Five Safeguards to Protect Yourself Against Another Madoff

By Ron Kelemen

As if 2008 wasn't bad enough, the spectacular Bernard Madoff scandal and now the Alan Stanford scandal are only making things worse. How can you protect yourself against these kinds of crooks?

1. Independence and Separation of Duties

Use a large independent custodian to hold the assets at arms length. Your advisor can only direct it to make buys and sells and to send you money. And when the custodian sends you money, it can only go to your address or to your bank account, not to the advisor. Madoff created his own subservient custodian and brokerage company that took marching orders from his advisory firm.

You may want to give extra scrutiny to proprietary investments. These are financial instruments manufactured by the advisory firm, brokerage firm, or insurance company of your financial advisor. While some of them may be very good investments, they may not pass the independence test and may have conflicts of interest.

2. Transparency

Madoff's clients received irregular and fictitious statements that he manufactured. ***By contrast, you should receive a detailed independent statement every month, or at least every quarter. It should list all transactions, holdings, and the values of each.*** Many independent advisory firms prepare quarterly performance reports and special reports for client update meetings. If so, inquire about their data downloads and software. The data they use should come from a computer download from the custodian. They should use professional-grade software from an independent company that pension funds, mutual funds, and other institutional advisors also use. This makes it extremely difficult—if not impossible—to "cook the books."

You should receive detailed disclosures about your advisory firm and its practices when you open an account. This is called form ADV-II, which is on file with the SEC. Your advisor should offer to give you an updated version every year. You can also view them at www.adviserinfo.sec.gov.

Finally, some investments are just more transparent than others. You pretty much know (or can learn) what you are getting with publicly traded stocks, bonds, and mutual funds. You can view audited statements prepared by large reputable accounting firms each year. You generally can't with hedge funds and private equity funds.

3. Due Diligence

Madoff scammed some large charities and endowment funds. But many big endowment funds, or most of the state and large company pension funds avoided this disaster. ***Like any good investment advisor, they diversified and followed a very strict investment selection process. You***

should do likewise by understanding your advisor's investment strategy and due diligence process before you sign on. Ask questions. Many Madoff investors reported that they didn't ask questions. They were fearful that he would expel them from the fund. As long as the investment returns came in every quarter they adopted a "don't ask, don't tell" mentality.

4. Diversify

Some of Madoff's victims (including some hedge funds) invested their entire portfolio in one of his proprietary non-transparent funds. ***There is a big difference between investing <u>with</u> one investment advisor and investing in only one <u>investment</u> offered exclusively by the advisor. Use your advisor to help you diversify into many transparent investments across different asset classes.***

5. Your Common Sense

This is the most important safeguard of all***. Most of Madoff's victims allowed greed to blind their common sense.*** (Although some wanted to be a Madoff client more for the social status.) Madoff's promises really were too good to be true. High double-digit returns year in, year out simply are neither possible nor sustainable. Nothing goes up forever, stays the same forever, nor stays down forever. If your returns are very good in a down market, you had better go back to Step #3 and ask questions. ***You should engage a financial advisor not only for investment advice, but also to help you manage risk.***

(Ron Kelemen is an independent CERTIFIED FINANCIAL PLANNER™ with 28 years of experience, and is listed by Medical Economics *magazine as one of The 150 Best Financial Advisors For Doctors. He offers fee-only investment management and wealth management advice through The H Group, Inc., one of the largest independent registered investment advisory firms in the Northwest. 960 Liberty St. SE, Suite #210 • Salem, OR 97302 • (800) 285-6240 • website: www.PlanningVisionProcess.com)*