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How You Can Avoid Investment Fraud

In the wake of what appears to be the biggest investment fraud in history, perpetuated by famed investor Bernie Madoff, it is important to know how to make sure this will never happen to you. As with many things in life, a little common sense will go a long way. Here are some rules to follow:

1. Avoid Illiquid Investments

A liquid investment gives you the ability to get your money whenever you want. Some investments that have the most cache (private equity, venture capital, and hedge funds) also require long lock up periods – periods of time when you cannot redeem your money. The period could be anywhere from one to ten years. A lot can happen in that time. Then, when you are allowed to redeem your money, there are usually limited windows each year (as frequently as once per quarter, but often just once per year). If there is any chance you may want or need your money before the lock up period is over you should not even think about investing.

2. Demand Transparency

The hedge fund world is relatively unregulated and notoriously secretive. Investors receive few reports as to their account value, and even less information as to how their money is invested. When they do receive information investors must rely on statements created by the hedge fund itself (as opposed to a statement from an independent third party). This is referred to as a lack of transparency, which presents many problems.

If you only receive statements quarterly (perhaps even less) it becomes difficult, if not impossible, to judge the underlying risk of your investment. The far bigger problem is confidence in the validity of the information provided. Without independent third party statements you are simply taking their word for it. We want to trust that our advisor is honest, but we can't afford to wake up one day to find that the account information provided is false.

How can you avoid this? Only invest where you will receive a valuation from an independent third party at least quarterly. As a Registered Investment Advisor I manage assets. I do not, however, possess the funds. The money is held at firms such as Fidelity or TD Ameritrade. My clients certainly receive statements from me each quarter on my letterhead, but I am not their only source of information. Fidelity and TD Ameritrade send them monthly statements and trade confirmations. They can also use the internet or call the custodian anytime to view their account value and holdings.

3. Don't Abdicate Control

Every so often you hear about this with high profile actors or sports figures, but it can happen to anyone. These are very busy people who trust their manager to direct their financial affairs. In order to direct these affairs the manager needs a power of attorney on the client's accounts. Then, somewhere down the line, the client is surprised to learn that their money is gone. To avoid this, do not give anyone the ability to transfer money out of your accounts without your permission and signature. Yes it takes a bit more of your time and effort, and it requires you to be aware of your finances, but that's a good thing!

4. Always be Diversified

A fundamental principles of investing, perhaps the most basic, is diversification. Proper diversification dictates that to reduce risk you should spread your money among various types of investments. Most hedge funds (or private equity or venture capital) require minimum commitments of hundreds of thousands of dollars if not multiple millions. In order to be properly diversified you need a variety of these investments (not to mention a solid base of more traditional investments such as stocks and bonds). There is a reason that such investments are recommended mostly to ultra high net worth investors – because they can invest in multiple funds with a relatively modest portion of their investable assets. These investments can go horribly wrong, even if there is no fraud. Ultra high net worth investors can afford to have one or two of these investments blow up as long as others do well. They can also afford to be patient and wait years before some investments bear fruit.

Will this limit your ability to invest in certain desirable, sexy investments such as hedge funds, private equity, and venture capital? Probably. There is a saying for this type of investment: If you can't afford to lose your investment then you shouldn't invest in the first place. Can you? As a rule of thumb, you shouldn't invest if the minimum investment requires more than 10% of your investable assets.

I do feel sorry for that retired couple in Florida who had their entire $1mm nest egg invested with Bernie Madoff, but the bottom line is they violated every one of the rules above.

Happily, it is easier than ever to gain access to many alternative investments (commodities, long/short funds, market neutral funds, currency funds, etc) previously unreachable by the average investor. More and more alternative mutual funds and exchange traded funds (ETFs) are available today that were not available just five years ago. Most investors would be better off sticking with them.

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