Avoiding Scams, Scoundrels and Schemes: 10 tips to mitigate investment risk

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Investing is a difficult exercise for investors, big and small. Below we explore a number of examples and ways to mitigate your investment risk thereby increasing your chances of success.

1. Don't put all your eggs in one basket

Spread your investments across different assets and asset classes. While it may be simpler for an investor to invest solely in shares, a superior, less risky portfolio return may be achieved by investing in other asset classes such as fixed income and hybrids. There are a range of these products listed on the ASX or available via a specialist fixed income broker.

2. Don't be afraid to get a second opinion

It is important to trust your selected advisor's judgement but don't hesitate to obtain a second opinion from another professional. The small extra cost can repay itself countless times by helping to avoid a poor investment decision. In addition, examine the possible incentives being offered to the advisor. A good advisor should be transparent and disclose any incentives they may receive as a result of your investment.

Guvera was an unlisted music streaming service, which offered advisors up to $30,000 worth of referral fees or free options to raise money off their clients. This was in addition to subsidised trips to opulent fundraising events hosted by an associated company. The company raised approximately $180 million off investors before winding up, having never made a profit and wiping out the invested funds of over 3,000 investors.

3. Understand how your investments make money:

It is essential to understand conceptually how your investments make money and how returns are being generated. Without this level of understanding, investment risk is increased substantially especially in cases where leverage is utilised to generate more attractive returns. Whilst leverage can be beneficial in certain circumstances, it is often bad especially where used excessively.

Storm Financial was financial advisor aligned with a number of large financial institutions. Broadly, all of its clients were provided generic advice to mortgage their homes to the hilt and invest in indexed funds run by Storm's partners, with periodic re-balances and accentuated by margin loans provided by Storm's partners. In a rising market and conservative leverage this may have worked well for a time however, the GFC brutally exposed the flaws inherent in the business model. Towards the end of the jig, it turned out Storm was keeping it's clients permanently geared at 90% (ie. 90c of debt for every dollar invested) without notifying them of any increases in leverage; making its clients highly vulnerable to any downturn in the market. Storm and its partners were incentivised via a gamut of high fees including a large portion upfront and trailing commissions.

The GFC passed and 3,000 of Storm's clients were left destitute and many more badly affected with total losses estimated at $3 billion.

Scandalously, the principals of Storm were served with civil penalties of only $140,000 collectively; a slap on the wrist for those who destroyed the lives of so many.

4. Recognise the value of governance:

Good governance is critical for any successful investment. This covers aspects such as the use of internal controls and separation of duties within the organisation, the independence of the entity's auditor as well as accurate disclosure of related party transactions.

In addition, the value in the use of independent 3rd party providers should not be underestimated for investors in managed funds or schemes. Outsourced providers for administrative functions like unit pricing allows a 3rd party to critically assess the fund which theoretically reduces the risk of fraud. Independent auditors play an important role and their commentary should be read carefully.

A good board with the requisite processes, structure, and skills play the largest part in defining the entity's governance and culture.

In the entrepreneurial 1980's Laurie Connell's merchant bank, Rothwells, had a number of issues that were highlighted above. In particular, governance was exceptionally poor with Connell holding the position of both the managing director and chairman. The board of directors rarely met and investment practices were not enforced or reviewed. In addition, Connell's companies were the largest borrowers of Rothwell's funds however, these were cleared off the balance sheet before each audit date involving a number of mechanisms with friendly companies. The auditor, imported from Queensland to Western Australia, gave the accounts a clean bill of health until the end. Ironically, Qintex another 1980's Aussie fraud imported their auditors from Victoria to Queensland.

5. Private investments are far more difficult than public. Be wary of private entities held within a public structure.

Investments in private unlisted companies are far more difficult to assess and invest inthan public, listed opportunities. The major difference is the lack of liquidity in private investments. Generally, in a public listed investment; liquidity is available at an open and relatively transparent price. Private companies unless exceptionally attractive, generally struggle for secondary market liquidity and at a greater transactional price than the public markets.

Governance can be a big issue due to the lack of protection for minority investors, especially where no binding shareholder agreement exists. In addition, disclosure requirements vary significantly between private and public companies. Be wary of public listed companies that conglomerate private opportunities, without providing clear and transparent valuation metrics and disclosure for their downstream investments.

Blue Sky Alternative Investments is a recent example where a critical public report from an external party led to scrutiny from the wider investing community. Blue Sky was exposed for significant flaws in their disclosure, private investment valuations and performance calculations, which led to a loss of over 95% of its stock value from its peak in a period just over 12 months.

6. Beware products with a veil of secrecy. don't invest in products that you don't understand.

Beware of those bearing products that are sold with airs of exclusivity, veils of secrecy and little disclosure. In addition, be wary of schemes that appear to target a particular ethnic or religious segment of the population.

