# Protecting Your Investments

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WHAT'S COVERED

In this lesson, you will examine ways to protect your investments from losses and frauds. Specifically, this lesson will cover:

## 1. Protecting Yourself as an Investor

The table below summarizes some of the most important savings and investment products that you are likely to use during your lifetime financial journey. Note especially the level of risks and returns associated with each asset (with four stars being the highest risk).

**Table: Savings and Investment Products**

| | Bank Products | EE/I Bonds | Stocks | Bonds | Mutual Funds | ETFs | Hard Assets Including Real Estate |
|---|---|---|---|---|---|---|---|
| **Key concept** | Low risks mean low returns. | Guaranteed returns are state income tax-free. | Stocks are a great long-term investment. | Bonds are appropriate for those who need current income. | Funds provide diversification and professional management. | ETFs blend the best of stocks and index mutual funds. | Hard assets can be good diversification tools. |
| **Risk** | * | * | *** to **** | * to **** | * to **** | ** to **** | *** to **** |
| **Return** | * | ** | * to **** | * to **** | * to **** | * to **** | * to **** |
| **Where to buy** | Directly from a bank or credit union. | Directly at a bank, credit union, or through the Internet. | Usually in a brokerage account but sometimes in a dividend reinvestment plan. | Almost always in a brokerage account. | Through a financial advisor or directly through a no-load mutual fund through the Internet. | Almost always in a brokerage account. | In local stores, marketplaces, and real estate markets. |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| **Protection** | Depositors are insured through FDIC. | Although not insured, guaranteed by U.S. government. | Not insured; brokerage account has SIPC coverage. | Not insured; brokerage account has SIPC coverage. | Not insured; brokerage account has SIPC coverage. | Not insured; brokerage account has SIPC coverage. | Not insured. |

One thing should stand out from the previous table: Few of the investments that you are likely to use to build wealth provide any type of protection against losses linked with fluctuations in the markets. Although it is true that the government works daily to help make the investment world safer, only bank and credit union savers have access to direct account insurance.

Federal and state regulators constantly monitor the investment and insurance marketplace for wrongdoing on the part of companies and individuals. Regulations are in place to make sure that a baseline level of safety exists in the event of a firm or system-wide failure that could result in the loss of cash or securities.

- The **Securities Investor Protection Corporation (SIPC)**, for example, protects investors against the loss of cash and securities held at a brokerage firm.
- The limit of SIPC protection is $500,000, which includes a $250,000 limit for cash held in an account.
- SIPC insurance is there to protect investors in case a brokerage firm goes bankrupt.

HINT

SIPC insurance does not protect against either the decline in the value of your securities or bad investment advice.

Even with FDIC and SIPC insurance in place, you cannot afford to be complacent about your money or investments. It is important to take steps to be aware of possible frauds, misrepresentations, and consumer rip-offs. You can do this by:

- Always being skeptical of unrealistic promises.
- Never relying solely on reputation or word-of-mouth referrals.
- Verifying details of investment proposals.

Most importantly, you can protect yourself by always applying the principles of diversification. This means spreading your wealth among different assets, accounts, and advisors.

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# 2. Bernie Madoff: A Cautionary Tale

Bernie Madoff was one of the most respected and influential people on Wall Street. He ran the world's largest hedge fund, which is a private investment company that caters to the investment needs of wealthy individuals and organizations. Let's learn a bit more about hedge funds and Bernie Madoff.

## 2a. Hedge Funds

**Hedge funds** get their name from the investment approaches these firms use to manage client money. Hedge funds pool money from wealthy investors and invest in securities or other types of investments with the goal of obtaining positive returns. Hedge funds, however, tend to be less well-regulated than other managed investment products and services, like mutual funds. Because hedge funds are not highly regulated, hedge funds can only solicit investments from accredited investors. An **accredited investor** is someone who has:

- Earned income that exceeded $200,000 (or $300,000 together with a spouse) in each of the prior two years and reasonably expects the same for the current year.
- A net worth more than $1 million, either alone or together with a spouse (excluding the value of the person's primary residence).

Here is how Madoff described his hedge fund to investors and federal regulators.

