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The Scam du Jour

It is a reality of history that financial excess invites financial abuse. During a bubble, scams and dishonesty proliferate, as people are distracted by the potential of immense profit. When the bubble bursts, this malfeasance is revealed. This was the case with the bank collapses of the 1930's, the junk bond debacle of the 1980's, and the mutual fund preferential trading disgrace of the early 2000's. All of these were created by an investment bubble, and the scams were revealed when the bubble collapsed.

Now we are facing the collapse of the real estate and mortgage bubble, and once again the receding tide has left its flotsam of rip-offs and shady dealings. So it seems timely to review how to avoid a scam.

When I talk to people who have been ripped off, they are usually indignant and surprised. They feel that they were pillaged without any warning. Yet in reality, that's not usually the case. Scammers are like wolves in sheep's clothing. They clothe themselves in legitimacy and look like honest businesspeople until you look beneath their outward appearance. With a little training, you will be able to spot the fangs and avoid being fleeced.

1. **If it sounds too good to be true...it might be.** Every year, thousands of gullible investors find themselves caught by their own greed. Anytime you hear someone discuss an investment with an expected return of more than 10% annually, you should see a big yellow light in your brain's traffic control system. Sometimes a 20% annual rate of return is real…but more often it is not. When any proposed annual rate of return is higher than 10%, you should keep in mind that you are playing with lots of risk. Before you invest with mega-gains in mind, you should be able to identify that risk and have a plan to manage it. Most scams I have encountered use outsized expected returns to lure you. And often they caress you with the word "guaranteed", which of course means that if they are still solvent and you can still find them five years from now, they will be happy to meet their legal obligations. Note the word "if".

2. **Keep it simple.** In the past few years we've watched as Wall Street geniuses pitched a new class of mortgage-based investments to the world. Nobody could understand them, but we were assured that this was because we were less intelligent and educated than the best and the brightest in the room. Whoops! It turned out the geniuses had not fully gamed out their own inventions either. Moral: if you can't understand it, there's a decent chance they can't understand it either. If you ever want to witness a complicated scam in action, look up an oil-and-gas drilling scam on the web. Movie-making scams are also famous for their complexity. In fact, celebrities are often the first affluent people ripped off by bogus entertainment investments.

3. **Keep it liquid**. Almost all scams share the characteristic that once invested, your money is hard to retrieve and your investment is hard to price effectively. Scammers flock to legitimate investment types which are hard to sell, and then use that genuine characteristic to hide their absconding with your cash. Rare coins, gold coins, oil wells, real estate, fine art, collectible firearms, antiques… the list goes on. All of these are legitimate investments, but all are hard to sell, with relatively few forums for pricing. Thus they are all high-risk environments for fraud. In contrast, you find relatively few rip-offs involving plain old Treasury bonds and index mutual funds. This is because these investments have lots of publicly available pricing information and you can sell them in five minutes, with low or non-existent fees.

4. **Maintain a separate portal to your money.** Scammers make themselves the gatekeeper of your wealth. In other words, you can only get to your money by asking them for it. Of course, since your money is now funding their condo in the Caymans, they will say no, and have a good excuse for the first few years. (See #3, above). Scammers will also often ask you to commingle your money with funds provided by other people. To avoid this, seek an investment in your own separate account, in a third party domicile such as a bank or a brokerage firm, where you can independently access your money without anyone else's knowledge or permission. That way you can keep tabs on your own money. For this separate portal we use Charles Schwab, but any discount brokerage will do.

5. **Avoid debt as part of your investment plan.** Debt in any investment which you yourself don't manage is a ticking bomb, and should be approached with suspicion. Especially don't loan money to people without a written agreement, your very own shiny-bright lawyer, and a third-party recipient, such as a bank or a title company. Do I need to tell you that you should never give a financial advisor the ability to create debts in your name? Nope, didn't think so. For one thing, scammers with an authority to borrow from the investment can then borrow your own money and pay it back to you as a false dividend. Check out "Ponzi scheme" on the Internet.

6. **Know your investment's performance.** If you have your own account, and you have your own access to information about the performance of that account, then you have the ability to see how the account is doing. This can be as simple as knowing if your account went up or down in value last month. Your financial advisor should be willing to provide a performance number, and then demonstrate how he or she got it. We put our performance numbers on the front page of our quarterly report.

7. **Understand the expenses of your investment.** It is vitally important that your financial advisor should be completely honest. If you ever establish that your financial advisor has waffled on this, run screaming from the room. Especially be conscious of any self-dealing, hidden commissions, or hidden fees. In general, I would avoid providing a limited power of attorney for trading to any advisor who is compensated by commissions.

8. **There's always another bargain.** Scammers frequently use the "Gotta buy it today or it's gone forever" sales ploy to make you put your money down. Have you ever been to a timeshare seminar? Actually the world is replete with bargains. If you miss one today another will come along shortly.

9. **Buy the steak, not the sizzle.** Many scams involve "royalties" or "participation", but you don't own the actual investment. Some examples of this include oil and gas deals where you get a cut of the action but you don't own the oil well, and movie deals where you get a cut of the gate but no ownership of the celluloid. You need to own something more than a contract.

It all comes down to having the discipline to look away from what is easy and quick. The best investments that I have seen are often unpopular, mundane, and ignored. Yet, they provide value and long-term performance. Our job as investors is to recognize these opportunities rather than be distracted by what is flashy and trendy.

Time, discipline, and consistency should make us rich if we are able to be patient and pay attention to the details.