

NEWS

HOW TO AVOID LOSING MONEY IN HIGH RISK UNREGULATED INVESTMENTS



Since base rates came down to almost zero, investors have been looking for investments with returns to compensate for the drop in interest they earned on cash and bonds. Due to the high volatility of stock markets and losses on investments that were previously considered safe, they have started to look outside the traditional asset classes and often find potential returns offered by unregulated collective investment schemes (Ucis) look extremely attractive.

As an investment adviser based in the Cote d'Azur, I have been asked to analyse many such funds and proposals. The preponderance of wealthy individuals in the region attracts those trying to raise money for their funds, presumably after they have exhausted possibilities in the financial centres of Europe. Many of these funds are promoted directly to potential investors living in Monaco and on the Riviera, often at a lunch at a smart hotel or a cocktail party.

Risky nature

These investment funds cannot be marketed to the general public and can only be offered to 'sophisticated' or high net worth clients due to their risky nature. The IFA promoting the fund or giving the advice must be regulated but by accepting that you are either sophisticated or high net worth, as defined by the FSA, you may be waiving your right to protection or even to complain.

However, it is worth knowing that a recent FSA survey of IFAs discovered the quality of advice surrounding unregulated collective investment schemes was seriously lacking and many advisers weren't even aware of their regulatory requirements.

Depending on the jurisdiction in which the investment is being offered, the information the promoter must legally provide to the potential investor may be much less explicit than for a fully regulated investment and, as a result, the

potential risks can be much less obvious. A Ucis is not subject to the investment and borrowing restrictions designed to ensure a prudent spread of risk, making it more risky. It is often less liquid and less transparent than traditional investments, and there is a real probability the entire investment could be lost if things don't work out.

I've come across a range of different investment schemes that I advised my clients to avoid, some of which are still on offer. Not all turned out to be fraudulent (although some did) but in all cases I believed the risks were understated and the potential returns overpromised – both a recipe for disaster. Here are some examples:

- The 'green' fund that made a return of 12% for investors in its first year even though the underlying assets weren't yet profitable. Investor money was being recycled back to the fund from working capital (supplied by the fund) in the form of a rental payment.
- The commodity trading fund that offered annual returns of 40% but which turned out to be South Africa's biggest Ponzi scheme.
- The bridging loan fund that ground to a halt during the credit crunch – withdrawals were suspended and its assets were written down by 75%.
- Investment directly into a Brazilian timber business via a Swiss holding company. No-one among the fund directors had specific experience of forestry and the ability of European investors to assess the complexities of Brazilian corporate law in case they needed to get their investment back was certainly debateable.
- A traded endowment fund whose marketing brochure promised 'massive secure rewards from the secondary market in life assurance policies'. These two elements rarely go together in the investment world: it's one or the other.

In many cases the fund is attempting to raise money for what is effectively a start-up business and which carries the risks associated with an untested business. The fund structure facilitates the ability to pay a rate of return from day one but this can only be done by placing at risk the return of capital, something that is usually

downplayed. I have also seen the 'sophisticated investor' denomination explained as a way to compliment the client rather than inform them of their reduced right to regulatory protection.

An investment is usually based on trust in the person promoting the fund and therefore needs to be sold directly by someone who inspires confidence and who can sell the concept. Often 99% of the information investors get is positive but no matter how smooth the sales pitch, an investor should do their own due diligence or pay an unbiased third party professional to do it for them.

Rewarding owners not investors

Some funds even purport to have no management charges and this should certainly raise some questions about how people are being remunerated. Furthermore, a major criticism of many of these funds is that they often reward the fund owners more than the fund investors, even though the investors are the ones putting up the capital and taking the risks.

Many of the fund examples above share the same characteristics. Here are some things to watch out for: promised returns that are much higher than other mainstream investments; returns that are fixed or guaranteed; a promise of non-correlation with stock markets or other investments; a lack of transparency surrounding the fund structure and specific financial details; no secondary market, meaning only the fund manager can return your capital; an absence of explicit management charges; and a lack of documentation. And, as always, if it looks too good to be true, it probably is.

MORE ON... Richard McCreery

Richard McCreery is an IFA based in the South of France. He created RM Wealth Management in 2003. The firm specialises in providing original research, analysis and advice to a small number of high net worth and sophisticated investors.

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