Can you spot a Ponzi scheme?

Posted on: November 3, 2009

On June 29, 2009, Bernard Lawrence 'Bernie' Madoff was sentenced to 150 years in prison for perpetrating what has been called 'the largest investment fraud in Wall Street history.' Actual losses have been estimated at $64.8 billion by prosecutors. Apparently, Madoff admitted to his sons that his company, Bernard L. Madoff Investment Securities LLC, was nothing more than a giant Ponzi scheme.

What is a Ponzi scheme? The phrase was coined in the 1920's to describe a fraud orchestrated by Charles Ponzi, a clerk in Boston. A Ponzi scheme is defined by Wikipedia as 'a fraudulent investment operation that pays returns to separate investors from their own money or money paid by subsequent investors, rather than from any actual profit earned.' Ponzi did not invent the scheme, but his became known throughout the United States because of the enormous amount of money it took in.

While there are no hard and fast rules to define a Ponzi scheme, some clues that a financial fraud may be occurring are:

Unusually high or consistent returns - Charles Ponzi was able to defraud investors by promising 50% return on their money in 45 days at a time when annual interest rates were only 5%. Madoff consistently delivered 10% to 12% annual returns no matter what the securities markets were doing. Even Warren Buffett has experienced negative returns in his portfolios.

Friend or family euphoria - The key to making a Ponzi scheme work is to attract a steady stream of new investors. Typically, the first few investors are paid the promised returns, often with their own money or funds from new investors, to make the scheme look legitimate. They get so excited they re-invest their returns and recruit their own friends and family to invest. In July 1920, Ponzi was taking in a million dollars per week.

Meaningless words - The promoter may use terms like 'proprietary investment strategy', 'high-yield investment programs', 'offshore investment' or 'hedge future trading' to deceive an unwary investor. These phrases are essentially meaningless, but may sound impressive to someone who is not familiar with financial jargon.

History has documented many get-rich-quick scams all over the world that bilked billions of dollars from investors. We've all heard that 'if it seems too good to be true, it probably is,' yet a little bit of greed or desperation can cloud the judgment of just about anybody. There is no such thing as high returns with no risk. Remember, the higher the return, the greater the risk of loss.

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