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KEN FISHER

with LARA HOFFMANS

HOW TO SMELL A RAT



The Five Signs of
Financial Fraud

How to Smell a Rat

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Financial Fraud*

Ken Fisher
with
Lara Hoffmans



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Acknowledgments

Both 2008 and early 2009 were very tough capital market environments. They were terrible times, made all the more so by the discovery, late in 2008 and early in 2009, of some pretty big, ugly, heinous financial frauds. Though scams are typically outed at and around bear market bottoms—and this was no different, just a bigger bear market hence bigger outing of scams—something struck me about the media coverage of all these scams. They were missing the very easy and obvious unifying element all the scams had in common that would make it simple and easy for investors to avoid being scammed. (I won't tell you here, you must read the book to find out.) And in that, I saw a book not only that I could write, but that I should write, and now was the time. To me, this was important—it was worth a bit of my time to get it out, fast.

And to get it out fast while keeping 100 percent focused on my day job required some major help, so I turned to Lara Hoffmans, who worked with me on both of my last two books. I described the book and gave her ideas, names to pursue and research, and a myriad of inputs. She then put together an organizational plan which, once blessed, she pursued in doing the heavy lifting in constructing an entire first draft of the book.

I am a writer—love writing and have for a long time. Pretty much in the small percentage of my life when I'm not directly working, I'm either putting time into my family or one of three hobbies. Writing is one of them. Now writing is mostly re-writing, editing yourself, seeing how you can say what you wanted to say but better, shorter, punchier, and with less words—and all that's fun for me. But books can also be a lot of work. But in this one Lara did most of the grunt-work heavy lifting, and I got to have most of the fun. So I really do have to acknowledge Lara for over-the-top contributions to making this book a reality. She did so on my last two books, but with each book she seems to pull off a greater portion of the total labor load.

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Clients at my firm sometimes get irked, thinking I take time away from work for these books, which I should be spending on them. But I never do, never have. I always work a minimum 60-hour week—always have—and most weeks it’s more like 70 hours. I indulge my writing hobby after that on weekends. As with any hobby, the release recharges me for my “day” job. Unfortunately, the person overwhelmingly who gets short changed when I do this is my wife of 38 years, Sherrilynn, who I never get to spend as much time with as I should and who is always patient with me as I exert myself on any of my hobbies. To her I always owe a debt of gratitude and particularly so when I launch off on writing which requires longer sustained bursts of energy than my redwoods hobbies.

Finally, thank you for taking time with this book. I’ve done five books before and had two *New York Times* best sellers. If even two of the five signs of financial fraud resonate in your head like a bestseller and keep you from being scammed by a con artist, having put the little time I did into this book will have been very worthwhile for me.

Ken Fisher
Woodside, CA

Introduction

Imagine this:

Jim's a decent, hard-working, working stiff—frugal, with a nice nest egg. Between his job, family, a serious Saturday golf addiction, and some community commitments, he hasn't the time, know-how, or inclination for investing details. And there are so many confusing options—tens of thousands of mutual funds, thousands of money managers. Hedge funds. Brokerage products with confusing names. Too much! So he turns to friends for advice—like you might. Turns out his golf partner, boss, and a few fellow church members all invest with the same adviser—have for years—Mr. Big Time. They swear by him!

Big Time is pretty famous—held a big government post in the '80s. He manages several billion now, mostly for rich folks—way out of Jim's league. Big Time is so big, he's his own broker-dealer—Big-Time Portfolios, Inc. Jim's friends say Big Time never had a down year—not 1987, not in the 2000–2002 bear, and not the most recent bear. His returns look pretty darn stable—and after a few rough years, stability sounds good to Jim.

Jim's golf buddy fixes a meeting. Big Time's office is posh, including photos of Big Time with diverse celebrities. All of the last three Presidents. Brett Favre. The Pope. Bono. There's Big Time flying his private jet. Winning a regatta in his yacht. He does well—it shows. He's dripping with success.

