

The Failure of Crowds

Allen Stanford's Ponzi scheme is a stark reminder of our collective inability to discern wisdom from crowd behavior, especially in financial decisions.

The Miami Herald today published an expose, here, of Allen Stanford's final, desperate days to prop-up Stanford International Bank, in Antigua. Stanford Bank had sold \$7 billion worth of fake certificate of deposits to unsuspecting investors, including the Libyan government, which was defrauded of nearly \$140 million. The well-researched story, covering nearly 2 full-spread newspaper pages, details Stanford's increasing desperation and failed attempts to attract additional investors to his Ponzi scheme in its final days.

In searching for a theme, a unifying theory of Stanford's fraud, it became apparent that there was none. Stanford's fraud was brilliant for its massive scale, its sheer audacity and the garish opulence of Stanford's monthly personal expenditures, but sophisticated it was not. In fact, Stanford's scam was frighteningly simple: as long as sufficient investors were lured into depositing their savings at Stanford International and the stock market continued to escalate, Stanford and his group could continue to live extravagant lives of leisure and deception. The fraud would continue as long as inflows of funds, or investors providing new sources of cash, exceeded outflows of funds, or investors redeeming their certificate of deposits. As in Bernie Madoff's fraud, which likely occurred for 3 decades, Stanford's fraud, which occurred over a decade, would collapse as soon as this dynamic was inverted, or outflows representing redemptions exceeded investor inflows.

For much of the last decade, this dynamic remained viable and steady for both Madoff and Stanford. The economic collapse of 2008 reversed this equation, and redemptions quickly exceeded investor deposits. As a result of the stock market collapse, investors required cash and redemptions quickly increased. Coupled with unsustainable personal expenses by both Madoff and Stanford, cash reserves were no longer sufficient to maintain the facade, and their paper empires collapsed. These Ponzi schemes were brilliant in their sheer simplicity, in their ability to collectively dupe regulators, investors, sophisticated feeder-funds, employees, and banking analysts for years, if not decades. But they were terribly unremarkable, unsophisticated and blindingly simple in scope and dimension. They occurred because institutions and individuals failed, no refused, to perform any due diligence and research prior to investing their savings. Regulators, who have been exposed as paper tigers, were unwilling or unable to perform basic due diligence and perform even routine analysis, which likely would have exposed these frauds years ago.

The Herald article reveals Allen Stanford the man, a charming, shrewd and cunning businessman who bungled nearly every legitimate attempt at building a business or successful real estate venture, and who resorted to very simple financial statement fraud in an effort to keep his empire afloat. The remarkable element of both Madoff and Stanford's frauds is that both of these thieves were un-remarkable, unsophisticated, and routinely simplistic. Their fraudulent enterprises were kept afloat by charm, persistence, cunning, and a unique ability to persuade otherwise sophisticated and worldly individuals to abandon skepticism and prudence. But-for the collective

ignorance of crowds, these frauds would never have occurred. Collective rumor, especially in Madoff's fraud, fueled investor hysteria and drove massive amounts of money into these schemes.

These frauds ultimately demonstrate that, contrary to currently popular belief, there is little wisdom in crowds and groups of individuals, sophisticated or not. Group dynamics in financial fraud events are susceptible to the same errors in judgment, perception, and hysteria traditionally associated with non-fraud events, such as the housing bubble or other asset bubbles throughout history. Groups of people, random or not, are clearly incapable of making informed decisions regarding their financial futures and their investments. Individual investors must perform their due-diligence irrespective of their identification or association with a group or other dynamic, or face the consequences and their losses.