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AVOID PERSONAL FINANCIAL DISASTERS

In the mid-eighties I took one of those personality tests that determine what type of person you are, what your strengths and weaknesses are and what type of career you'd be suited for. The results were not too surprising: I was basically a pretty normal person, pretty good at math, probably never going to be a great artist or preacher.

But then, at the end of the session, the person giving me the results told me something that has turned out to be one of the most important pieces of information that I have ever received in my life. It was this:

Dave, you can't tell when people are lying to you.

What? You mean I can't tell by looking directly into someone's eyes and monitoring their body language whether they are telling me the truth? Exactly.

And you know what? Neither can you.

Think about it. Ever watched a great actor in a movie? There are great actors all around us each and every day. The problem is that some of them want to rip us off.

I was fortunate enough to learn this lesson in my twenties and it has stood me in good stead when it comes to investing, as well as life in general. I don't assume everyone I meet is lying to me. For example, I have known my buddy Stu for over thirty years and I know I can trust him because he has never once lied to me.

On the other hand, I initially do not trust people I meet for the first time, even if they have been referred by a friend or client.

Unfortunately, many people did not take the personality test in their twenties that I did. They learned the hard way that many people can't be trusted. One of the early examples when it comes to investing rip-offs was that of Charles Ponzi.

THE PONZI SCHEME

This scheme is often at the root of many investment scams today.

Charles Ponzi (pronounced "pon-zee") was born in Italy in 1882 as Carlo Ponzi. He grew up there and emigrated to the U.S. in 1903 at the age of twenty-one.

His first stop? Canada. He went to Montreal, where he was convicted of forgery in 1908 and sentenced to three years in prison. After his early release for good behaviour he was soon arrested on immigration charges for trying to assist five other people get into the U.S. illegally. He was jailed again in 1910.

After his release, he spent time in several cities and held various jobs, including dishwasher, waiter and office clerk. He eventually settled down in Boston in 1917, where he worked in clerical office jobs.

On December 26, 1919, Ponzi established a company called the Securities Exchange Company. He had hit upon an idea to make himself rich. It had to do with postal international reply coupons (IRCs). These are coupons that can be exchanged for one or more postage stamps for the minimum postage for an airmail letter to be returned to any other country that is a member of the Universal Postal Union. The purpose of an IRC is to send someone a letter in another country with sufficient postage for them to send a reply. For letters in the same country you can simply use a self-addressed stamped envelope, but for mailings to other countries, using an IRC does away with the need to use foreign postage or currency.

Ponzi claimed that he could make money by taking advantage of different postal and exchange rates in different countries. For example, he claimed he could send $1 to Italy and with the IRC he could buy

$3.30 worth of stamps in Boston. He promised a 50% return in 90 days. In the beginning he actually did pay that rate of return – often in only forty-five days.

To many people, it sounded like a good idea. The money started to flow in.

Within a few months people began lining up at his company's door. Thousands of people invested their hard-earned savings. At its peak the company was bringing in more than $1 million a week, and that was in the early 1920s.

The problem was that he never really bought the IRCs or even attempted to make any money for the investors. He simply paid the return out of the money that other investors had put in, and he just spent the rest.

It was so devastating that even the U.S. Securities and Exchange Commission (SEC) devotes a page to it on its website.

Here's what it says:

> *Ponzi schemes are a type of illegal pyramid scheme named for Charles Ponzi, who duped thousands of New England residents into investing in a postage stamp speculation scheme back in the 1920s. Ponzi thought he could take advantage of differences between U.S. and foreign currencies used to buy and sell international mail coupons. Ponzi told investors that he could provide a 40% return in just 90 days compared with 5% for bank savings accounts. Ponzi was deluged with funds from investors, taking in $1 million during one three-hour period – and this was 1921! Though a few early investors were paid off to make the scheme look legitimate, an investigation found that Ponzi had only purchased about $30 worth of the international mail coupons.*
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> *Decades later, the Ponzi scheme continues to work on the "rob-Peter-to-pay-Paul" principle, as money from new investors is used to pay off earlier investors until the whole scheme collapses.*

(U.S. Securities and Exchange Commission, "ponzi" schemes. http://www.sec.gov/answers/ponzi.htm.)

How could people fall for a scheme that promised such huge returns in so little time? Well, they did, and they continue to do so.

If you look up Charles Ponzi in Wikipedia, under "Similar Schemes" you'll see a new name: Bernard Madoff – Bernie to his friends.