Amazingly enough, when Jim comes to Big Time's office, Big Time himself meets Jim! (Though he makes it clear he's very busy and can't talk long.) Jim asks about performance—what's the strategy? BT explains: It's proprietary—even most staff aren't 100 percent privy to it—wouldn't want it to get out. If an employee left and took it outside—maybe gave the secret to a competitor—it would hurt Big Time's clients. Mr. B is earnest—he must protect existing clients. Jim feels bad insisting about knowing all this, but this is his life savings. BT hasn't got time to explain—it's complicated—involves option hedging RMBSs overlaid with swaps, some arbitrage, some playing volumes—which cuts the volatility, hence the consistency.

Jim's only ever bought mutual funds and a few individual stocks—he's not sure he understands. BT says he's just about out of time. Jim quickly asks where he can get more information? Will he get statements? And from whom? BT says Big-Time Portfolios sends quarterly statements. How is he structured? Big Time explains he manages a “hedge fund”—which means he doesn't have to register with the SEC, and isn't. But this is better for his clients. If he registered, he would have to divulge his proprietary strategy, and good-bye market advantage.

But BT encourages Jim to ask his golf partner, boss, and church buddies. They've been happy and can tell Jim all about it. But BT warns Jim—he prefers Jim doesn't talk to non-investors about the fund. Big Time wants to protect the exclusivity of his clients—he only lets “certain” people invest with him. Jim's friends really shouldn't have told him about Big Time, but Mr. B's OK this one time because he knows Jim's friends.

Jim can't quite believe that he's really going to be “in the club.” Who does he make the check out to? Mr. Big says to Big Time LLC. Mr. B will personally deposit it. Jim hands Mr. B a check, they shake hands, and Jim walks out feeling like a million bucks—sure to get 15 percent a year forever.

How many red flags did you spot? The biggest was early on. Maybe Mr. Big Time is honorable and won't embezzle. But if he is a fraudster, or evolves into one, it's now simple to swindle Jim. Why? Jim failed to see the five signs of financial fraud. That's what this book is all about: Five simple signs that, if heeded, can help protect you from investing embezzlement.

Don't Let Your Money Get "Madoff" With

2008 was miserable enough for most investors without finishing on news of Bernard Madoff bilking clients out of approximately \$65 billion over 20 years. His victims included big names from all walks of life—from politics to Hollywood luminaries. But they weren't just big-pocketed stars. He reportedly bankrupted Holocaust survivor Elie Wiesel *and* his Foundation for Humanity. Madoff stole from many in his Jewish community, not all so wealthy either. Madoff accepted investors, big and small—an equal opportunity embezzler—fooling them with claims of exclusivity and consistently positive returns.

I needn't retread this—you've read about Madoff. Years from now folks will recall Madoff as the guy who used his powerful community connections to garner a big chunk of his victim's assets—which he then embezzled in a massive pyramid scheme. Turns out, many scammers do this—prey on affinity groups. (This book details why they do and shows you how to spot it up front.)

And it wasn't just Madoff—2009 opened on endless news of similar scams, including the bizarre case of *Forbes* 400 member and Antiguan knight, Sir R. Allen Stanford. We'll cameo some of the most egregious cases—recent and historic. But a Google search renders more than you need.

This book doesn't aim to detail their deceptions, follow the money, or give you all their dirty laundry. There will be many books doing post mortems—and even more on the next round of big-time fraudsters. And there will be more future scams—100 percent certainty. Always are! No matter what regulators may devise, there will always

be scamsters. We've had them since long before Charles Ponzi became synonymous with the timeless "rob Peter to pay Paul" swindle in 1920. The only thing to do is protect yourself.

So how can you ensure you never fall victim to the next Bernard Madoff, Stanford, or Ponzi?

Just One Thing

In my 37 years managing money for individuals and institutions, 25 years writing the "Portfolio Strategy" column in *Forbes*, and a lifetime studying markets, I've witnessed money managers—all kinds, good and bad. I've also seen and studied the occasional fraudster (and in truth, though sensational, they're very rare) who forgoes money management for thievery.

