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Hire Harry Markopolos

"We're not looking for fraud or the future or giving a statement that the accounts are correct.

"We are saying they're reasonable, we are looking in the past and we are not set up to look for fraud."

- David Dunckley, Chief Executive of Grant Thornton, giving evidence to the Business, Energy and Industrial Strategy Committee after the failure of its audit client, Patisserie Valerie.

If you want to be soundly depressed about human nature, read *No One Would Listen* by Harry Markopolos. Remember Bernie Madoff's $64 billion Ponzi scheme ? Grupo Santander probably does. As, presumably, do Fortis Bank, HSBC, UBP, Natixis, RBS, BNP Paribas, BBVA, Nomura, Tremont Capital, Axa, Dexia and Unicredit – just some of the entities who ended up with over $100 million exposure to Madoff's, erm, creative accountancy. On five separate occasions, beginning in 2000, Harry Markopolos warned North America's Securities and Exchange Commission, the SEC, about the Madoff fraud. In his 2005 submission alone, Markopolos highlighted 30 reasons to suspect Madoff of fraud. Reviewing the book, market commentator and author James Grant offered the following:

> How to improve financial regulation and reduce the federal budget deficit, all in one fell swoop ? Fire the SEC. Hire Harry Markopolos.

The spirit of Bernie Madoff is alive and well and now manifest somewhere in the wreckage of Patisserie Valerie, the coffee and cake chain that has just collapsed with a mysterious £40 million black hole at the centre of its accounts. Investors should feel rightly indebted to J.K. Galbraith for coining the term "the bezzle" in his fabulous account of *The Great Crash*:

> In many ways the effect of the crash on embezzlement was more significant than on suicide. To the economist embezzlement is the most interesting of crimes. Alone among the various forms of larceny it has a time parameter. Weeks, months or years may elapse between the commission of the crime and its discovery. (This is a period, incidentally, when the embezzler has his gain and the man who has been embezzled, oddly enough, feels no loss. There is a net increase in psychic wealth.) At any given time there exists an inventory of undiscovered embezzlement in – or more precisely not in – the country's business and banks. This inventory – it should perhaps be called the bezzle – amounts at any moment to many millions of dollars. It also varies in size

> with the business cycle. In good times people are relaxed, trusting, and money is plentiful. But even though money is plentiful, there are always many people who need more. Under these circumstances the rate of embezzlement grows, the rate of discovery falls off, and the bezzle increases rapidly. **In depression all this is reversed.** Money is watched with a narrow, suspicious eye. The man who handles it is assumed to be dishonest until he proves himself otherwise. Audits are penetrating and meticulous. **Commercial morality is enormously improved. The bezzle shrinks**.

If Enron could bring down Arthur Andersen, it is not wildly implausible to speculate that the collapse of Patisserie Valerie could inflict similar damage on Grant Thornton, the company's auditor for over a decade. Company CEO David Dunckley may have been technically accurate when he told a parliamentary committee this week that the auditors are not stating that the accounts are correct, or that they are looking at the past, or that they are not set up to look for fraud, but his statement does rather raise the question of what the hell an auditor ***is*** being paid for. Perhaps RMS Titanic never promised safe passage to its customers. And, yes, Emperor Hirohito of Japan was linguistically veracious when he told his fellow citizens after the atomic bombing of Hiroshima and Nagasaki that

> The war situation has developed not necessarily to Japan's advantage.

If you require an education in economics, don't reach for your wallet and look to the LSE. Just bear in mind the following observation from Steven E. Landsburg:

> Most of economics can be summarized in four words: "People respond to incentives." The rest is commentary.

As ever, Berkshire Hathaway's Charlie Munger deserves the last word on the topic: "Show me the incentive and I'll show you the outcome".

If people are ***determined*** to commit fraud, there is probably not much any of us can realistically do to stop them. We do recall what won us over to investing in Vietnam, however, roughly three years ago – apart from the extraordinarily attractive valuations and growth prospects of this admittedly frontier market. We met with the chairman and chief executive officer of the country's largest securities broker. We confessed that we had some questions about the standards of corporate governance in the country. She responded that they had indeed experienced a fraud perpetrated by the bank manager of a local bank. As a result he had been executed.

There are, however, certain steps one can take at least to ***minimise*** the risk of control fraud and the related risk of catastrophic capital loss. One is obviously to develop an acute judgment of other people's character. One is not to invest in banks. One is to allow oneself to be naturally drawn to superior allocators of capital, running shareholder-friendly businesses in which they already have a meaningful equity stake. And one is to diversify anyway, because you simply never know.

Charlie Munger, outspoken as always, also has something to add to the risk debate, in this interview with the BBC's Evan Davis. Asked how worried he is by the then current decline in the share price of Berkshire Hathaway, Munger replies as follows:

> Zero. This is the third time that Warren and I have seen our holdings in Berkshire go down top tick to bottom tick by 50 percent. I think that it's in the nature of long term shareholding, with the normal vicissitudes and worldly outcomes and markets, that the long term holder has his quoted value of a stock go down by, say, 50 percent. In fact you can argue that ***if you're not willing to act with equanimity to a market price decline of fifty percent two or three times a century, you're not fit to be a common shareholder and you deserve the mediocre result you're going to get***.

Munger gets nought out of ten for investor empathy, but ten out of ten for insight and veracity. If you do not know who you are as an investor, the markets are an expensive way of finding out. The physicist Richard Feynman offers a variation on this theme:

> The first principle is that you must not fool yourself – and you are the easiest person to fool.

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