BERNIE MADOFF

Bernard L. Madoff was arrested on December 11, 2008 by U.S. Federal authorities in New York City on charges that he perpetuated a massive securities fraud on the investors in his investment hedge fund. Estimates of the losses ranged up to US$65 billion. We now know that this was the total inflated market value of the investors' money. According to recent federal filings Bernard L. Madoff Investment Securities LLC, the firm Madoff started in 1960, actually held $17 billion in over two dozen funds.

A *New York Times* article dated December 11, 2008[1] quotes an associate director of enforcement for the U.S. SEC as calling it "a stunning fraud that appears to be of epic proportions."

The funds had been widely marketed to wealthy investors, hedge funds and other large institutional investors for decades. In fact there were approximately 77 "feeder funds" all over the world bringing in money that was forwarded to Madoff. Madoff's funds were popular because they promised high returns with low fees.

It seems that part of the reason that this scheme lasted so long was that the returns promised and reported seem to be high but not outrageously so. For example, one of Madoff's funds, the Fairfield Sentry Limited Fund, reported assets of US$7.3 billion in October 2008 and claimed to have paid more than 11% interest each year during its fifteen-year track record, according to the *Times* article.

I guess Bernie learned his lessons from Charles Ponzi well.

How did he do this? How did he convince dozens of sophisticated investors and financial institutions to trust him with their funds?

Well, one of the reasons is that he appeared to be a nice guy, with little or no ego. He used to tell interviewers that he got his initial

[1] (http://www.nytimes.com/2008/12/12/business/12scheme.html)

earnings to start his firm in 1960 by working as a lifeguard at city beaches and installing underground sprinkler systems.

In fact, I just watched a thirty-four-minute video of Madoff that was posted on YouTube, entitled "Bernie Madoff on the modern stock market." It was a roundtable discussion on October 20, 2007, shortly after the subprime mortgage crises started in the U.S. with stock markets riding high. One of his employees, a computer programming expert, sits beside him throughout.

During the video, he exudes charm. He said he employs highly educated MBAs, but he himself was "happy to graduate college." At one point he hired engineers from MIT to help with the computer trading models the firm employs but they "think too much." That gets a laugh from the audience.

He seems to know what he is talking about. He comes across as an expert. He never interrupts anyone. He'd be the kind of guy you'd want to introduce your kids to if they wanted to get into the investment industry. Well, except for the fact that you now know that he is a consummate con artist.

A couple of the most interesting comments actually come at the end from the audience. One individual in the investment industry makes the point that most people who invest big money in the stock market actually made their fortune somewhere else – in an actual business – and bring the money to the market in an attempt to make more. They did not become wealthy by buying stocks!

His employee, a guy who at the time made his living investing, makes the point that the market is fuelled by greed and fear. He goes on to talk about greed being a slow process, and fear happening fast. When markets are going up month by month, year by year, people get in. Some start early, some late. Some invest a lot, some not so much. When things go bad, the "herd mentality" causes people to panic. The fear of losing money causes everyone to act. They all sell. Markets crash, and they crash quickly.

Yeah, we know.

I realize that Bernie Madoff is an American dealing with many wealthy investors, so you may not be able to relate to the plight of the people who trusted him. But, con artists don't just exist in New York. They live everywhere, even in Canada.

OUR VERY OWN CANADIAN FRAUD

The Eron Mortgage fraud happened in British Columbia. That is not a typo. It's not the "Enron" fraud. It's our own very particular Canadian Fraud.

What's different about this fraud is that a detailed study of the ins and outs of how and why it happened was performed. And the results are intriguing.

The report is titled "Eron Mortgage Study." The principal researcher was Neil Boyd, LL.B., LL.M., Professor and Associate Director, School of Criminology at Simon Fraser University. The study, conducted in 2004 and 2005, is the first comprehensive study of an investment fraud and includes responses from more than 2,200 Eron Mortgage investors. This was a detailed project. Researchers reviewed relevant existing research on investment fraud; reviewed the B.C. Securities Commission findings on the case, held several focus groups; and distributed two sets of surveys – an initial one to 520 random Eron investors, and a refined, final version to 1,765 investors. They also conducted 180 telephone interviews and had face-to-face meetings with regulators, legal counsel, accountants and other experts in securities legislation and investor fraud.

The first thing that strikes you is the sheer number of victims. Roughly 2,800 people became prey to this one scheme and this is just one private market deal in one Canadian province.

The second thing that hits you is the absolutely devastating affect that losing money in this scam had on people. Consider this quote received from an Eron investor:

> *It made sense to me. Joe Blow has a piece of property but can't proceed, because of not having capital to proceed. Therefore he borrows money at high interest until he gets the infrastructure together for this project that he's hoping to have happen. As soon as he's got something, the banks or someone else can mortgage it for him, and he would pay back the high interest loan.*
>
> *A friend of a friend that told me about Eron, and at the time I was a struggling single parent, and he encouraged me and*

an awful lot of others to invest in this … so I invested all the savings I had – about $14,000. All I remember is that I was a single parent and was struggling. I know that to some people the $14,000 wasn't much, but it was disastrous to me.