The thieves can be creative, but structurally the scams are similar. That's good news because avoiding a would-be con artist is easy, no matter how convincing he is. There are just a couple questions—one or two *tops*—you must ask to avoid most all scams. Be vigilant for a few more red flags, and you can have even better success. But, interestingly, most people don't know the questions to ask.

And because these rats are so despicable, I'll tell you—right here, right now—the number one most crucial thing you must do. I don't care if you're reading this in your favorite bookstore and never read another word. If I can help even one person not fall victim to a financial scam, I'll consider the time it took to write this book worth it.

You can avoid hiring a would-be thief by:

Never hiring any form of money manager or adviser who takes custody of your assets.

What does that mean? Said another way: Always make sure the decision maker (who will decide what you should own, like stocks, bonds, mutual funds, etc.) has no access to the money—meaning they can't get their hands on it directly. I'll explain what that means in more detail in Chapter 1. But, simply said, when you hire a money manager,

you yourself should deposit the money with a third-party, reputable, sizable, big-name custodian wholly unconnected to the money manager or decision maker. That custodian's job is to safeguard the security of your assets. Do that—even if you do nothing else from this book—and you can mostly protect your money from being “Madoff” with.

If your adviser has access to the money because he controls or is somehow affiliated with whoever has custody of your assets, there is always, *always* the risk he carries your money out the back door. Maybe he's pure of heart and won't, but why risk it? Don't give him a chance.

Better Yet, Here are Five Signs

Here are five signs your adviser might now be or could evolve into a swindling rat:

1. Your adviser also has custody of your assets—*the number one, biggest, reddest flag.*
2. Returns are consistently great! Almost *too good to be true.*
3. The investing strategy isn't understandable, is murky, flashy, or “too complicated” for him (her, or it) to describe so you easily understand.
4. Your adviser promotes benefits like exclusivity, which don't impact results.
5. You didn't do your own due diligence, but a trusted intermediary did.

This book examines each sign in detail—from a variety of perspectives—and shows you how to use them together like a checklist to help ensure a con never swindles you. Note: Just because your manager displays one or a few signs, it doesn't mean they should immediately be clapped in irons. Rather, these are signs your adviser may have the *means* to embezzle and a possible framework to deceive. Always better to be suspicious and safe than trusting and sorry. Remember, Madoff and Stanford (allegedly) ran their scams for years—Madoff for possibly two decades! Folks looked into their eyes and trusted them.

Big or Small—a Con Wants 'em All

Madoff stole billions. Stanford's alleged to have done the same. Even some relatively "smaller" cons stole many millions. That may make smaller investors think they're safe. If you don't have a big bundle, a con artist won't be interested, right?

Dead wrong. The scandals you read about are sensational size-wise, but these scams go on endlessly on smaller scales in small towns everywhere. These don't make the papers—maybe not outside their regions—because the scams get outed before getting too big. But victims don't care if it was a big scam or small—they still lost everything. And even the biggest scams started small, once.

And successful con artists rely on their communities to supply victims (detailed in Chapter 4). Many intentionally prey on friends and neighbors—which means the small-town angle suits them fine. Madoff was based in Manhattan. But plenty of cons focus on smaller communities where their connections buy them less scrutiny—like Darren Palmer who terrorized Idaho Falls, Idaho, or Nicholas Cosmo, who based himself in Hauppauge, New York—a hamlet in Long Island a ways outside slick Manhattan.

Small Fish, Big Rats

But smaller investors needn't fear con artists, right? Why would a con artist bother with them? Because they're rats. Big or small—they want them all. If you have money to invest—whether \$10,000 or \$10 million—some con wants you. They need constant incoming funds to support the pyramid—wherever they can get them. And as the scam wears on and they get desperate, they may increasingly turn to smaller investors—any investors—to keep money flowing in. And that's when you can get really hurt. They have no hesitation at all to take all your money and leave you penniless, knowing full well what they're doing and how it will impact you. There is no sympathy there. No soul. No guilt or remorse. It is a form of intentional activity that is no different from simple stealing—just gone about differently so they can get much more money from you than they could steal at gun point.

