How To Select An Investment Advisor in a Post-Madoff World

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The Ponzi scheme episode with Bernard Madoff has resulted in many people asking how to prevent connecting with a dishonest investment advisor. No selection process is 100% reliable. However, some simple criteria can carry the chances of hiring a dishonest person down to near zero.

Limit Access to Funds

You do not want the advisor to have disbursement access to your money. Without disbursement access to your funds, the advisor cannot remove any funds from the account. Keep your funds in custody with a large broker-dealer where your investment advisor can be given rights to initiate trades within the account, but cannot add to or remove anything from the account. When contracting with a professional investment manager, ensure that the investment manager is an entirely separate entity from the custodian.

Professional Affiliations/Designations

The Chartered Financial Analyst (CFA) designation is the gold standard for managing a portfolio of stocks and bonds. A CFA charter-holder is not a "financial planner". Investment managers who hold the CFA designation are specialists in managing a portfolio of stocks and bonds. Earning the CFA designation takes at least four years, and one must pass all day exams (three parts given on different dates). Each exam requires at least 250 hours of independent graduate-level and PhD-level study. The pass rate on Part I of the CFA exam process has been as low as 35%. The CFA designation, by definition, indicates a sincere interest in the profession as well as demonstrated knowledge and integrity. A CFA charter-holder must adhere to a strict Code of Ethics that is monitored by the CFA Institute. In short, if an investment advisor has accepted, and overcome, the great challenge of the CFA program, it should provide you, the investor, a great deal of comfort knowing that this advisor is very serious about his/her commitment to the investment profession.

Performance Reporting

One wants to work with a money manager who measures investment performance results using Global Investment Performance Standards (GIPS®) as defined and administered by the CFA Institute. This has become the global standard in measuring true investment performance in nearly 30 countries. The importance here is that GIPS® gives one a universal standard for comparing money manager performance on an apples-to-apples basis. Once you are examining performance, look at results for 1, 3, 5, 10, 15 years as compared to other managers and broad, relevant market indices. In general, long-term results are more important than short-term results. Any successful long-term performance will, no doubt, have short periods where the style is out of vogue.

SEC Registration

Check the advisor's record regarding any significant issues with the U.S. Securities and Exchange Commission (SEC). A Registered Investment Advisor (RIA) must comply with strict regulations and is examined periodically on-site by the SEC. It is a red flag if any investment manager you are considering has a questionable regulatory or legal history or has gone unchecked for no apparent reason.

Conflicts of Interest?

Finally, be aware if you do not understand the investment strategy proposed by your investment manager. If an investment strategy proposed by your investment manager does not make sense, is overly complex or is simply impossible to understand, back up and seek additional counsel before proceeding. Think of the various types of firms that want to assist you with your investment/retirement funds and then consider what their primary business consists of, along with the complication of deciphering how they will be paid by you. What percent of your assets will end up in their pockets over time? What do they really want to sell to you? To what extent are your best interests aligned with their best interests?

Following the above criteria, Bernard Madoff would not have been hired by anyone. Still, the above does not assure good performance results. But, it does help to greatly reduce the risk of selecting a dishonest investment manager.