That's often the "hook": the ideas seem to make some logical sense.

The other thing to take careful note of is the personal connection angle. Boyd's research on the dynamics of victimization indicated that frauds are most likely to be successful if the victim had some kind of personal tie to the con artist. In most cases, the initial contact was in person or through a third party, television or the media as opposed to mail or telephone.

What Did the "Average" Victim Look Like?

There was no common attribute among survey respondents, no single "flaw" that researchers could find. Most (61%) of the investors were male and working at the time of the investment. The average age of the Eron investors was fifty-five at the time of first investment, with approximately 64% over age forty-five at that time.

They seemed to be no better educated or more affluent than the average British Columbian of similar age. About one-third had a University education, one-third had some college or post-secondary training and the rest were either high school graduates or did not complete secondary education.

The majority were not wealthy. At the time, about two-thirds had total annual household incomes of less than $75,000 with only 12% reporting that it was over $100,000. This is similar to the average Canadian.

The majority (60%) had a household net worth of under $250,000 excluding their principal residence.

Almost half (48%) considered themselves conservative investors and fully 78% admitted they were not "very knowledgeable of the securities market and mortgage investments."

The study seems to confirm the desire to attain wealth the "easy" way. While 62% thought the Eron investment was no-risk or low-risk, the number one reason people were attracted was the high guaranteed rate of return. Sophisticated investors would know there is no such thing as a high guaranteed rate of return. In this case, 34% of the investors did not even know they were investing – they thought they were providing a loan with a guaranteed rate of return.

How Did Investors Become Involved in Eron?

Most of them heard about Eron through family and friends; however, Eron seminars, brokers, newspaper and television ads were also important. Most respondents (55%) read the Eron investor prospectus, but it is not clear that would have done any good as there is no proof it was an honest document. Since this was not a public company, it did not have to file a prospectus with the B.C. Securities Commission.

What Steps Did They Take Before Investing?

Less than half the investors took additional steps beyond reading the prospectus. These steps included viewing photographs of the project, consulting with family and friends who were involved, speaking with other investors or visiting the Eron offices. It is not clear, though, if this would have done any good in this case, as it was a bogus operation.

Very few people took steps that may have warned them early enough. Only 13% reviewed audited financial statements, 11% sought independent professional advice, 7% actually visited the properties and only 6% checked with regulatory agencies.

Only 2% of the investors bothered to check the backgrounds of the two principals that invented the scheme. If they had, they would have found out that both had been bankrupt before and had a history of failed businesses. This may have been enough to discourage some, but a background check is not a fail-safe way to protect yourself. Remember, Bernie Madoff was the chairman of the NASDAQ stock exchange at one point and had a very good reputation.

Why Did They Invest?

When asked the main purpose of their Eron investment, 58% said to build their retirement savings. The next most common answer, at 19%, was to enhance current lifestyle. This is a significant finding. It means that many people are worried about financing their retirement and are willing to take significant risk to try to solve the problem.

This makes many people pre-disposed to being ripped off. Retiring well involves a bit of work and those who say you can simply hand your money over and walk away knowing you're being well taken care of are probably trying to make money off you.

Where Did They Get the Money?

Tragically, in most cases the money used for investing in the scheme was not from excess savings but from existing retirement savings, mortgages on their homes and loans from financial institutions. Boyd's conclusion is that "a significant number of the investors jeopardized their financial security because of their apparent concerns for their financial futures."

In other words, in pursuit of their goals they ignored point number one of a successful retirement strategy: avoid situations that could lead to personal financial disaster.

The Lessons of Eron

The lessons of Eron are simple:

- **Don't believe anyone who says they can guarantee a high rate of return.** Achieving a high rate of return means accepting risk – the risk that you could lose it all.
- **Knowing someone involved does not help.** In fact, it often does more harm than good. People seem to "let their guard down" when friends or family are involved.
- **Investment education is the best defense.** Trying to blame securities regulators after the loss is essentially a waste of time. Educate and protect yourself – don't get involved in the first place.

- **Check the background of the people involved.** In this case both principals had gone bankrupt before. Would you trust your life savings with someone like that?

EXTRAORDINARY POPULAR DELUSIONS

Beware that disaster can strike even if there is no con artist. People's own lust for wealth can lead to disaster all by itself. All you have to do is think back to the dot-com bubble around the year 2000. People were freely investing in companies that did not have any profits. In fact, many companies did not even have any *revenues*. All they had were ideas. Buying pet food over the Internet anyone?

