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How Not to Get Rich Quick (or The Story of the Ponzi Scheme)

I care more about return of capital than return on capital.
Will Rogers

There are seasons when it is very difficult to make money in the stock market. 2002 was such a time with the major stock market indices down 20% or more. There are also periods when investors can suffer significant unrealized losses in the bond market. 1994 was such a year when total returns for long U.S. Treasury bonds were -20% and worse. And there are times when investors lose money in both the stock and bond markets. This is what happened during the first quarter of 2005. The Dow Jones Industrial Average and S&P 500 Index were both down 2.6% (the NASDAQ Composite was down 8.1%), while the 10-year U.S. Treasury bond had a negative total return of 1.2%. During one of these unsettling periods, it is important to maintain a balanced, long-term perspective. Above all, patience is required. Having been frustrated by markets where nothing seems to work, investors need to avoid the temptation of swinging for the fences or diving into some get-rich-quick scheme. There have been times when investors throw caution to the wind as in the Y2K stock market bubble. 1920 was also such a time – in Boston and throughout New England.

If you had been caught up in the frenzy to invest with Charles Ponzi in June or July of 1920, you would have had to wait in line with dozens, and on some days, hundreds of other people in Pi Alley outside of 27 School Street around the corner from Boston City Hall to hand over your money to the clerk at the Securities Exchange Company. And all that you would have received for your cash or check was a written promise by Ponzi to pay you back your principal in 90 days plus 50%. The certificate looked like this:

No. _____	Boston, Mass.	_____ (date)
The Securities Exchange Company		
for and in consideration of the sum of (<u>amount invested</u>) dollars, receipt of which is hereby acknowledged, agrees to pay to the order of (<u>investor's name</u>), upon presentation of this voucher at ninety days from date, the sum of (<u>invested amount plus 50% percent</u>) at the Company's office, 27 School Street, Room 227, or at any bank.		
\$ (<u>amount due</u>)	The Securities Exchange Company	
	_____ Charles Ponzi	

It is easy to look back in wonder and disbelief that anyone could have been drawn into a scheme which promised investment returns of 50% within 90 days (and verbally Ponzi usually promised investors their 50% return within 45 days). Was it that Ponzi inspired great confidence because of his sterling character and fine reputation? Hardly. Actually, no one in Boston knew very much about him at all. If they were familiar with his background, the scheme would have never gotten off the ground.

According to Mitchell Zuckhoff in his recent book, *Ponzi's Scheme – The True Story of a Financial Legend*, Ponzi first arrived in Boston on the S.S. Vancouver as a penniless Italian immigrant in November, 1903. He was born into a middle class family in Northern Italy in 1882 and was a bright and likeable student. He was accepted at the University of Rome, but rather than applying himself to his studies, he frittered away his small inheritance with a group of much wealthier students who lived *la dolce vita*. Rarely attending classes, he exhausted his bank account and was unable to pass his exams, which kept him from graduating. Like many in Europe at that time, he headed to America to make his fortune.

Dreams of Fortune Lead to Prison

Unfortunately, Ponzi met a cardsharp on the S.S. Vancouver and was quickly fleeced of his money. He arrived in Boston a penniless Italian immigrant. During the next thirteen years, Ponzi encountered one misfortune after another – most of them self-inflicted. He moved up and down the East Coast working as a clerk, a factory hand, a dishwasher and in other odd jobs until he finally landed in Montreal. There, after working in a bank, he was arrested and sent to prison for 20 months, convicted of forging a check for \$423.58. Soon thereafter he was arrested by U.S. authorities for trying to help smuggle five Italian immigrants into the U.S. from Canada. This led to a two-year sentence in a Federal penitentiary in Atlanta. After his release, he wandered throughout the Southeast doing odd jobs, until at the age of 35, he decided to return to Boston to turn his life around.

A Fresh Start in Boston

Ponzi got a job working as a clerk in a firm engaged in international trade, and by mid-1917, he was earning \$25 a week. A year later, he married a pretty young woman, Rose Gnecco, the daughter of a fruit merchant who had emigrated from Genoa. Having apparently turned over a new leaf, Ponzi nonetheless spent all his free time dreaming and scheming of ways to make a lot of money quickly. Furthermore, he had the “air and the tastes of a millionaire.”

At this point, Ponzi came up with his idea to use International Reply Coupons (postal coupons) to make his fortune. During World War I, various European countries and the U.S. had established a system of international postal currency that held a fixed value from one country to the next. These coupons could be redeemed for stamps in any post office of a country belonging to this union. The system was established when there were fixed exchange rates. After the war, however, economic dislocation caused many countries to float their currencies. Ponzi discovered that by changing one U.S. dollar in Italy for an International Reply Coupon, he could use the same coupon to get \$3.30 worth of stamps in the U.S. Unfortunately, he also found out that the U.S. Post Office would not pay cash for the stamps.

