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How to Avoid Ponzi Schemes

Boomers don't have time to recover from financial disasters

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Just when you thought Bernie Madoff and his Ponzi scheme were behind us, an alleged perpetrator's suicide reminds us that investment fraud is an ongoing, international problem.

On July 7, the managing director of a hedge fund shot himself after running into the ocean at his home in Palma, Spain. This occurred as authorities arrived to serve him with an arrest warrant charging him with being part of a $378 million Ponzi scheme. He died on the way to the hospital.

You aren't alone if you didn't know that much about Ponzi schemes before the Madoff scandal surfaced. It was on December 11, 2008 when 70-year-old Bernie Madoff confessed that his estimated $50 billion in assets was actually a big Ponzi scheme and that he had duped thousands of victims out of their savings, often their life savings.

What you may not know is that there a number of other Ponzi schemes still going on, with the number of victims for each scheme often in the hundreds and the offenders less well-known than Madoff. But the end result is the same: someone's emergency fund or nest egg is wiped out. (See, for example, "Michigan Busts Ponzi Scheme Targeting Seniors", "California Arrests Alleged Mastermind of Multimillion-Dollar Ponzi Scheme," and, more recently, "Michigan Files Charges in $2 Million Ponzi Scheme".)

Most victims don't write or talk about their experiences because of the shame often associated with being the victim of a con artist. An exception is Boomer Jacquelyn Mitchard, the author of fifteen books. Her book, The Deep End of the Ocean, was a selection of the Oprah Book Club, and turned Mitchard into a very wealthy author. As she chronicles in her December 6th, 2009 article in Parade magazine, "The Richest Woman in Town," she and her husband, who had seven children at that time, found their life took a dramatic turn when the summer before, Mitchard answered the phone and her assistant told her, "The money. It's all gone."

Mitchard had lost all her money in a $190 million Ponzi scheme that was allegedly the work of a Minneapolis money manager and a local radio personality.

Mitchard's Parade article is worth reading because she has been willing to go public with being the victim of a Ponzi scheme. Her story, however, is more about how she and her family decide not to let their economic downturn get them down; they even choose to go ahead with the adoption of two girls from Ethiopia. It does not describe how she and her husband got into the Ponzi scheme in the first place, along with more than 1,000 others.

Therefore, today we'll concentrate on understanding some of the red flags to watch out for so you are less likely to be a Ponzi scheme victim although it can truly happen to anyone.
Defining a Ponzi scheme

You have certainly heard the term enough times, but exactly what is a Ponzi scheme? As David Krueger, M.D. points out in "The Secret Language of Money" (McGraw-Hill Books, 2009) (co-authored with John David Mann), it's named after Charles Ponzi, an Italian who arrived in Boston in 1903 at the age of twenty-one, then moved to Montreal in 1907.

He came up with the scheme that would make him infamous after serving time in prison for other financial mismanagement and after failing to make money legitimately. Ponzi's scheme went like this: He would resell an International Reply Coupon (IRC) to buy stamps for a lot less money in the United States, selling the stamps at a profit. He then offered his investors – as Krueger points out, made up initially of "his network of friends and colleagues" – with the offer of a 50 percent return on their investment within 45 days or 100 percent within 90 days.

The scheme part is that Ponzi wasn't really buying the coupons; he was using the money that newer investors gave him to pay dividends to the earlier investors. The scheme could continue working as long as investors kept reinvesting their profits; once investors requested a return of their investment and profits, the scheme could fall apart like a house of cards because there just weren't any legitimate earnings to draw on.

At the height of the scheme, Ponzi's investors were putting $250,000 a day in his venture.That was a huge sum in those days; and within six months Ponzi had generated millions of dollars. But Ponzi's scheme became public and he was sentenced to five years in prison for mail fraud. Eventually he was deported to Italy where he struggled to earn a living, finally moving to Brazil where he spent his last years in poverty, dying in a charity hospital.

Madoff

Bernie Madoff took Ponzi's scheme to a much higher level, and it went on for decades. Unlike Ponzi, who had spent time in prison before his infamous Ponzi scheme, Madoff had a stellar reputation before the scandal broke. He had been a respected investment advisor and philanthropist.