This is not a new concept. I read a great book called *Extraordinary Popular Delusions and the Madness of Crowds* (Charles Mackay, 1980) that details sixteen different cases of people losing their heads, and then their shirts, over the latest "sure thing."

It includes the tale of Tulipomania, where more than a few lost fortunes on a single tulip bulb! (The story of the merchant who ate a tulip mistaking it for an onion is worth the price of the book).

It also includes the story of the South-Sea Bubble of England in the 1700s, where thousands were left penniless believing the South-Sea Company would make them rich through free trading with the ports of South America. During this period it seemed everyone wanted to invest in almost any idea imaginable to get rich.

One such company's prospectus actually stated its purpose as: "For carrying on an undertaking of great advantage; but nobody to know what it is." The government had to declare it illegal just to prevent people from investing in it!

But probably the most important lesson of the book is what happened after the South-Sea bubble scam had been exposed. Everyone was after the heads of the directors of the South-Sea Company, who by their fraudulent practices had brought the nation to virtual ruin. Here's what Mackay says:

> *Nobody seemed to imagine that the nation itself was as culpable as the South-Sea Company. Nobody blamed the credulity and avarice of the people – the degrading lust for gain, which had*

swallowed up every nobler quality in the national character, or the infatuation which had made the multitude run their heads with such frantic eagerness into the net held out for them by scheming projectors. These things were never mentioned. The people were a simple, honest, hard-working people, ruined by a gang of robbers, who were to be hanged, drawn and quartered without mercy

(Charles Mackay, Extraordinary Popular Delusions and the Madness of Crowds [New York: Harmony Books, 1980], 72)

This is an important point that was also made in the Eron Mortgage Study. Sure, there are con artists and there always will be. But the con artists cannot be successful if people don't fall for their schemes.

OTHER POTENTIAL DISASTERS

It's not just chasing the riches promised by schemers that can lead to financial ruin. There are many other potential disasters awaiting Canadians. Here are but a few:

Credit Card Disease

I once had an e-mail from a gentleman whose credit card debt exceeded his family's total annual gross salary. He said they simply could not afford to live without credit cards. While most Canadians aren't in this bad a situation, a large percentage – the card companies say it's approximately 30% – carry a balance month to month. In other words, they spend more than they make, using credit cards to make that possible.

This is not only a waste of money (with interest charges at 20% or more), it can lead to the ultimate personal financial disaster: bankruptcy. But you know what? This is not the credit card companies' fault. And while you could argue that the rates are excessively high, the companies are not forcing consumers to use their cards. The problem is the spending habits of the people.

That's why it's so hard to pay off a credit card balance. You may be able to pay a big chunk down but the additional charges during the last month often offset any paydown. Add the fuel of easy credit card availability and many Canadians are putting their whole financial future at risk.

Taking Out a Mortgage on Your Home to Invest

You could end up losing your investment … and your house.

The Latest Stock Chase

Many people seem to want to get rich, easily and quickly. What better way than the latest stock market darling? Enron, WorldCom, Nortel, Bre-X anyone? The folly of this strategy usually becomes clear too late.

Trusting Your "Friends"

There are more and more stories surfacing these days about incompetent or even out-and-out fraud by "investment advisors." Now obviously, I don't want to paint all advisors with the same brush, but many people place their retirement in the hands of friends or even relatives that are simply unqualified or even rip-off artists.

Mortgage Fraud

Imagine a senior having paid off the home mortgage, only to have it stolen from her by an unscrupulous thief who registers a mortgage on her property without her knowledge.

HOW TO PREVENT PERSONAL FINANCIAL DISASTERS

You need to have preventative controls in place so you don't get conned. In other words, don't expect a "big brother" to bail you out of a bad decision. In most cases the government, the securities regulators and other watchdogs are not even responsible for trying to recover your money.

Avoid getting sucked in altogether. As Boyd states in his report's conclusion to the Eron Mortgage fraud:

> *We can make improvements to regulatory law so that it better protects investors, but it will ultimately be a well-informed and skeptical investor who is less likely to be victimized. (Neil Boyd, Eron Mortgage Study: Final Report [March 31, 2005], 37)*

CONCLUSION

Very few people think about this, but avoiding personal financial disasters should be the number one rule of personal finance. Unfortunately, the vast majority of Canadians make at least one major mistake in their personal finances during their life. This often puts them back years and can result in financial devastation.

And just how do they get into these disastrous situations? By falling for the slick sales pitches of unqualified advisors and in some cases outright con artists. The best way to avoid the disasters is to avoid the schemes that can lead to them.

If you take just one thing from this book, make it this one.