Bernard Madoff has been one of the highest profile scams of late, with investors losing an estimated $18 billion. Madoff ran a Ponzi scheme, which involved paying returns to existing investors from the incoming funds of new investors; he managed to run the scheme over a time span of decades using a number of mechanisms. Primary was the fact that he claimed his fund was by invitation only, and he required secrecy from his investors. This provided his operation with an aura of exclusivity, and ensured that most existing investors stayed 'invested'. His industry links and associations also provided a veneer of legitimacy.

He also targeted specifically Jewish individuals and associations and played upon his own Jewish identity to build affinity with investors. Finally, his claimed annual 'returns' were consistently around 10%, enabling him to stretch the scam out over decades.

7. Beware of investments that sound too good to be true.

Firepower International was a fraudulent company that claimed to have invented a fuel additive pill that led to lower pollution emissions, increased fuel efficiency, and a cleaner engine. Scientifically, they claimed to achieve this by burning more of the heavier elements in fuel. Investors only needed to possess a rudimentary, high school level understanding of chemistry to understand the sheer absurdity of these claims. The company had achieved a level of credibility given the support of the Australian government agency Austrade and various government ministers; as well as a widespread sports sponsorship campaign by the company itself.

The charade ended when ASIC began an investigation into the company, for raising funds without adequate disclosure to investors. Firepower had raised anywhere between $60-$100 million from investors via intermediaries. These investors were sold shares 'cheaply' in the cents, with the projection that the shares would trade in the dollars one day. Interestingly, there was no actual Australian company, with no shares legally issued; yet the product was being sold by registered financial intermediaries. All the sponsorship and government agreements were with a legal entity that did not exist.

Needless to say, investors lost their entire amount invested. The promoter of the company walked free with no financial penalties or jail time.

8. Use your common sense

Don't invest without reviewing the appropriate issue documents such as a prospectus or an information memorandum. When in doubt, ask a trusted advisor. Don't sign legal documents without prior review by a solicitor to ensure that you understand the risks and your legal liabilities and obligations to be fulfilled under the contract. Don't be blinded by high returns or promises, there is no 'free lunch'. Beware the charismatic promoter.

Land schemes have always been a particularly notorious segment in the Australian market for the improper raising of funds. Typically, the promoter of the scheme secures an option over a parcel of land; with investors required to complete the acquisition. Investors are promised a high return dependent on the rezoning of the land at an unknown point in the future. The promoter is usually the only party to have a full understanding of the trail of funds, the issuing of shares or units and the rezoning process itself. This sole point of responsibility generally leaves the scheme open to abuse, and many investors get burnt by these schemes every year.

9. Consider tax but don't make it the sole basis of your decisions

In the 1970s the Australian government began offering tax incentives for rural industries and in particular tree plantations. The vehicle generally used for these investments were managed investment schemes (MIS). One of the biggest attractions with an investment in an MIS was that it gave the investor an immediate large tax break and allowing the deferral of tax until the end of the MIS or exit of the investor.Conventionally a plantation is an unattractive with substantial costs incurred at the front end of the investment, maintenance expenditure required annually and an uncertain return (or loss) achieved after an uncertain time period; this also assumes there are no natural disasters in the interim.

These structural impediments along with too much debt and the pursuing of unprofitable schemes burned many investors in the late 2000s. Thousands of investors were affected by the collapse of Timbercorp and Great Southern Plantations, two of the largest operators in the space, along with a litany of smaller operators.

10. Avoid where possible complex and international structures.

Allco was a financial services group which floated a number of different listed vehicles in the 2000s. The companies were largely involved in businesses which dealt with property and infrastructure as well as heavy fixed assets such as rail, aviation, and infrastructure all on a global basis. Whilst each segment is simple enough, Allco's engaged in a mind-numbingly complex array of cross-holdings and interrelated transactions in which the associated companies financed each other. The disclosures in financial statements were extremely difficult to decipher even for the dedicated professional investor.

In addition to the heavy borrowings within the companies undertaken as a course of business, the core identities in the group also held their stock in the companies with a high degree of leverage. This provided a strong incentive to attempt to support the share prices of the various satellites. Long story short, the advent of the GFC reduced the value of the assets and the cash flow available within the Allco satellites; the principals of the group were forced to liquidate their holdings due to margin loans and the majority of the Allco satellites were wound up. Ultimately, approximately $3 billion of equity raised went up in smoke.

Pulling it all together

If an investor has no appetite or inclination to perform due diligence upon their investments, they should consider outsourcing part of their portfolio to a trusted professional advisor. We would recommend speaking to an independent financial planning practice, to alleviate any concerns around incentives.

In addition, skilled active fund managers should be identified and explored as part of this consultative process.

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