The Money Comes Rolling In

Convinced, nevertheless, that this scheme was his ticket to wealth, Ponzi quit his job and used his meager savings (pawning his young wife's jewelry as well) to start the Securities Exchange Company with a small office at 27 School Street in the heart of the Boston financial area. At this point, Ponzi had net debt of \$2,500, and as he liked to say, his "only assets were his hopes." He began to promote his company and spread the story of the coupons-stamps-cash continuum in attractive terms. As Ponzi said, "We are all gamblers. We all crave easy money. And plenty of it."

At this point he made several important decisions: he would concentrate on many smaller "investors" rather than a few, wealthy speculators (who were usually harder to convince), and he would get others to do the selling. His first success was a fellow Italian immigrant, Ettore Giberti, from Revere, who heard about Ponzi's scheme and wanted to learn more. Ponzi convinced him to sell his scheme to his acquaintances for which he would pay him 10% of the money he brought in. In January, 1920, Giberti brought in 18 people who gave the Securities Exchange Company a try with a total of \$1,770. Importantly, Ponzi never even used the International Reply Coupon scheme but, in February, he used some of the money to pay off the people who wanted their money back. As he expected, most people, having seen others paid off in full, preferred to "re-invest" their money for another 50% return. Thus in February, 1920, 17 new investors ponied up \$5,290. By March, the new funds that came in totaled \$25,000. During seven months in 1920, Ponzi's Securities Exchange Company took in the following from over 30,000 people:

Funds "Invested" with Charles Ponzi in 1920

January	\$ 1,770
February	\$ 5,290
March	\$ 25,000
April	\$ 140,000
May	\$ 440,000
June	\$2,500,000
July	<u>\$6,500,000</u>
Total:	\$9,612,060*

* equivalent to more than \$100 million in current dollars

By May, 1920, Ponzi had offices through Massachusetts, Maine, New Hampshire, Vermont, Connecticut, Rhode Island, and New Jersey. Money poured into Boston from as far away as Bangor and New Haven. Also in May, Ponzi bought his young wife a beautiful house in Lexington, Massachusetts and brought his mother from Italy to live with them. During the same month, he purchased a controlling interest in the nearby Hanover Trust bank. By this time, Ponzi had become a local hero and philanthropist. He personified the hopes and dreams of many people. Bostonian Clarence Barron, the legendary journalist who had already bought the Wall Street Journal and its parent, Dow Jones, wrote several blistering articles about Ponzi, reasoning that 50% returns in 45 or 90 days were impossible – with or without International Reply Coupons. But investors continued to flock to Ponzi, cash in hand.

In August, 1920, the merry-go-round came to a halt. Banking authorities began to close in on Ponzi. Then an enterprising journalist from the *Boston Post* uncovered Ponzi's prison record in Montreal. Things went swiftly downhill from there, although for some weeks investors still tried to give Ponzi more money. Ultimately, Ponzi pleaded guilty to fraud in a Federal court and, although he did everything possible to repay investors as their notes came due and did not steal any of the money, he was sentenced to 5 years in prison. When he was released, the Commonwealth of Massachusetts prosecuted him on different charges, and after several mistrials, Ponzi was finally convicted and served another seven years in jail. Upon his release in 1934, he was immediately deported to Italy. Approximately 20,000 people held notes at the time of the collapse of the Ponzi scheme, and they received 37.5% of their principal back.

To this day, Ponzi remains the king of all get-rich-quick schemes and has entered into the English language, according to the Oxford English Dictionary, as follows:

Ponzi scheme: "A form of fraud in which belief in the success of a fictive enterprise is fostered by payment of quick returns to first investors from money invested by others."

Getting Rich Slowly

It is very helpful, we find, to look back periodically at how much money can be made as a shareholder in a well-run, quality, growth company over a long period of time. It is especially useful during periods such as these when the stock market seems to be going nowhere for months on end – due, at the moment, to the steady increase of short term interest rates by the Federal Reserve Bank, higher energy prices and the fear of higher inflation. Recently a young individual became a client of Bradley, Foster & Sargent, Inc., and the assets which he wanted us to manage included a number of stocks that had been bought by relatives years earlier. The table below shows the increase in share price since the shares were purchased:

Company	Years Held	Purchase Price Per Share	Current Market Price	Times Increased (not including dividends)
G.E.	83 years	\$.04	\$35.78	895
Exxon	62 years	\$.44	\$60.90	138
Philip Morris	26 years	\$.63	\$65.54	104
Automatic Data Processing	35 years	\$.87	\$45.25	52
Citigroup	26 years	\$1.13	\$45.25	40

It is easy to look back with ridicule or scorn on those who invested with Ponzi, assuming that we never would have done so. But we only need to look to the stock market bubble of 1997-2000 to see how easy the journey is from investor to speculator, then from speculator to day trader, and finally to pure gambler. At Bradley, Foster & Sargent, Inc., we strive to create and manage wealth with the long view in mind and to help our clients become rich ... slowly.