on the island.

The depositors are people from around the world, but perhaps not enough from one place in particular to arouse the interest of a regulatory agency. It is out of their jurisdiction anyway.

The owner is a powerful man. A "Forbes" list billionaire. Any unsubstantiated suspicion could have legal consequences for the denouncer. Perhaps the nature of this beast is a "well-known secret." Many think it's strange, but no one wants to say anything.

Hey…the animal has webbed feet!

IT'S A DUCK! (I presume.)

I almost forgot. The bank's name. It's the Stanford International Bank, located in the paradisiacal island of Antigua in the Eastern Caribbean.

The name has nothing to do with Stanford University, a well-known U.S. learning institution. It takes its name from owner Sir Allen Stanford, a Texan billionaire and cricket aficionado. Sir Allen has organized cricket matches on the island with $20 million prizes for the players. The Antiguan authorities knighted him, not her majesty Queen Elizabeth II. He was recently named World's Finance's "Man of the Year" for 2008.

A little update on things also. For those who may not know, 2008 was an awful year for investing. The S&P had its worst performance since the great depression, falling 38%. Few investment categories weathered the storm. For stocks, corporate bonds, commodities, currencies and/or hedge funds, it was all pretty bad.

In a Nov. 28 note to its depositors, the Stanford International Bank acknowledged that it had performed poorly. But just "a little" poorly. They acknowledge a $110 million loss up until that date (a quarter of the equity). Doing a little math, that doesn't mean that the bank's investment portfolio lost money (like almost everyone). It means that they didn't profit enough to get back to break even. Since the bank invests the money of its depositors and has to pay them interest plus the commissions to its affiliated advisors, it must earn at least 8-9% on its investments in order to compensate these costs. The bank is recognizing that in 2008, the year of the great crash in the markets, it "only" made a 5-6% return on its portfolio. Quite an act of contrition. The bank also affirms that it had no positions in Bernie Madoff's funds. What a relief!

Additionally, to improve the bank's financial standing, the bank has issued $541 million in new capital, presumably out of Sir Allen's bank account. This was for the peace of mind of the bank's over 30,000 clients. But then, the 2007 audited statements affirm that bank had over 50,000 clients. Well, if it's more than 50,000, it's more than 30,000 also, right? Or maybe a few clients got lost.

Another little tidbit extracted from the Internet. Health Systems Solutions (HSSO) is a small ($8 million market cap) health technology company in which SIB reportedly has a 20% stake. In October 2008, HSSO offered to buy another company in the industry: Emageon Inc (EMAG) for $62 million. Emageon accepted and the deal was to close in December after EMAG's stockholders approved it. SIB was supposed to fund the deal (we're assuming taking an equity stake, since they do not provide loans by definition). SIB did not send the money when agreed and EMAG filed a complaint in Federal Court. The two parties (HSSO and EMAG) later reaffirmed their merger intent and agreed (on Dec. 29) to extend the closing deadline to Feb. 11. Because of SIB's initial failure to fund, HSSO was required to put up additional escrow amounts and faces additional penalties if it fails to deliver again.

SIB's failure to deliver those $62 million is a bit perplexing. According to its financial statements, the bank is extremely liquid. Even if the 2007 statements are a bit dated, at that time there was $627 million in cash and of the $7 billion portfolio, about 90% of the portfolio was listed at a term or one month or less. Such liquidity is a constant in SIB's financial statements over the years, so we must presume that this time the deal should close. We'll be keeping an eye on it.

All along this taxonomical discussion, we have been saying that the animal certainly looks like a duck. True to Heisenberg, we must be willing to admit that it may not be a duck, if better evidence indicates that it is not. What would be better evidence in this case? How about a complete audit by a more familiar name such as KPMG? Or maybe a statement by the bank's global custodian, a Credit Suisse or a Morgan Stanley, affirming…"yeah these guys have $8 billion worth of securities in custody with us." That would be nice. A DNA test very difficult to refute, if you will. But if it were only the animal saying it's not a duck…that would sound like a bunch of quack.

Summing it up, be careful. But in particular, be careful with animals that look like ducks that say that they're something else. Because they could be that other something, although it's very likely that they are just ducks.

Disclaimer: The Stanford Group operates a commercial bank in Venezuela. I have not analyzed this bank and am unaware of its relationship with Stanford International Bank. Please, do not accuse me of destabilizing the financial system.

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