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INTEGRITY VERSUS INSIDIOUS GREED

We recognize that some may feel that the recession and market volatility of 2008 were the most distressing events of the past year and our empathy for the difficult emotions we all feel during a downturn is undiminished. However, as we write this piece, the U.S. equities markets are 22% higher than their low point in 2008. That fact serves as a reminder that over any lengthy investment horizon there will be recessions, recoveries, down markets, booming markets and all market phases in between. We wanted to focus for a moment on a truly unexpected event that resonated deeply with us as trusted fiduciaries of our clients' assets.

We're certain you're aware that former Wall Street mogul, Bernard Madoff, lied to the faces of friends, relatives, philanthropists, trustees, and charities for three decades as he brazenly stole billions from them. We wanted to give you the confidence to know that; in no uncertain terms, could what happened to Bernard Madoff's clients, happen to you here at Rockwood Wealth Management.

To understand your protection from this type of sinister fraud requires that we take a brief look at the differences between the client/advisor relationships at Rockwood Wealth Management and those at Bernard Madoff's firm.

Advisory firms (like Rockwood Wealth Management) and even most hedge funds typically hold their portfolios at an independent custodian that acts as third party clearing firm (such as Fidelity, Pershing, or Charles Schwab). Peculiarly, Madoff's firm was its own broker-dealer and supposedly processed all its own trades. For clarity, Madoff's firm took in client money, invested it in its own hedge fund product, custodied and tracked the client accounts itself, generated its own statements, and sent its own account holdings reports to clients. This self-contained advisory and trading operation prevented clients and outside investigators alike from independently verifying the account holdings.

At Rockwood we work hard to purposefully foster a culture of transparency, disclosure, and above all—i*ntegrity*. Conversely, it seems that Bernard Madoff manufactured a client/advisor culture shrouded in secrecy, deceit, obfuscation, and treachery. Although Madoff was a supposed pioneer of electronic trading, he refused to provide his clients with access to their accounts. Since his Ponzi scheme would have unraveled even more quickly if clients requested redemptions from his hedge fund he told his clients that if they took their money out that they may not be able to invest with him again.

What's particularly frustrating for us about Madoff's case is that the unusual manner in which he conducted business was no secret on Wall Street. Outside analysts raised concerns with Madoff's firm for years. Financial analyst Harry Markopolos complained to the SEC's Boston office in May 1999 telling the SEC staff they should investigate Madoff because it was impossible to legally make the profits Madoff claimed using the investment strategies that he claimed to use. In 2005 Markopolos sent a 17 page memo to the SEC, entitled *The World's Largest Hedge Fund is a Fraud*. The memo concluded: "Bernie Madoff is running the world's largest unregistered hedge fund. He's organized this business as 'hedge fund of funds privately labeling their own hedge funds which Bernie Madoff secretly runs, getting paid only trading commissions which are not disclosed.' If this isn't a regulatory dodge, I don't know what is."

Suspiciously, Madoff's company avoided filing disclosures of its holdings with the SEC by selling all its holdings for cash right before the end of each reporting period. Such a tactic is highly abnormal and should have attracted lots of attention from regulators. Madoff's use of a small auditing firm, Friehling & Horowitz, which had only one active accountant, was also extremely atypical. Friehling & Horowitz has reported since 1993, in writing, to the American Institute of Certified Public Accountants that it doesn't conduct audits. So yes, somehow a $50 billion hedge fund was having its financial statements audited by one tiny accounting firm, with one accountant, a long standing crony of Madoff's who had not performed audits since 1993.

Despite the afore mentioned red flags, we think the most egregious indicator of wrongdoing was the highly improbable steady investment returns from equities despite exceedingly volatile markets. He reported via client account statements performance of only 5 down months since 1996 and 72 consecutive months of positive returns. As a client of Rockwood Wealth Management, you already know that equities fluctuate and that we are certain to experience down periods in the global equities markets en route to positive long-term returns. With the U.S. market down nearly 40% for the year, Madoff had suspiciously reported to clients a year-to-date +5.6% return into November of 2008. Until his son turned Madoff into the authorities, clients and regulators refused to believe that the returns Madoff proclaimed were too good to be true.

Sources involved in the government inquiry into Madoff state that the onset of the fraud may have gone back to the 1970s. By the 1980s, the apparently legitimate trading division of Madoff's firm traded up to five percent of the total trades made on the New York Stock Exchange. Madoff's firm was the first prominent practitioner of "paying" for trades to be placed at his trading desk, in other words paying brokers from other firms to execute their customers' orders through Madoff's firm. This practice has been referred to as a "legal kickback" and asking this method, the firm became the largest dealer in NYSE-listed stocks in the United States. We consider this practice to be categorically immoral.

That's right, imagine yourself as the client of a non-Madoff broker who "advises" you that you need to make a trade—and then your "advisor" places that trade at Madoff's trading desk knowing that he would get a kickback for doing so on top of the commission he charges you!

To be certain, we could fill pages upon pages about the differences between what happened to Bernie Madoff's clients and your relationship with us. We thought the following table might help provide you with some clarity:

	Rockwood Wealth Management	Madoff Securities
Is there a fiduciary arrangement where the firm is required to act in its clients' best interests?	Yes, we're proud of our fiduciary role and we welcome the additional regulatory requirements that accompany it.	No. Steps were taken to actively avoid a fiduciary requirement.
How are holdings reported to clients and the SEC?	Statements from an independent custodian (Fidelity, Pershing, or Charles Schwab).	Self-generated statements—which, of course, were later found to be fraudulent.
How is the advisory firm compensated?	Professional Fees in a strict, fully disclosed, clearly defined, Fee-Only agreement signed by the client and advisor.	Primarily undisclosed brokerage commissions from his clients and clients of other brokers who received kickbacks for trading at his firm.
Do clients have access to their accounts if they choose?	Yes, at any time online or by requesting a statement from the custodian.	No.
What investment vehicles are typically utilized to accomplish clients' investment objectives?	Institutional passively managed mutual funds registered with the Securities and Exchange Commission.	An unregistered hedge fund, not subject to a strict regulatory environment.

Ironically, we wrote in early 2008 that that competition among market participants will make it highly unlikely that any single investor can consistently make significant profits over and above all other investors. We stated that the existence of a "market magician" or someone that has a magic formula for consistently beating the market is a glaring falsehood. When writing those lines we had no idea that the uncovering of Bernie Madoff's fraud would provide us with such convincing and timely evidence that we were correct.

In a final note about Madoff – not surprisingly, as he knew his scheme was caving in around him, he thought he had time for one more swindle. When he was finally arrested; apparently showing no signs of remorse towards those he had cheated for years, Madoff was working on a plan to distribute his funds' remaining $300 million to his close family members.

Firm Update

We've reached the successful completion of our merger and are pleased to report that our new office space at 362 West Bridge Street in New Hope, Pennsylvania is open and ready for business. For those of you in the Bucks County area we hope that you will find it comfortable and convenient.

Although 2008 has proved a very difficult year for the financial services industry at large, Rockwood Wealth Management has strengthened and grown its client base while many other firms have found theirs shrinking. While there continues to be a consistent migration of investors from broker-dealer relationships to Fee-Only advisory relationships, we know that we have only you to thank and we wanted to tell you how much we appreciate our relationship with you.