I spoke with Ronnie Sue Ambrosino, a 57-year-old Arizona-based coordinator of the Madoff Victims Coalition, a group of more than 400 victims of Bernie Madoff who are seeking restitution and who also offer each other emotional support. Ambrosino had been investing with Madoff for about thirty years when the Ponzi scheme came to light. She initially met Madoff through her first husband; they invested their wedding money with him. Says Ambrosino, "We trusted Madoff. I refinanced my house to put more money into Madoff. The loan was at 6% but I was getting 10% from Madoff. Everybody did the same thing."

Ambrosino explains that how much someone's lost isn't really the issue. "Whether it's $30,000 or $40,000, or 8, 15, 20, or 50 million dollars, it doesn't matter. Right now, they're sitting with zero," says Ambrosino.

Who are the victims?

The Madoff victims, and the victims of other Ponzi schemes, come from all classes, races, religions, and ethnic groups, the young, and the old, new parents, widows and married couples, the healthy and the sick. What they all have in common, however, as Ambrosino points out, is that "everybody has been devastated, everybody has been demolished."
Protect yourself

Unfortunately, there are other con artists out there just looking for new, unsuspecting victims. It is therefore up to you to know how to spot them so you're less likely to be deceived.

Here are six red flags that indicate you might be dealing with a Ponzi scheme rather than a legitimate investment situation:

1. You find the investment through an affinity group
2. The promised returns are excessive compared to what is typically being offered
3. The invested funds are at the complete disposal of the investment advisor
4. You put everything with one investor/investment advisor
5. You are told you will be part of a select or elite group
6. You find yourself thinking with your emotions
Beware the affinity group

Tom Ajami, co-author with Bruce Kelly, of "The Financial Serial Killers" (Skyhorse Publishing, July 2010) cautions potential investors to be leery of finding your investment advisor through an affinity group — your church, synagogue, or other house of worship, your country club, or some other shared association.

Alas, says Ajami, because that financial advisor is part of your affinity group, you are more likely to let your guard down. You do not scrutinize this new person as much as you should or need to.

Referrals are an extension of this: in theory, a referral should help to protect you from getting involved with unsavory types. After all, someone you trust has vouched for this investment advisor and the recommended investment. But you need to be even more cautious if you find someone through a referral, especially if the referral is from someone you know for a long time and trust. This might seem counterintuitive since we are always being told that it is because someone you trust and respect has recommended someone that you should be more open to doing business with them because they seem to have been pre-approved or pre-screened.

Ajami, a trial lawyer who has recovered millions of dollars for defrauded individuals, cautions potential investors to do their research so you are more likely to avoid unwittingly hooking up with a Ponzi scheme con person. "Some of these people who are scamming have records," says Ajami. "Put their name in the Internet. Do a very basic background check. Start with a Google search. If you have the money, hire someone to do a background check."

FINRA (Financial Industry Regulatory Authority) offers a free service called FINRA BrokerCheck. It is a place to start to see if there are any complaints lodged against a specific broker. Ajami also suggests asking your lawyer or accountant if they have heard about a particular financial advisor or hedge fund manager, to see if they have a reputation, good or bad.

Miguel Gomez, a financial advisor with http://www.lfa-ia.com Lauterback Financial Advisors, LLC in El Paso, Texas, also points out the SEC maintains a database for all Registered Investment Advisory firms, and "smaller firms (with under $25 million under management per current legislation) are registered directly with the states; check with your state securities regulator."

Another source of information is ConsumerAffairs.com's Investments Section, with scores of comments about specific brokers and financial advisors available for your perusal.

The most important thing you can do is to do the research, on your own and with the help of a thorough and well-regarded background check service. As Ajami explains, "The vast majority of people give money to someone based only on blind trust."
If it sounds too good to be true ...

Sarah Wilson is a consultant and fee-only financial planner with T.E. WEALTH in Calgary, Alberta, Canada. Wilson says potential investors should be aware of what the typical investment returns are today so they will know if someone is making unrealistic promises that could foretell a Ponzi scheme.

Says Wilson: "If you go to the bank, in general, you're lucky if you're getting 1%. If you want to go into bonds or something, you're getting something like 3%. So if you're at a cocktail party and someone says to you that I can get you between 15 and 20% back on your money within two years, you know it's probably too good to be true and you should not quite believe it. Unfortunately, because they are such good manipulators who do this, they just keep overwhelming you about how you're special and you can get more than the average person."

