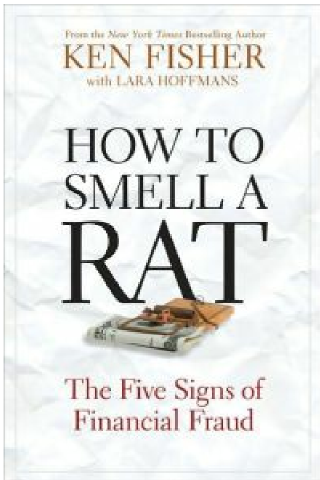

Book How to Smell a Rat

The Five Signs of Financial Fraud

Ken Fisher and Lara Hoffmans
Wiley, 2009
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Recommendation

The unlamented year of 2008 was a terrible time for investors. The news that money wizard Bernie Madoff stole some $65 billion from his investment clients with a giant pyramid scheme added insult to injury. Though already in his 70s, Madoff received a 150-year prison sentence for his thievery. Many felt the punishment was too light. The world is full of crooks and charlatans like Madoff. Fortunately for investors, they often give themselves away if you know how to spot them. In this savvy manual, business journalist Ken Fisher (writing with investment expert Lara Hoffmans) details five warning signs that can reveal crooks posing as financial advisers. *BooksInShort* recommends this book to investors who are suspicious and to those who ought to be.

Take-Aways

- The number of con artists is legion. Always has been. Always will be.
- They target small investors as readily as large ones. Investors of all types can become victims of embezzlement.
- Small firms with fewer people and fewer safeguards are more likely to suffer accounting fraud than big ones.
- You can “smell a rat” if you are aware of five suspicious factors:
- First, never hire a financial adviser who assumes physical custody of your funds.
- Second, beware of experts who never had a bad run. No one beats the market every year.
- Third, don’t accept an investment strategy you don’t understand. An adviser should be able to explain his or her investment tactics clearly.
- Fourth, avoid advisers who tout their exclusivity. Rejecting new customers doesn’t make financial sense for an adviser who earns a living from clients’ fees.
- Fifth, don’t delegate due diligence. Do your own checking before you hire an adviser.
- Test a money manager by asking a few hard questions before you hand over your cash.

Summary

The Penny-Stock Scam King

From the 1930s to the 1950s, Walter Tellier reigned as the consummate con man. He lived in style in wealthy Englewood, New Jersey. He belonged to the prestigious Westchester Country Club. His fancy cocktail parties were annual hits at North American Securities Administrators’ conventions. Tellier always came across as the paragon of respectability. In truth, he was a cheap swindler who bilked thousands of investors. During the 1950s bull market, Tellier made a fortune selling naïve investors worthless “penny stocks” at ridiculously low prices, from 15 cents to 50 cents a share. Tellier used “boiler rooms” – ugly lofts manned by criminals and college kids to tout his phony stocks over the telephone.

"Thieves can be creative, but structurally...scams are similar. That's good news because avoiding a would-be con artist is easy, no matter how convincing he is."

"Entry-level swindlers" known as "coxeys" phoned suckers whose names Tellier collected from direct mail lists. Claiming to be calling "from Wall Street," the coxeys made outlandish claims about the can't-miss value of Tellier's penny stocks. Often, victims forked over $50 to $100 each to buy the specious stocks. Next, the "loaders" or "dynamiters," slang terms for more experienced swindlers, would work the phones. These con men convincingly pushed victims to spend more – sometimes all they had or could borrow – supposedly based on sizzling tips from corporate boards or the stock exchange. Tellier and his cohorts introduced many of the classic techniques that contemporary boiler room operators still use to fleece the gullible.

"How can you rat out the rat? By knowing how they operate."

Eventually, the authorities caught up with Tellier and shut down his boiler rooms. The penny-stock king went to jail for four and a half years and paid an $18,000 fine. He then disappeared from public view, but the penny-stock swindle he perfected lives on in more sophisticated guises. Today, most boiler rooms are not in dingy basements. Instead, they look like run-of-the-mill brokerage offices. The people who tout the fake stocks wear expensive suits, speak well and drive nice cars. But they are, in essence, just like Tellier's corrupt coxeys and loaders.

"If the adviser can't or won't describe the strategy to your satisfaction, walk away."