- Madoff told the **U.S. Securities and Exchange Commission (SEC)** that his firm bought holdings in the world's stock markets and "hedged" these positions with options that gained in value whenever stock prices fell.
- Madoff also advertised that he knew when to move between cash and stocks, thus hedging the bets he was making in the markets.
- Madoff claimed that investors in his hedge fund could make between 8% and 10% annually with little downside risk.

This last point is important because it paved the way for one of the biggest frauds in recent history.

TERMS TO KNOW

**Hedge Fund**
An investment that pools money from wealthy investors and invests in securities or other types of investments with the goal of obtaining positive returns; tends to be less well-regulated than other managed investment products and services, like mutual funds. Can only solicit investments from accredited investors.

**Accredited Investor**
Someone who has earned income that exceeded $200,000 (or $300,000 together with a spouse) in each of the prior two years and reasonably expects the same for the current year; and a net worth more than $1 million, either alone or together with a spouse (excluding the value of the person's primary residence).

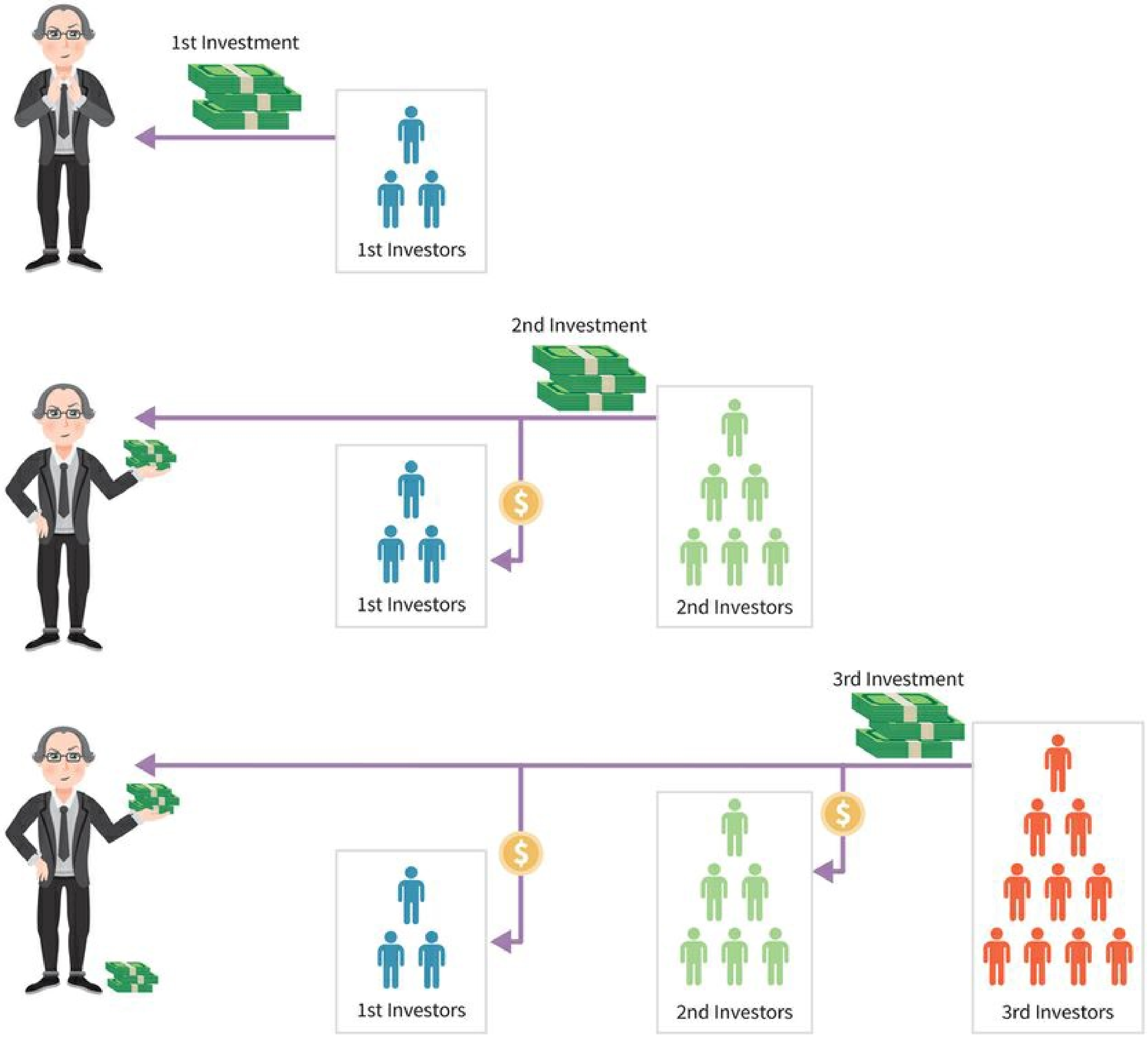
## 2b. Madoff's Fraudulent Scheme

Madoff's firm was so successful that he was able to establish strict standards for those that he would accept as clients. Typically, clients had to have several millions of dollars to invest and be politically and socially connected. Investing with this man was considered a privilege, and people lined up begging to give him their money.

Madoff was able to perpetrate his scheme using the media as a way to promote his investing record. Here are examples of what the financial media reported about Madoff before he was exposed as a fraud.

- Madoff was called the "Investing Wizard" of Wall Street because he offered his clients "100% safe investments with high and extremely consistent rates of return over significant periods of time."
- From 1992 through 2008, financial magazines reported that Madoff's hedge fund was able to generate returns in excess of 9% annually, in every possible market environment.
- Gossip magazines reported that Madoff's clients made up an exclusive club of the rich and famous.

After reading these glowing reports, would you have invested with Madoff? Unfortunately, many people who had the chance answered “yes” without asking the right questions. His clients failed to uncover that Madoff was engaged in running the world’s largest Ponzi scheme. As shown in the following illustration, he used money coming into the firm from new investors (new victims) to pay off previous investors (old victims). Few actual investments were ever made. For the fraud to work, Madoff needed to bring in more investors every year. His fraud was exposed when some investors wanted their money back, but Madoff could not find enough new investors to pay them back. When Madoff’s fraud was discovered, his clients had already lost an estimated $50 billion!