Also, don't be fooled by claims of exclusivity! First, this is a red flag. Second, it's a lie. Madoff claimed to be very exclusive. And you know from media reports he had big clients—hedge funds, billionaires, banks. *But he also accepted tiny, not-so-exclusive-at-all investors*—including retired school teachers.¹ Nothing wrong with school teachers, but they typically don't have billions. Some victims reported losing their life savings—of \$100,000. Some victims had still less.²

Madoff, though a long-time successful rat, is no different from any other con artist rat. They *project* exclusivity intentionally, hoping you'll feel grateful they're letting you into their club. They want victims to *think* they're safe so they won't be fearful and suspicious as the scam is put in place and continued. They want victims to think that an adviser for really big investors can't be a con artist—those big investors are smart. Wrong way to think! Cons have ways of netting big fish, but they want little fish, too—and more of them. Little fish, medium fish, big fish—they can all get conned. As long as you don't think the rat himself smells fishy, *you* can get conned. (But no more, because you'll follow this book's prescriptions and avoid getting embezzled.)

In fact, smaller investors *should* be disproportionately worried. These kinds of financial frauds typically create a façade mimicking a discretionary adviser. Many discretionary advisers, particularly larger, legit ones, have firm minimums—discussed more in Chapter 4. Maybe that's \$100,000, \$1 million, or vastly more. They set some level under which they feel they're too inefficient to help clients much. That's fine and normal. Why charge you fees if you won't get much benefit?

What's *not* normal is for some swaggering, supposed big-time adviser with big-time clients to claim to have high minimums, but just this once, just for you, he'll gladly take you, Mr. Little-For-Now, with your ten grand. This is just the opposite of what a legit adviser will do. If a legit adviser has account minimums, they stick to them pretty strictly. If you meet an adviser who talks like Mr. Big Shot and is anxious to invest your \$5,000 IRA contribution, be very, very worried. Some clever cons will specifically cast for small fish—because they know they won't have a long investing history to compare them to.

Big or small—\$10,000 to invest or \$100 million—all five of this book’s rules apply.

Fool Me Once

Folks may think, “Those people were fooled. But I wouldn’t be fooled. I’m very smart.” Probably very true! Just remember: Victims were fooled, but they weren’t stupid. People who aren’t fools are often fooled. Of Madoff’s alleged \$65 billion swindle, \$36 billion came from just 25 investors—including hedge funds, charities, and even some super big, rich, influential and sophisticated individuals. You don’t become a \$1 billion-plus investor by being stupid or a fool. Perhaps they weren’t suspicious enough, but not overt fools. They were smart and they were fooled. A dose of cynicism can help protect you from becoming so victimized.

Bear Markets Don’t Cause Scams

Were 2008 and 2009 so unusual in having so many scams? Hardly! Bear markets reveal scams, but bear markets don’t *cause* scams. Madoff did it for decades—2008 just popped him out into the open when he couldn’t keep it going any longer, as bear markets and recessions do for many scamster rats. If a scamster successfully avoids detection long enough to get enough money from victims, big volatility simply unmasks deceptions—for a few reasons. First, downturns make it harder to bring in new money. A pyramid scam needs constant new money to cover distributions to older investors. Without fresh money, it collapses.

Also, investors in general, even in perfectly legit investment vehicles, tend to get fearful and redeem shares during downturns, putting additional pressure on fraudsters. Or perhaps one or two investors get curious as to why they’re getting positive returns when everyone else is down—though this introspection is actually very rare and con artists rely on that. Scamster rats tend to be pretty charismatic with pretty, fancy whiskers, claws, and tales instead of tails—but enough frank scrutiny from victims can be their undoing.

