Book Review

How to Smell a Rat: The Five Signs of Financial Fraud

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Author: Ken Fisher with Lara Hoffmans
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His coauthor, Lara Hoffmans, is a content manager at Fisher Investments and contributing editor of MarketMinder.com. She also coauthored with Ken Fisher The Only Three Questions That Count and The Ten Roads to Riches.

As I read this book, I concluded that Fisher is a superb story-teller. He is very clear about his five signs of financial fraud. Each sign is supported with historical accounts of how innocent people were scammed by financial advisers they knew and trusted. It is unfortunate that many of these situations occurred very recently. The caveat “buyer beware” is relevant to the investment world as much as it is to shopping for any new product or service.

First Sign of Financial Fraud
Your financial adviser also has custody of your assets. Fisher explains that the financial adviser who has custody of your investments can take money out the back door any time he or she wants. In Fisher’s words, a rat can inflate asset values, issue false statements, shift money around, or steal it entirely. As examples, Fisher cites Bernie Madoff and R. Allen Stanford. He notes that Madoff claimed to be exclusive and that most of his clients were big (think of hedge funds, billionaires, and banks), but he also accepted tiny investors such as retired school teachers. Fisher notes that Stanford was a repeat Forbes 400 member, but the U.S. Securities and Exchange Commission (SEC) charged that the $8 billion he managed was a Ponzi scheme.

To avoid fraud, you should insist on a separate account in your name at a third-party custodian. Fisher says that you should never hire a discretionary money manager who holds assets at a broker/dealer that he or she owns or controls.

Second Sign of Financial Fraud
Returns are consistently great. In fact, returns are almost too good to be true. Fisher says that unwary clients do not complain about returns that are consistently up although the adviser’s upward trend is not consistent with the market. To separate an honest adviser from a fraudulent one, look for these two warning signs: “eerie consistency” from year to year or average returns that are much greater than long-term stock averages. Each of these results is suspicious. An adviser who manages any amount of stocks should have year-to-year variability instead of “eerie consistency.”

To avoid fraud, your financial adviser should manage to a stated benchmark and you should understand that benchmark. The benchmarks could be the Standard & Poor’s 500, the Morgan Stanley Capital International (MSCI) World Index, the Russell 2000, the Europe and Asian Foreign Equities (EAFE), or the National Association of Securities Dealers Automated Quotations (NASDAQ). Fisher points out that Madoff and Stanford did not use

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benchmarks. Your financial adviser should have a reason-
able record of past performance. This record should be
available to you. Your financial adviser should explain how
deviations from the benchmark link to overall strategy.

**Third Sign of Financial Fraud**
The investing strategy is not understandable. The finan-
cial adviser says it is too complicated for you to easily
understand. Fisher says that rats want clients who will not
question too much because the clients are busy, intimidat-
ed, or distracted by inflated performance claims. To avoid
fraud, Fisher says that you, as a long-term investor, should
have one of three goals: growth, income, or both income
and growth.

Growth means that you need your money to grow for fu-
ture expenses, such as retirement and/or a bequest for heirs
or charities. Income means that you want your investment
returns to cover part or all of your living expenses now
or in the future. If your goal is both growth and income,
you need returns to cover living expenses (now or future)
and you expect some growth. Be sure that the strategy
explained by your adviser is congruent with your goals.
Understand the adviser’s benchmark and set realistic
expectations. If the advisor will not or can not explain the
strategy that he or she will use, find another adviser.

**Fourth Sign of Financial Fraud**
Your adviser promotes benefits that do not impact results.
The benefits can be sold as charity, political connections,
fancy offices, expensive toys, corporate or personal bling,
and exclusivity, which could be being allowed “in” at
amounts below the firm’s stated minimum. Fisher says that
good con artists often build their reputations by making
large charitable donations, being active politically, and/or
pandering to affinity groups. However, these actions
should not be sold as a “benefit” to clients. Fisher sum-
marizes this point by saying don’t be swayed by things that
don’t matter with regard to investment performance.

**Fifth Sign of Financial Fraud**
You did not do your own due diligence, but a “trusted inter-
mediary” did. Fisher states that only you can protect you.
A good rule of thumb is never pay a big fee to someone to
get in between you and the ultimate decision maker. A SEC
registration is a good start, but it is not foolproof. Check
the Form ADV (e.g., the SEC form used to register as an
investment adviser). Look for inconsistencies. Avoid feeder
funds and other funds of funds since they can layer on ad-
tional fees that diminish performance. Finally, Fisher says
never accept a recommendation from a friend or associate
at face value. Always do your own due diligence.

Fisher’s closing tips repeat the suggestions offered
throughout the book:

- Separate the decision maker from the custody of
  your investments. Check Item 9 on the Form ADV
  found online at www.adviserinfo.sec.gov. Be sure
  that assets are held in a separate account in your
  name. Be sure that the custodian is a large, well-
  known institution with 24/7 Internet access.
- Ask for the financial adviser’s benchmark. Find
  out the historical returns for that benchmark.
  Be suspicious of consistently positive returns or
  similar returns, year in and year out.
- Know your goals and have reasonable expecta-
tions. Ask for an explanation of the adviser’s
  investing strategy and be sure that you understand
  the strategy.
- Be very cautious about hiring an adviser who
  relies on a flashy façade and social or political
  connections. You want to hire an adviser because
  of their financial decision making and not on
  things that do not matter.
- Do your own due diligence.

In closing, I want to commend Fisher for his straightfor-
ward approach and the extensive list of resources. The
content has been thoroughly researched and documented.
This is an excellent reference for your personal library or
for teaching or developing educational materials. Educa-
tors could easily use the cases mentioned by Fisher to
develop in-depth assignments about what went wrong and
why. Another potential assignment could be to create a
profile of victims’ characteristics based on the description
of cases in the book.