

KEYSTONE FINANCIAL PLANNING ELECTRONIC NEWSLETTER

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Financial con artists prey on greedy investors

Greedy investors and savers who seek low risk and unrealistic returns face big risks of being defrauded. As the stock market enters its third year of declines and former stock investors search for “safer” returns, it is likely that more fraudulent alternative investment schemes will pop up, state and federal securities regulators warn.

The recently resurrected case of fraud at the Baptist Foundation of Arizona provides a stark warning to such investors that even the most innocuous-sounding pitch can be dangerous. The 1999 bankruptcy of the religious foundation caused some 13,000 investors to lose \$590 million. The case is back in the news because a trial is about to begin with a familiar target—the accounting firm Arthur Andersen LLP—defending its audits of the organization.

The Baptist Foundation was set up in 1948 by the Arizona Southern Baptist Convention. Its purpose was to raise money for religious purposes, such as building new churches. Investors, including many elderly persons and churches, bought promissory notes from the Foundation and earned competitive interest rates. The notes were marketed as ideal retirement investments that also promoted Christianity. Unfortunately for those investors, the Foundation's holdings in Arizona real estate plunged in the late 1980s. The Foundation used accounting fraud to hide the losses and continued to take in new money from investors, paying rates as high as 12% at a time when market interest rates were much lower. Questions were raised in the late 1990s and the Foundation collapsed in 1999. Many elderly retirees saw their life savings wiped out, and they are now suing Andersen for damages.

The U.S. Securities and Exchange Commission warns investors who are offered high returns to scrutinize them carefully. Returns correlate with risk, it says: low risk equates to low returns. To get high returns you must assume high risk. “Most fraudsters spend a lot of time trying to convince investors that extremely high returns are ‘guaranteed’ or ‘can’t miss,’” the SEC says. “Don’t believe it.”

State securities regulators worry that promissory note schemes are growing because investors are afraid of more stock market downturns. “Investors should stay away from notes promising high returns—upwards of 12% monthly—from little-known companies,” warns the North American Securities Administrators Association. It says that recently scam artists have enlisted some unscrupulous independent insurance agents to peddle their notes. The association also warns about prime bank schemes. “Scam artists, often operating over the Internet, promise investors returns as high as 300% through access to the investment portfolios of the world’s elite banks,” NASAA says.

Your best advice: be very skeptical and use trusted advisors and securities regulators to check out any unusual investment.

Shameless funds charge too much

Mutual funds are one of the most important innovations of all time for individual investors, allowing them to obtain wide diversification and professional investment management at

reasonable cost. That makes it the more shameful that large portions of the mutual fund industry continue to exploit shareholders with excessive costs, while delivering below-average returns.

Some fund companies offer very inexpensive products. Investors in funds offered by Vanguard, TIAA-CREF, Dimensional Fund Advisors, and others can buy into the stock and bond markets at the same low cost enjoyed by large institutional investors.

Other mutual fund companies are hurting their investors by offering funds with high fees, suggests a recent study by Morningstar Inc., an independent rating service. Costs are expressed by each fund's expense ratio, which measures the expense of operating a fund—brokerage commissions, record keeping expenses, the portfolio manager's salary—as a percentage of the assets of the fund. Morningstar looked at all mutual funds with \$100 million or more in assets during 2001 and found 30 that had annual expense ratios of 2% or greater, which is about double the industry average. By comparison, the lowest-cost mutual funds had expenses as low as 0.15%.

The study backs up a finding of much academic investment research: higher investment costs, on average, are accompanied by lower returns. Many of the 30 funds that had higher expenses did not perform as well as the average of their peer groups. For instance, the AIM Large Cap Opportunities Fund had an expense ratio of 2.34%, Morningstar said. (AIM disputes that figure. It estimates 2001 expenses at 2.12%.) The fund's performance wasn't so hot last year. The fund lost 26.6%, placing it in the 67th percentile of the large-cap-growth category, below average for all funds in that group.

Another fund with high expenses, the Kelmoore Strategy Fund, Class C Shares, had expenses of 2.41%, according to Morningstar. The fund invests in stocks, covered call options, and secured put options, placing it in the 97th percentile of Morningstar's "hybrid" funds category last year. That was virtually the bottom of the heap as it lost 13.7%, following a loss of 15.1% the previous year.

Mutual fund investors **cannot** control the market's investment results, but they can control their cost of investing. They should compare a fund's expenses to its peers before taking the plunge. Funds with higher than average expenses should be avoided.

Every month Morningstar publishes a list of average expenses for dozens of fund categories. For instance, the most recent list shows that the average large company domestic stock fund has an expense ratio of 1.24%.

Other types of funds may have higher or lower expenses. It costs more to invest in small and international stocks, but investors still should not overpay. The average domestic small stock fund has an expense ratio of 1.41%, and the average large cap foreign fund has expenses of 1.65%, according to the most recent Morningstar survey.

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