This is why, in a bear's depths, scams get uncovered. Media and politicians label these "indictments of the era," saying the "excesses" of previous good times and some lack of oversight created the fraud. (Pretty much every market and/or economic downturn is blamed on excesses of the previous period—always been that way since the Tulip Bubble in 1637, and probably before.) Wrong! The fraudster created the fraud—no one and nothing else—and market volatility uncovered it. A fraudster is never an indictment of any era—he's just an indictment of his own soulless black heart. He's a rat. We've always had human rats. These are bad criminals and must be thought of as solely criminals—to be put in a rat cage and not let out. They are stylistically different, but otherwise no different from criminals that engage in larceny, burglary, and theft. No one would say the detection of a house burglar is an "indictment of an era"—so these guys' detection isn't an indictment of anything but themselves.

Normal Market Volatility Is Just that—Normal

During periods of big volatility, some may feel they've been cheated. A thief steals your money, and the market dings your portfolio—sometimes hard. Is there really a difference?

Absolutely! Market volatility is normal—thievery is not, as shown in Chapter 2. Perfectly good and healthy firms like Procter & Gamble or Coca-Cola experience wild stock price swings—in good economic times and bad. And the broad market periodically goes through stomach-churning corrections and soul-crushing bear markets. Yet after bear markets are over, stocks come back—and the stocks that got cut in half, for example, can come back faster than you might have feared, making you whole again. Over long periods, stocks have averaged about 10 percent a year (see Table 2.1), depending on how and when you measure—and that *includes* big down times. But the money a con takes from you never, ever comes back. Gone forever!

Over the long term, equities are likeliest to give you better returns relative to cash or bonds³—but it's never a smooth ride. Bull markets

feel wonderful and bear markets nauseating. But over time, stocks have been a great long-term investment vehicle for investors who have had the stomach to ride it out.

Ironically, this is exactly opposite to what Madoff, Stanford, and hundreds of other scamming villains have claimed over the years. Many of their victims were fooled by claims of consistently positive, high, but largely stable and non-volatile returns. The problem: Those big, smooth, positive returns Madoff's and Stanford's investors thought they got were carefully constructed fiction. It's hard to escape this universal investing fact: If you want market-like returns, you must accept market-like volatility. No way around that. Anyone telling you otherwise may have malevolent intent.

Bear markets are followed by bulls eventually, forever and ever, Amen. Always been that way, and unless aliens invade or the body snatchers win, I'll bet it will keep being that way. As much as things change, things stay the same—particularly people. Which is why, no matter how much effort regulators and politicians put into protecting we the people from villains, someone will always be scamming, and some will do so spectacularly. But starting now, you don't need to fear you might be hiring a Madoff-redux. Read this book, follow its five simple rules, and you can avoid suffering an investing embezzlement or Ponzi scheme of any form. Rat free!

This is my sixth book, including two *New York Times* bestsellers. After Madoff, I feel like it should have been my first book. And if an investor asked me which of my books I thought he or she should read first, it would be this one—because sometimes the return *of* your money is simply a lot more important than the return *on* your money. And that's what this book is all about—making sure you can always have the return of your money. I hope you like it.

Chapter 1

Good Fences Make Good Neighbors

Fortunately for our friend Jim from the Introduction, the SEC and FBI shut down Big-Time Portfolios almost immediately after his meeting—before his check was even cashed. Now Jim must find someone else to manage his money. He wants someone trustworthy—he was beyond lucky to escape unscathed last time. He won't be fooled again.

A few towns over, he finds Trusty Time LLC. They manage a few billion and have been around a while—so they must be safe. And they're big enough that they do money management and are their own broker-dealer, so Jim can write them a check and deposit his money directly with them. Jim thinks that's convenient! Cuts down on his paperwork.

Jim's headed straight for trouble again. He's considering a decision maker who takes custody of assets—financial fraud sign number one.