

Ten Tips on Avoiding Investment Fraud

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Recent revelations of investment fraud, including the massive Ponzi admittedly committed by hedge fund manager Bernard Madoff, has heightened our awareness of investment scams. CFA Institute recently published *10 Tips on Avoiding Investment Fraud*. We agree with these guidelines and endorse them for our readers.

1. **Understand clearly the investment strategy** – “Some investment opportunities appear alluring simply because they are described in impressive, complicated terms,” said Stephen Horan, CFA, head of private wealth management content at CFA Institute. “Investment strategies and financial products should be clear and understandable. The nature of the risk involved can vary widely and should be well understood. Even the venerable Peter Lynch advised people to invest only in what they understood – advice he abided by in his successful career. If you don’t understand it, stay away.”
2. **Match investment strategy to reported performance** – One of the red flags in the Madoff affair is that reported performance was too consistently good. Other investment scams, popular on the internet, purport to use ultra-safe “prime bank” financial instruments from the world’s largest banks. E-mails that promise double-digit returns are incongruent with the safe investment strategies they purport to offer.
3. **Watch for e-mail solicitations and Internet fraud** – The internet is a low-cost way for scammers to reach millions of people. Horan says that “unsolicited e-mail messages offering you investment opportunities that sound too good to be true probably are. Online bulletin boards and electronic investment newsletters are also fertile ground to disseminate false information on thinly traded stocks for a pump-and-dump scheme. Treat information from unknown sources on the internet with great suspicion.”
4. **Be wary of “sure things,” quick returns, and special access** – Legitimate investment professionals do not promise sure bets. Legitimate get-rich-quick schemes simply do not exist. Scammers often make the implausible combination of safety and high returns seem plausible by granting you “special access” based on your relationship with a mutual acquaintance or affiliation with a specific religion or ethnic group. Also, understand clearly the terms by which you can redeem shares or exit the investment.
5. **Understand what, if any, regulatory oversight exists** – Fraud may be less prevalent in regulated settings, like mutual funds. Hedge funds are less regulated than mutual funds. Horan said that investors should also “be careful of offshore investments, as well. Many are legitimate, but many others have different regulation, and it is far more difficult to locate and recover your money overseas should something go wrong.”

6. **Assess the operational risk and infrastructure** – Any investment management operation should have a physical infrastructure for trading and administration. Ask to see them and inquire about the firm’s processes and controls. It is important that a firm have separate, independent operations for asset management, trading, and custody to provide checks and balances against fraud. Ask to see the firm’s Code of Conduct, which outlines their ethical and professional responsibilities.
7. **Ask about independent audits and who performs them** – “Investors should ask for audited financial statements of the organization,” said Horan. “An auditor should be independent, reputable, and congruent with the size and scope of the investment operation.”
8. **Assess the personnel** – Ultimately, the reliability of any operation is predicated on the integrity and competence of its people. So find out who makes investment decisions and who implements the investment strategy. They should be competent people with relevant experience, education, and training.
9. **Perform a background check** – Horan believes Investors can easily become their own private investigators. “The Financial Industry Regulatory Authority (FINRA) allows investors to check the background of brokerage firms and the registered representatives it oversees in the U.S. If a brokerage firm or broker is not listed, find out why. If they are, make sure their record is clear.” Registered investment advisors (RIAs) will probably not be registered with FINRA since they are not brokers. Instead, RIAs must file registrations with the U.S. SEC. “Again make sure they are not subjects of investigation, and be wary if you are pressured to make an investment decision before you have time to investigate.”
10. **Limit your exposure** – “One of the surest ways to avoid the catastrophe associated with investment fraud is to limit the amount you invest,” said Horan. “Diversification is one of the most fundamental and enduring investment principles. Investors often expose themselves to unnecessary risks by concentrating their funds in one or two securities. By limiting your exposure to five to ten percent of your assets, diversification can protect you if an investment turns out to be fraudulent.”

Horan advised that “although these tips cannot guarantee that you will avoid investment fraud, they will increase the likelihood that you will make smart choices. Also, by asking the right questions and arming yourself with relevant information, you become one of the informed investors who are more difficult prey for scam artists.”