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How You Can Avoid Ponzi Schemes

The Madoff Aftermath

Simple steps can help you stay clear of offers too good to be true

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Fallout from Bernard Madoff's alleged multibillion-dollar Ponzi scheme is still raining down on investors' heads. Victims' rolls are headlined by big banks, insurance giants, large philanthropies and hedge funds.

Wealthy individuals including Hollywood heavyweights also were hit. Many suffered losses through investments in hedge funds and other investment pools.

"Many were unaware that their local investment adviser funneled their monies into investments run by Madoff," said Robert Klueger, an Encino, Calif., tax attorney specializing in asset protection, who has no clients in this case. "Relatively few invested directly with Madoff."

Madoff is a former chairman of the Nasdaq Stock Market. The FBI arrested him on Dec. 11, charging him with securities fraud. The FBI said Madoff told a senior employee on Dec. 10 that his investment advisory business was "basically, a giant Ponzi scheme" and that he estimated losses to be at least \$50 billion.

In Ponzi schemes, early investors are paid contributions from later investors.

The SEC also has filed a civil suit, as have several former investors. The Secu-

rities Investor Protection Corporation is liquidating Madoff's firm, with Irving Picard acting as trustee.

On Friday authorities charged that the scam dates back to the 1970s.

So how can investors avoid being duped by such a scheme?

Three key steps can provide safety, says Rob Francais, chief operating officer of Aspiriant, an independent wealth management firm in Los Angeles and San Francisco.

"First, look for separation of where your assets are managed and where they are custodied," said Francais, whose firm runs about \$4.1 billion for 400 families. "In the Madoff situation, both advice and custody were in the same place. Independent custody gives you separate, third-party confirmation of asset values and transactions."

"Without separation, it's much harder to know if your account statements are accurate," Francais said.

Beware Of Red Flags

Second, you should maintain healthy skepticism. "If something appears too good to be true, it probably is," Francais said.

Madoff allegedly did not promise dazzling outperformance. But he did claim unusually steady returns. "Madoff supposedly said he was getting 1% to 1.5% returns a month, with only two down months over 20 years," Francais said.

An offer of that sort of consistency should raise warning flags.

Third, put money to work

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only in investments you understand.

"If you can't understand how returns are generated -- or the manager won't share his strategy with you -- be extra skeptical," Francais said.

If a manager says his strategy is proprietary or too complex to discuss with a non-professional, you're taking on extra risk if you proceed.

"If you work with a firm like ours, if we don't have someone in-house who already understands an outside money manager's complex strategy we can go outside to find a specialist," Francais said. "That's part of what you're paying for."

Madoff told prospective clients he would not accept them if they asked too many questions, Klueger says.

Another reason for learning about a manager's strategy is to understand its risks. "For example, does a manager use leverage? If so, how much?" Francais said.

Once you discover you have been taken in by a scheme, you can seek reim-

bursment from the Securities Investor Protection Corp. The industry group replaces up to \$500,000 in eligible securities lost due to theft or fraud by a broker.

You can also sue. Civil remedies often are based on a claim that someone -- a broker, money manager, marketer, accountant -- defrauded you or failed to perform fiduciary duty.

Sometimes you can also seek help from law enforcement authorities.

Securities regulators in most states, especially larger ones, often pursue settlements in cases stemming from fraudulent investments, says attorney Michele Adelman, a former state prosecutor now with Foley Hoag in Boston. Settlements typically include restitution to investors.

Seeking Records

Massachusetts, for instance, has begun to subpoena records from Madoff's investment firm and from a firm that marketed his products.

Nationwide, whether victims will be able to recoup any of their losses may depend on whether they invested early or late, Klueger says.

The court-appointed trustee who sorts out Madoff's mess is likely to try to retrieve distributions that went to early investors. The trustee is likely to deem those distributions as fraudulent conveyances, not legitimate profits, Klueger says.

Funds retrieved and liquidated assets would be divided up among all eligible investors.