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Do your homework on money managers

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From worrying about banks and a financial meltdown, investors are now wondering if they can trust the person investing their money.

In this year of shocks, investors were dealt another a little over a week ago. Someone considered one of the nation's elite money managers, Bernard Madoff, reportedly confessed that he misled investors for years about the money they were making.

The $50 billion firm collapsed, allegedly wiping out funds of supposedly savvy investors -- multimillionaires, colleges, foundations, brokerage firms and hedge funds. The clients, many of whom had done social gymnastics to get into his fund, may have nothing.

The situation serves as a reminder that investors need: Don't take on a broker, adviser, money manager or hedge fund without thorough checking.

Here's what insiders say you can do to protect yourself:

Avoid safety in numbers. Seeking the easiest approach possible, many busy investors turn to an adviser simply because a friend has been happy with the person. But people can be happy for the wrong reasons. Madoff supposedly delighted clients with seemingly consistent returns, apparently avoiding the downturns in the market.

You might not be able to protect yourself from a masterful fraud, but most investors fail to do the simple checks that will show whether the person or firm has been in trouble. Go to the Financial Industry Regulatory Authority at FINRA.org or AdviserInfo .sec.gov.

Also keep in mind that anyone can call themselves a financial planner. Financial planners with the certified financial planner designation or members of the National Association of Personal Financial Advisors have more training than others.

Snobbery might not make money. Remember Groucho Marx's line about not wanting to belong to a club that would have him as a member?

Investment crooks tend to play on that mentality, according to Billy Proceda, who investigates fraud in bankruptcy cases. There was an aura of exclusivity around Madoff. People allegedly joined clubs to try to be close to him and others who could get them into his fund. "Be skeptical rather than thinking, 'I'm so

lucky he'll take me as an investor.' Don't let someone's charisma or people surrounding him blur your vision," Proceda said.

Investors should always understand in depth the money manager's investment strategy and test it repeatedly as a client by examining monthly financial statements. The statements should not come directly from your adviser. Instead, they should be sent from the custodian that holds your assets -- a broker-dealer, bank or trust company. Also, when you write a check to invest money, it should not be written directly to the adviser.

A large firm should also have an independent auditor from a major accounting firm, said Keith Black, who evaluates funds for Ennis Knupp. The goal is to have independence.

Beware of secrets. Some money managers and hedge funds claim to have secret investing strategies that they cannot share.

If you are dealing with simple strategies such as investing in stocks and bonds, you can test whether the returns you are obtaining seem right by examining averages for the type of investments you have. For example, if you have a fund that invests in large-cap stocks, compare its results to the Standard & Poor's 500 index. Indianapolis financial planner Susan Elser says she expects individuals to go to independent sources such as a newspaper or Yahoo Finance to see if the returns they are receiving with her or other advisers are in the ballpark. She also expects clients to check the independent custodian used by the adviser if something seems amiss.

Some advisers use products they don't understand. Investors should ask the adviser to show them in dollars what the worst- and best-case scenarios would look like with the product, and how the fees translate into dollars over 10 or 20 years. If the adviser resists or can't, don't buy the product and be skeptical of the adviser.

Investigate strategies. Individuals often do not have the money or expertise to be in some of the hedge funds that attract wealthy individuals and institutions like endowments and pension funds.

Hedge funds should make up about 10 percent of a portfolio at most, said Russell LaBarge of pension adviser Strategic Capital in Chicago. And a person should hold several to diversify risk. If the investors don't have enough money to do that, they should not count on one, he said. Rather, he suggests inexpensive index funds, which are used widely by pension funds for core investments.

Meanwhile, hedge fund strategies involve deep analysis. Black said he spends at least half a day with the hedge funds he is considering for clients, and meets with everyone from traders to compliance personnel. The firms complete due-diligence questionnaires that end up roughly 30 pages long.

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