The woods are full of con artists waiting to fleece the sheep. Recent financial fraudsters include Bernard Madoff, who bamboozled $65 billion in a corrupt money-making scheme; Nicholas Cosmo, who promised stunning 80% returns on fake loans and stole $370 million; disgraced attorney Arthur Nadel and his "$350 million hedge fund scam"; Daren Palmer, who ran a $100 million Ponzi scheme; and Robert Brown, who promised investors to cover any money they lost, but instead scammed them for $20 million.

Big Fish? Small Fish? Con Artists Try to Hook Them All

If you are a small investor, don't think that financial con artists will skip you to chase bigger fish. While the big shots make the papers when they get hooked, con artists also target small investors. Often, they infiltrate trusted circles of small town friends and then take them for all they have. Con artists need money to prop up their frauds. Your $5,000 or $10,000, pooled with similar relatively small amounts from other gullible investors, works just fine for them. Don't think that you are too smart to get burnt, because that is what fraudsters want you to believe. Madoff fooled numerous smart, sophisticated financial advisers and clients. Each of the six types of investors can become a victim of financial fraud, including:

1. **"Confident Clark"** – Smarter than any adviser, you enjoy studying the market and making your own investment choices.
2. **"Hobby Hal"** – You work hard to learn about the market. Investing is almost a second job for you or, at least, it's a pastime you take seriously.
3. **"Expert Ellen"** – As a busy professional, you don't have much time to study the markets. And, as an expert in your field, you respect other experts. That's why you trust a financial adviser to make your investment decisions.
4. **"Daunted Dave"** – The market is too complex for you, so you turn over your investments to professionals who know what they're doing.
5. **"Concerned Carl"** – Lacking confidence in your investing skill, you hire an expert.
6. **"Avoidance Al"** – The thought of investing drives you nuts. You don't even like to think about who to hire to handle investing for you.

"Many smart people have a hard time getting their egos to openly admit they don't understand."

No matter which kind of investor you are, you don't have to get stung by a con artist because most fraudsters give themselves away. Look for one or more of these five, easy-to-spot signs that someone is up to no good:

Sign 1 – "Your Adviser Also Has Custody of Your Assets"

Madoff could fool his investors and bilk them out of their funds because he not only managed their assets, he also had custody of them. He could do what he wanted with the money. Madoff's investors didn't know what he was up to because he routinely sent them false reports about the supposed growth of their funds. No matter who advises you on your money, deposit your funds elsewhere, ideally, with a "big-name third-party custodian" with round-the-clock Web availability. Following this simple rule will do more to protect you from being scammed than anything else.

"Madoff...knew his strategy was murky...he claimed it was 'complicated' and 'proprietary' and he couldn't go into it further. Nonsense!"

Every Registered Investment Adviser (RIA) in the US must file "Form ADV" with the government. Check it out at www.adviserinfo.sec.gov. Make sure that your financial adviser has answered "No" to all the queries in "Item 9" about custody of your money. Does he or she belong to a large, well-known firm that also serves as a fiscal custodian? If so, make sure the firm is insured with SIPC [Securities Investor Protection Corporation]. Overall, you're better off with an adviser who does not hold your funds.

Sign 2 – "Returns Are Consistently Great!"

The greatest investors in the world guess right only 70% of the time. However, con artists never say they have bad years. They claim to guess right all the time. Unbelievable? Yes, so don't believe it. Fraudsters try to demonstrate unending positive returns in order to hook investors. They claim to have some secret formula that enables them to beat the market all the time. Sign on the dotted line and you, like the crooks' other ecstatic investors, can benefit from their magic.

"When you allow your money to be commingled, there's no clear delineation between what's yours, what's someone else's and what the rat wants to steal."

How do con artists maintain this fiction? Simple. They send investors glowing (and incorrect) reports year after year. This works wonders. Of course, no one is apt to take money out of an investment with bountiful annual earnings. Instead, the investor keeps the money where it is, as the con artist expects. When someone does draw out funds, the crook has enough new sheep to maintain the pyramid. Do not fall for this classic scam. Always run from anyone who shows you great returns every year with no losses. Ask for documentation of past performance. Expect to see some down periods. If you don't, that is always a red flag.

Sign 3 – "The Investing Strategy Isn't Understandable"

Madoff's promotional literature described his investment strategy this way: "Typically, a position will consist of the ownership of 30 to 35 S&P 100 stocks, most correlated to that index, the sale of out-of-the-money calls on the index and the purchase of out-of-the-money puts on the index. The sale of the calls is designed to increase the rate of return, while allowing upward movement of the stock portfolio to the strike price of the calls. The puts, funded in large part by the sale of the calls, limit the portfolio's downside." Of course, this is nonsensical. Madoff meant for his strategy to be inscrutable gobbledygook, because he had "no 'underlying' strategy...just a lying strategy." Madoff often got angry when dazed investors asked about his methods.