Similar advice is offered by Charles C. Scott of Pelleton Capital Management, Ltd in Scottsdale, Arizona. Notes Scott: "The advice we've always given our clients harkens back to something most of our mothers/parents have told us: 'If it sounds too good to be true, it probably is' and now you could add 'and it's probably illegal.'"

More tips for the wary investor:

• Make sure the money is being held at an authorized custodian. Financial advisor Gomez suggests that you "make sure that your money is being held at a qualified custodian." Gomez notes that Bernie Madoff had total control of his clients' money. Says Gomez: "Their funds were deposited in one of his companies and were at his complete disposal. Make sure that doesn't happen to you by demanding to deposit your funds only to a third party that is an unrelated custodian. Typical custodians include Fidelity, Charles Schwab, and Pershing."

• Diversify; avoid putting everything with one person. It will mean doubling your efforts to do background checks on two, not just one, potential investment advisors or financial planners, but it at least means that you are less likely to lose it all if one turns out to be a con artist. It is another version of the advice to diversify your investments; in this case, you are diversifying who you invest with and not just what you invest in.

• Be suspicious if you are told that you are going to be part of an elite group. Scam artists know how to toy with the emotions of their potential investors. They appeal to the need that most people have to feel special and to feel that they are being given access to a deal that few others can partake in. Sadly, they will make up stories or lie to entice potential investors to feel that they are privileged to be clients of a particular investor and to be invited to participate in a really amazing investment opportunity (which actually turns out to be a Ponzi scheme).

• Don't get excited "Watch your emotions," suggests Chad Barker of the Raleigh Funding Group, Inc. in Cary, North Carolina. "One of my mentors said when your emotions go up, your intelligence goes down. If you feel yourself getting emotional — scared that you're going to lose the opportunity— take a break, collect yourself, or just say 'no.'"
Finding the right advisor

You might be tempted to put your money under the mattress to avoid putting your trust in an advisor who turns out to be a con man who leaves you penniless, but that's not the answer. You need to find someone you can trust. Here are some tips to help you find a financial advisor:

• Start with a referral from someone you trust but do not just take the name and run with it. Ask them extensive questions about the person they are recommending such as: why do you like your advisor, how long have you worked together, what have they done for you, did they create a financial plan, how are they paid, how often do you meet or speak, have you had any problems? Even after you get these answers, follow up by doing your own due diligence as noted above to check that person out in a very thorough way.

• There are a number of services that will provide information about financial advisors in your area such as the Financial Planning Association, the Certified Financial Planner Board of Standards, and the National Association of Personal Financial Advisors. Once again, check out any name that you are provided with.

• Look for someone who respects your preferred investment style as well as your risk tolerance and who shares your core values.

A trusted advisor can give you the right financial information and guidance based on knowledge and experience you probably don't have. Always make sure you understand how your advisor will be paid before agreeing to their services. You don't want to be surprised by a larger than expected fee or any hidden fees that might outweigh the value of the advice.
Be an educated consumer

Learn more about growing your money. Read more about finances, investing, and how to avoid being a victim. Boomers do not have the luxury of time to build up their savings accounts the way those in their twenties, thirties, and early forties do. Being financially savvy, and working with trustworthy investment advisors that are ethical and reliable, can take you a long way to helping you achieve your financial goals. Moreover, you may have to become a bit more realistic about what a realistic goal is, considering where you are starting from and what income, pension, social security benefits, and any other sources of revenue, including continuing to work part-time or full-time, that you have to work with.

It's also never too early to get your children educated about money. Prakash L. Dheeriya, Ph.D., Professor of Finance at California State University-Dominquez Hills, has written a series of books on financial issues for elementary school children. Notes Dheeriya, "I did not want my children to ever be victims of financial scams, schemes and frauds, so I wrote children's books on finance." His topics include everything from identity theft to money management tools.

What about the system that allows Ponzi schemes to exist?

According to Ronnie Sue Ambrosino, it needs to be fixed. The Securities and Exchange Commission (SEC) was receiving complaints about Madoff for ten years before he was finally caught and convicted. As you can see from recent news articles, there are others still out there, waiting to take your money. The government has proven it can't protect you. It's up to you. A wary investor may just live to save another day. A careless one won't.

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