

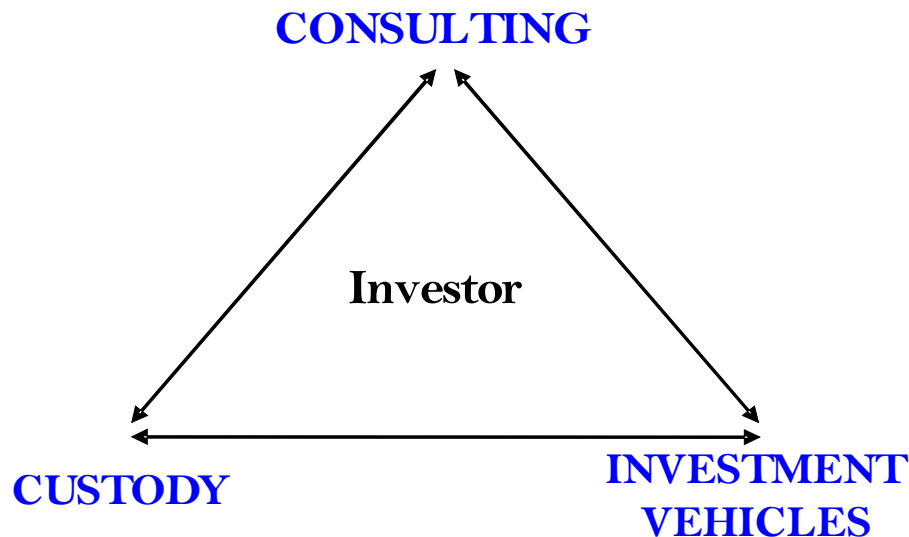
# Eden Prairie NEWS

## THE POWER OF THE PYRAMID

The *Madoff* Scandal and How to Protect Your Capital Against Fraud, Scams and *Ponzi* Schemes

As virtually everyone has either heard or read by now, *Bernard Madoff* defrauded investors of approximately \$50 billion, inflicting financial damage on thousands of unsuspecting investors. Since the news broke, many articles have been written about this multi-billion dollar scandal, which proved to be the largest investment fraud ever perpetrated in U.S. history. Most of these articles, however, focus on the sensational nature of the story without educating investors on what they can do to ensure they don't fall victim to this kind of pyramid scheme. This article provides you, the investor, with essential tools to ensure this doesn't happen to you.

Before investing your first dollar, it is important to know that when hiring a third-party to assist you in the management of your investments, you are likely to end up using: (1) consulting services, (2) custodial services, and (3) investment vehicles.



*The Virtuous Pyramid of Financial Services* <sup>TM</sup>

The key to protecting your investments from fraud is to create a *Virtuous Pyramid of Financial Services* by **keeping these 3 services separate**. Sophisticated investors know to never combine the custody of their assets with the management of them. All investors, individual and institutional, who lost money with *Madoff* broke this simple rule. Don't make the same mistake!

To illustrate the importance of this, let's review the function of each of these roles in the management of your investments:

### Consulting

The selection of an independent, objective consultant is your most important decision. This is because the consultant will assist you with the implementation of a sound *Investment Strategy*, one that is most likely to help you achieve your particular financial objectives. So, when selecting a consultant, what should you be looking for? First realize that "institutions" do **not** provide advice. Indeed, it always

comes down to a particular **person** assigned to manage your portfolio. So, check her/his credentials carefully. You should demand top academic credentials (MBA), professional designations (CFA), years of experience, and client references. Most importantly, however, your consultant needs to be 100% objective in making his/her investment recommendations. That is, your consultant's compensation should never come from the sale of mutual funds, company incentives, commissions, or the sale of any product (insurance, annuities, etc.). In fact, your consultant's compensation should be based solely on the value of the managed assets. In this way, their only incentive is to make your assets grow. Ask yourself: Does my financial advisor work for my custodian? If so, it's probably time to make a change.

## **Custody**

It is important that you, with the assistance of an experienced, independent professional consultant, evaluate and select a large, first-class, **institutional** custodian. There should be **no** financial arrangements between the consultant and the custodian.

The principal role of the custodian (bank or brokerage firm) is to **protect your assets against theft and fraud**. Many custodians may offer other services, including consulting services or the sale of specific investment vehicles. Resist the temptation to buy them! If these investments were recommended to you by an employee of the custodian, it is likely that there is a conflict of interest in the form of kick-backs, commissions or other compensation that will not be reported to you and may be built into the pricing of the security. Always ask yourself, who is this person working for? If the answer isn't exclusively you, walk away.

A second, but equally important function of the custodian is to provide you, and only you, with access to your funds. The custodian ensures that no one else, not even your consultant, has access to the funds in your account. The custodian also sends out monthly statements, giving you a way to check what your consultant is saying.

## **Investment Vehicles**

These are the actual investments. They can include a large and complex number of alternatives, such as: CDs; Treasury bills, notes and bonds; municipal and corporate bonds; structured notes, mutual funds, exchange-traded funds, hedge-funds, preferred stocks, common stocks, options, futures, etc. All are likely to have some form of risk (issuer risk, market risk, interest-rate, call risk, etc.) and varying potential for return. Unless you have the training, technology and time to dedicate to selecting and combining these into a sensible portfolio, you should consider hiring a trained consultant do this work. By carefully combining these instruments your consultant can produce a portfolio with a level of risk and expected return that matches your needs. The consultant should ensure that any funds purchased are audited by a reputable and independent entity.

Finally, use your common sense and remember than no one should...

- Guaranty an above-market return without risk, or
- Claim to have the ability to predict the future consistently - - this is called "market timing" and it doesn't work in the long run.

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