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ELECTRONIC Q&A

Living to Tell About Madoff

By TIERNAN RAY | MORE ARTICLES BY AUTHOR

James Hedges suspected there was something wrong a decade ago.

JAMES HEDGES, PRESIDENT AND founder of LJH Global Investments in Naples, Fla., has invested billions in hedge funds and private equity since 1990 through relationships with numerous hedge funds.

His clientele have been said to include the Cargill family, of the privately held agriculture giant Cargill, Inc. He's also helped out the University of Pennsylvania endowment and the Rockefeller family, if legend has it correctly. And in 1997, he took a meeting with Bernard Madoff in New York to consider placing money with the man now accused of perpetrating a $50 billion global Ponzi scheme.

Barron's chatted recently with Hedges about why he was able to dodge a bullet when he walked out of Madoff's offices eleven years ago without a deal.

Barron's: *You once took a pass on investing in Bernie Madoff's fund. What troubled you?*

Jim Hedges: I went in 1997 to meet Madoff, and spent two hours with him in his offices. His manner with me was wildly outside the traditional rapport I have had with managers and the kinds of access I have had to managers. I was told it was unusual for him to meet with anyone for that length of time, and that he was perturbed with the process. His whole tone during the meeting was curt, truncated, and he volunteered nothing. It was an extraction process to get him to answer anything. He was distracted the whole time, looking at people out on the trading floor through the glass wall of his office. Mind you, I was coming in to potentially invest billions of dollars for prominent families and institutions, representing extraordinarily well-known clientele. I couldn't be more the type of person for whom you would open up the kimono. And what it told me was that it was a fraud, full-stop. It was wildly impressionable on me. I have said over the years to many people: Do not touch Madoff with a barge pole.

Q: *What didn't you like in that initial interview?*

A: We have a due-diligence questionnaire that we use as a template for any investment. It's substantial, about 40 pages of factors we have to get comfortable with. It covers management's trading strategy, the back office, the pricing mechanism for the portfolio, how the manager is compensated, the checks and balances, and governance issues, and a whole host of other factors. We could barely get past page one with Madoff before alarm bells were going off. On the strategy itself, when I asked him to explain his investing strategy, it didn't line up. His strategy was like [defunct hedge fund] Long Term Capital Management, where you're saying you're going to sweep up pennies and nickels around the globe via arbitrage opportunities. His representation that he was going to get free money gains from the marketplace, without a principal risk, didn't make sense. One of the most important things in any fund investment is having realistic expectations. The client and manager buy into the same expectations. I looked at the return pattern that was offered, and my immediate reaction was it was too good to be true because of its predictable consistency. I saw no correlation between the strategy and how he delivered returns. I felt that the returns looked like what I and others have coined as "manufactured." In good times and bad times to have this consistent, narrow band of returns is not reality.

Q: *What else bothered you?*

A: I literally remember waving my arms in the meeting and saying -- I'm going to guess -- there were, like, 50 to 75 guys trading [stuff] behind his glass wall, out on the trading floor.

So what do these guys do? I asked. Because when you're investing with anyone, you want to meet the chef, and the sous chef, see who's preparing the dish. That request was turned down.

We don't ever allow investors to meet our team, is what Madoff said. I said, Let's go into pricing. Who holds the securities?

Manager's Bio

Name: James R. Hedges IV

Age: 41

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He said, We hold the securities. There was no global custodian, no prime broker. That never happens in a real business.

I said that what we do is look at three to five years of audited financials on funds.

He said, We're not going to provide audits. I was there representing a billionaire family, and to be told I couldn't gain access to an absolutely correct and appropriate thing to ask for, was amazing to me.

Title: President, founder, and chief investment officer, LJH Global Investments.

Education: Bachelor's degree in French and international studies, Rhodes College, Memphis, Tenn.; Master's degree in international management, American Graduate School of International Management ("Thunderbird"), Phoenix, Ariz.

Hobbies: Serious collector of contemporary art.

And then we get to an issue that is an enormous red flag to me. It was rumored to me at the time that there was $15 billion in assets under management at Madoff's operation. The assets have always been a heavily veiled secret. When I asked about assets and was patently shut down, it was moving beyond the realm of red flags into, This guy's got something to hide.

Q: *How is it that reputable hedge fund consultants such, as Tremont Capital, could have backed investments in Madoff's fund with all these red flags? What could Tremont and others have possibly been thinking?*

A: I was far from the only person to draw the conclusions that I drew about Madoff. Madoff was the fraud that happened in full view, with lots of complicit partners. This kind of thing requires complicit behavior. I believe the due diligence conducted by investors who were there was faulty, or possibly they were lied to, or it was not even done at all, perhaps put aside in deference to a relationship with a con man. Fairfield Greenwich allegedly derived some $300 million per year from their Madoff product -- that's the rumor. When someone is paying you or me or anybody that much per year to go to polo matches with high-net-worth investors and tell them about their portfolio, or on their boat in the south of France, it's hard to imagine [that] one's vision doesn't get skewed. Tremont had $150 million of their value attributable to their Madoff feeder fund. You want people to believe that all that's squeaky clean because you're getting a $150 million payoff.

A: *Is that common, that kind of conflict of interest, in this case?*

Q: A lot of this money in Madoff's operation came from European private banks with disintermediated private clients. If you go to one of these big private banks and look at their list of top managers, Madoff was always on the top of the list. You go around, as I've done for years, in London, Geneva, Monaco, it is always the same list of where they're putting their money. There's a "group-think" thing. And while the private bankers obtain fees for taking custody of the assets from investors and providing oversight and advice, the private banks and most of the conduits and feeder funds also were receiving what I call retrosessions -- fee rebates, soft dollars, however you want to term it. Some money was coming back from Madoff himself, so that the banks and conduits are getting paid both ways.

Q: *Is there further fallout for the hedge-fund business?*

A: The shake-out from this is so far-reaching, it is the most fascinating story in my entire 15-year history of investing billions in hedge funds. It will impact hedge funds and fund of funds, because people are going to have to liquidate other positions. The real estate market, the art market, other asset classes, people will be seeking liquidity. The charitable foundations that won't be able to make gifts. The way in which hedge funds are marketed and managers' diligence is going to have to change.

Q: *So what's to be done?*

A: If investors get more strident and responsible about due diligence and who they do business with, and hedge funds [are] more properly governed, this could be a silver lining in the next couple years. Hedge funds are a great business that has really, really gone wrong. It used to be all about innovation and performance. It was not about gaining access to institutional clients and having too much money to put to work.

As for regulation, the SEC had cited Madoff in '94 for some trading violations. You can go to the SEC's Web site type in an advisor's name, and they pop up, and you can see if there's [anything] on them. Thousands of people never took the opportunity to do that with Madoff. While the SEC is taking culpability, at the end of the day, this is a situation where, it's not about regulation. I'm not against further regulation in the least bit, but prudent regulation and procedures that are called for here to prevent this from occurring again -- not just more regulation for regulatory sake.

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