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MEMORANDUM

TO: Sterling Doubleday File
FROM: Barry Gonder
DATE: 8/24/90
RE: Conversation with Bernie Madoff (212-230-2424) of Madoff Securities.

CC: FLP, JJG, CL

Madoff manages money for the Mets and Sterling Equities. Wilpon arranged the call as part of our due diligence.

The strategy is based on writing covered calls, buying put options, and capturing the stock's dividends. The goal in the worst case is to have a neutral position/return.

In this strategy, Madoff never takes a "naked position".

Basic strategy:

A) Go long the stock of a large, dividend paying company.
B) Sell a call, take the call premium.
C) Buy a put to protect the down side, pay a premium. (Generally Madoff buys a put on the individual stock, but will use a put on an index against the entire portfolio if the portfolio's characteristics are a close match to index's.)

Return is a function of:

A) Difference between the premium received from writing the call and the premium paid to purchase the put.
B) Dividend yield on the stock.
C) Stock's appreciation. (Limited by the strike price on the call option sold.)
D) No ROR is guaranteed, but the down-side is protected by the put.

A severe decline in the market would yield zero to a 1% loss in the stock/portfolio using this strategy. The range of potential returns is -1% to 20%, with E(R) - 16% to 18% over the long term. A base return in the low-teens to mid-teens can be received from the put-call spread and the dividend capture. Additional upside is offered by the stock's appreciation to the strike price (after which it is called).

Put premiums are virtually always less than call premiums. <u>(BJG: Follow-up question: Why are put premiums less than call premiums?)</u>

Example of Strategy:

1) Buy a stock at $50.00.
2) Sell a call with a strike price at $55.00 and receive a $4.00 premium.
3) Buy a put with a strike at $45.00 and pay a $2.00 premium
4) Collect the dividend on the stock, assumed to be $3.00.

Net cash received is $5.00.

- If stock's price declines to $45.00 or lower: RETURN = $0.00; ROR = 0%.
- If stock's price appreciates to $55.00 or higher: RETURN = $10.00; ROR - 20%.
- If stock's price does not change: RETURN = $5.00; ROR = 10%.

"Its a simple strategy. You don't need to be a brain surgeon to figure it out. The key is to pick stocks which have the optimal dividend and put/call pricing and which have appreciation potential."

(BJG: Would "shorting against the box" provide a similar result?
Madoff: Similar results can be achieved, but you would lose the premium from writing the call. Shorting against the box is typically used to lock in a gain but not trigger a tax event. It is not an income generating strategy.)

The strategy focuses on locating high yielding, volatile stocks. The strategy works best in a volatile market. Madoff keeps portfolio at a neutral (0%) risk level to a risk of -1% to -2%, at any given time. (The -1% to -2% risk results because he can not always achieve a perfect hedge on the down side.) Therefore, the worst case down-side is 1% to 2%.

A long-term bear market with low volatilities and low volumes will lead to a zero or slightly negative return.

The strategy is helped by an increasing (appreciating) market over time.
A long-term bull market with high volatility and high volumes is optimal, although Madoff can achieve good returns in a neutral market if there are solid volumes (in excess of 120MM shares traded/day) and volatility. All it takes are some 8-10 point spikes on the Dow Industrials to give the requisite volatility. However, to achieve high ROR's, the strategy needs the market to appreciated by 10%+ per year.

- If the market is flat, but volatility and volumes are satisfactory, as described above; E(R) = 12%
- If the market is up 10%/year with good volatilities and volumes; E(R) = 18%+
- If the market is down; E(R) = 0% to 7%.

The market looks better today for this strategy than it has over the last few months because prices have come down and there is appreciation potential. Volatility has been good recently. A quick down-turn, like we have recently experienced is better for the strategy than a prolonged bear market of slow price deterioration.

Stocks purchased must be large-cap stocks, virtually all are in S&P 100, with a few exceptions, which are all in the S&P 500. The Focus is mainly on blue chips like IBM, GM, Ford, 3M, etc. The markets for the stocks and the options on the stocks must both have good liquidity. All options used are listed. Stocks used in implementing this strategy are not purchased on margin and Madoff does not take any uncovered positioned. All stocks employed are issued by domestic corporations and all are of high quality. S&P

"A" or "B". The strategy involves a lot of trading. (All returns discussed above are after transaction costs, but are pre-tax.)

Key variables driving the strategy are: call premiums, put premiums, dividend yields, each stock's volatility and the market's volatility. Madoff uses computer models, and experience (his own and that of his staff) to determine the individual stocks to purchase.

"With this strategy you never hit any home runs, but have lots of singles and a few doubles, and no strike-outs. The risk/return trade-off for this strategy is that you risk earning nothing to have the potential to earn twice the treasury rate. If you want to lock in the treasury rate you can buy TBills."

Madoff has been in the brokerage and money management businesses for about 30 years. He has been using this technique for about 25 years. During the first 15 years he did not purchase protective puts. However, for the last 10 years he has consistently used puts to protect his down-side. Over the last 10 years the returns have ranged from 12% - 25% per year depending on the year. His worst quarter in the last ten years was the 3rd quarter (October) of 1987, when he lost 1% on the portfolio's value for the quarter. (BJG: follow-up question: is this 1% loss at an annual rate.)

Going forward, Madoff expects to have returns in the 16% to 18% range. Returns will be lower than in the past because: 1) there are too many people using similar techniques; 2) the market will probably be lower, with less appreciation over the next year or so; and 3) put premiums are higher--as the stock market has become more volatile, more people have been buying protective puts, bidding the prices up. However, Madoff notes that put and call premiums tend to move in parallel, although the spread between the two have declined somewhat in recent years.

The monies invested by Sterling Equities' and the Mets' are managed in separate, special accounts. Bernie Madoff reviews the performance and positions in the accounts at the end of each day and helps develop the strategies. His traders and staff manage the accounts on a day to day basis.

Wipon is provided with monthly statements for the accounts which show all positions and trades/activity for the month. (All confirmations are forwarded as well.) Quarterly reports are also prepared for Wilpon which contain calculation of the ROR and an analysis of the activity for that quarter.

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