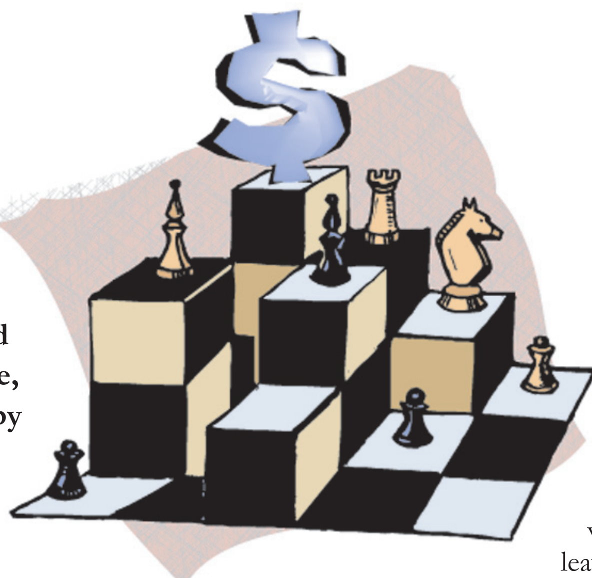
Due Diligence: 10 Steps to Avoiding Ponzi Schemes and Financial Fraud

By Karen C. Altfest



Bernie Madoff is now behind bars. But the uncovering of his enormous and long-running Ponzi scheme, and the fraud committed by several other financial hucksters, highlight the importance of asking the right questions and doing your own due diligence before selecting an advisor or participating in an investment.

What areas should you focus on when performing a due diligence review?

Here are 10 basic steps all investors can take—as well as certain indicators that should serve as red flag warning signs of the potential for trouble down the road.

1) Question everyone before handing over your money.

Even if you are approached by a family friend, a relative, or a major financial institution, ask:

- How much money am I expected to put in the investment?
- What kind of returns am I likely to make and over what period of time?
- Are any of these returns "guaranteed," and if so how and by whom?
- If the returns are not guaranteed, what is the upside potential and the downside risk?
- How and when can I get my money out?

Make sure you keep asking questions until you are satisfied with the information. If answers are unclear or not forthcoming, you have the opportunity and maybe even the obligation to walk out of that office.

Red flag: If someone tells you not to worry about where your money is going, that they will take care of it, you should leave quickly.

2) Question where your money will be held.

Regardless of who is making the investment management decisions (an investment advisory firm, your advisor on his own, or if you must sign off on each financial decision), a financial institution will have custody of your money. Make sure you know which company it is, and how you can contact the company. This firm, typically a broker/dealer, bank or trust company (known as the "custodian firm") is required to provide you with at least quarterly financial statements, and most will provide them monthly. Make sure that these statements will be coming to you directly from your custodian firm—not from your advisor.

Red flag: Ask if the account will be held in your name. If you do not have access to an account (as in a private investment) or daily ability to make withdrawals (as in a hedge fund), press harder for even more information about the custody of your assets and the reliability of the custodian.

3) Ask to see and keep written materials about any firm you are thinking of doing business with.

Look for academic credentials, professional certifications and designations, and a solid work history.

Red flag: Unexplained gaps in the work history, names of firms that you can't easily trace, and credentials that don't look right to you are all warning signs. Most professional certifications are backed by associations you can call or E-mail to make sure a person is an accredited designation holder.

4) Feel free to bring a trusted advisor with you when interviewing the firm.

Perhaps your attorney or accountant can come and ask questions you might not have thought of. If you do not have someone like that available to you, ask a good friend to be a second set of ears.

Red flag: If you are told that it is not necessary to bring another person to a meeting, that you don't need to take notes, and you cannot take anything with you from the meeting, you should be wary. The desire for privacy should come from you, not from the firm you are interviewing.

5) Check to make sure the firm has been in business for a suitable length of time.

Make sure they have offices you can visit, and where they are known. Don't settle for a meeting in some other firm's conference room without a thorough explanation of why you're meeting there.

Red flag: It is a clear warning sign if you can't locate the firm's office in the building directory, or if a firm's staff seems unfamiliar with the individual you are meeting.

6) If something sounds too good to be true—it probably is.

Don't fall in line because someone promises you the moon. If you want to take a risk, try this first: Every time you are interested in something that sounds attractive but incredulous at the same time, don't leave the meeting until you have asked 20 additional questions about it. Watch the salesperson's facial and body expressions while he addresses all your questions and determine whether this feels right for you.

Red flag: Omissions, answers that don't make sense and grandiose claims are warning signals. Unusual promises are most likely pie in the sky. You be the judge.

7) Take time to think about it.

Don't sign up for anything you must take advantage of that day. If something is good and honest, it will still be available to you 24 hours later.

Red flag: A salesperson who pushes you to sign something right away is not following a professional approach. There is likely to be another train coming down the same track. Back off from anything you can't take time to think about or discuss with family members.

8) Avoid investments, advisors and approaches that are opaque.

Investment professionals talk about investment assets in terms of transparency—that is, they are clear to anyone who wants to look into them. The reverse of this is an asset that is opaque, or a black box—that is, you cannot tell what it is, how it is handled, or what is happening with it.

Red flag: If you can't see the individual securities or assets within the investment, and don't know anything about it, you cannot possibly appraise it. Why would you want it in your portfolio?

9) Don't discount evasiveness.

One client told me that an advisor she visited became evasive when she asked about costs. There is no reason not to get a complete and satisfactory answer to your queries.

Red flag: Evasions and distractions are not a good substitute for clear, easy to understand answers to your questions. If an advisor seems angry or aggressive about your need to know, that is not a good sign.

10) Trust your gut.

This is your radar for what feels right and what could be wrong for you.

Red flag: That queasy feeling you get when things are not right might just relate back to your animal instincts. No matter who sent you to the firm, trust your gut and follow your instincts to flee. ▲

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