> "Wild, sensational claims from someone who is going to take your money is a huge red flag."

An investment plan should be easy to understand and should match one of the three most common investment goals: "growth, income or both." Make sure you ask your financial adviser to describe his or her investment strategy. If you don't understand it, ask the adviser to describe it again. If all you glean is mumbo-jumbo, watch out. The real strategy may simply be to separate you from your money. Always pin the adviser down regarding the specific benchmark he or she uses to measure performance. Never mistake "flashy tactics" for strategy.

Sign 4 – "Your Adviser Promotes Benefits Like Exclusivity"

Madoff touted the exclusive nature of his financial management practice. New investors had to woo Madoff to join his clientele. However, such an arrangement makes no business sense. Money managers earn their incomes based on fees they charge investment clients. The more clients they have, the more they earn. Just as a retailer would not arbitrarily limit the number of customers in its stores, purposely restricting a client base makes no sense. Odd fee set-ups are another warning signal. Always be suspicious if an adviser brags that he or she operates exclusively and takes only a few select clients. You don't want to be one of them.

> "Being suspicious of Madoff's fee structure might have saved you."

An ostentatious office can be a cautionary signal, as well. Plush decor does not improve the returns a financial adviser can achieve for you. Indeed, fancy trapping may detract from these results, since the adviser needs money to pay for all that marble and expensive upholstery. You also don't benefit from impressive pictures on the wall showing your adviser hobnobbing with celebrities. You should never let reputation sway you when you hire a money manager. After all, Madoff was the "former chairman of the NASDAQ stock exchange."

Sign 5 – "You Didn't Do Your Own Due Diligence...a Trusted Intermediary Did"

If you suffer from cancer, would you rely solely on someone else's advice about which doctor to retain? Of course not. You would learn everything you could about the doctor's credentials and experience. It's your life. You are not going to take chances. When it comes to your money, also conduct a personal investigation – called due diligence – about who to hire. Delegating due diligence to someone else is not a responsible decision.

> "If you're being fed caviar and crème brûlée instead of being given straight answers about the investing strategy, enjoy the meal – then find a safer place for your money."

Perhaps you feel that you have no need to worry if your financial adviser is registered with the appropriate regulatory agency (the Securities and Exchange Commission [SEC] in the US). While registration with a controlling agency is good and it's smart to work only with registered money managers or investment firms, a con artist can fool a regulatory agency. Madoff filed false reports with the SEC for years before the Federal Bureau of Investigation caught him. Don't mindlessly enlist an adviser based only on a recommendation. Always insist on total transparency from any financial adviser.

Accounting Fraud

If you own a business, be aware of the danger of accounting fraud. The newspapers routinely publish stories about con artists performing as accountants who bilk their unsuspecting bosses out of hundreds of thousands, even millions, over the years. Unfortunately, many small business owners assume that they have nothing to worry about when it comes to accounting fraud. They think that the real danger lies in big corporations where some faceless accountant can engage in fraud without getting caught.

> "Due diligence is your job. No one else's."

Actually, large firms have many safeguards to block accounting fraud. But in small companies, the same bookkeeper often does the accounting and handles all the incoming and outgoing checks. Someone in that role may find it far too easy to set up phony vendor accounts, issue fraudulent invoices and then pay them with your (real) money. By only stealing small amounts over time, a crooked accountant can maintain such a fraud for years without detection. If you own a business, hire two separate staffers for accounts payable and accounts receivable, and appoint a third general accountant. Then, you can only get burnt if all three people collude to steal from you.

Questions to Ask a Potential Financial Adviser

These warning signs tell you what money management situations to avoid, but, then, who should you hire? Find out by asking potential advisers some pivotal questions and paying attention to the answers. For example: Who decides which changes to make in the mix of assets? How often will you review my portfolio's allocation? How do you monitor the market to assess its future direction? Who changes the mix of foreign versus domestic assets? What criteria do you use to "underweight or overweight" US equities? In terms of equities, do you focus on "large or small cap, growth or value?" Does this ever change? If so, why? Who decides? What is their track record? Are you SEC-registered? Are you a broker? Are you a Registered Investment Adviser? What is your compensation? How can you prove your capabilities as a wealth manager? Never hesitate to ask precise, clear questions. After all, it's your money.

About the Authors

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