HINT

Cases like that of Madoff are actually quite rare; it is therefore important not to paint all financial advisors with a negative brush.

As you continue your lifetime financial journey you can learn several important things from the Madoff case:

1. No matter what an advisor’s reputation might be, it is important to document the advisor’s promises.
2. It is wise to be skeptical of anyone who promises to generate high consistent returns with low risk.
3. In the investment world, if something seems too good to be true, it likely is an investment rip-off.

**IN CONTEXT**

Assume that a fraudster using a classic Ponzi scheme starts with 6 investors and plans to increase the number of new investors by a multiple of 6 every year. In other words, the fraudster plans to take money from 6 people in year one, 36 in year two, 216 in year three, and so on. The fraudster's plan is to use money from later investors to pay off previous investors (plus pocket some money along the way). *How many years will it take for the fraudster in this scenario to run out of investors if you consider that the world's population is around 7 billion people?*

Here's the solution:

It will take between 12 and 13 years before the fraudster in this scenario runs out of investors, as the following shows. This is how Ponzi schemes fail. At some point, the number of potential victims drops to zero.

| Year | Investors |
|---|---|
| 1 | 6 |
| 2 | 36 |
| 3 | 216 |
| 4 | 1,296 |
| 5 | 7,776 |
| 6 | 46,656 |
| 7 | 279,936 |
| 8 | 1,679,616 |
| 9 | 10,077,696 |
| 10 | 60,466,476 |
| 11 | 362,797,056 |
| 12 | 2,176,782,336 |
| 13 | 13,060,694,016 |

## SUMMARY

In this lesson, you learned how to **protect yourself as an investor**. You studied the **fraudulent Ponzi scheme** orchestrated by **Bernie Madoff** which promised investors unusually high rates of return. **This cautionary tale** represents one of the biggest frauds in recent U.S. history. The tale emphasizes the importance of being skeptical of unrealistic financial promises.

Madoff's scheme was operating behind a **hedge fund**. This is when a private investment firm pools money from wealthy investors to put into securities and other investments. Hedge funds are less regulated than more common managed products and services, and they only allow accredited investors to participate.



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