Understand financial products before buying

GET PERSONAL

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TWO EVENTS over the last few days have hit the headlines — one from India and the other from Pakistan, in which the person with the mandate to protect has done quite the opposite. Both unfortunate events — the killing of a leading politician by his bodyguard in Pakistan, and the significant financial losses caused by a relationship manager closer home, have driven home the point clearly that whether it's your life or your wealth, you need to take responsibility to protect it yourself.

While protecting your life is not something that I profess to have much expertise in, protecting yourself from financial fraud can definitely be minimised by greater alertness and awareness. Unfortunately, investors spend far more time buying a television set than investing five times the amount in a financial product.

Betrayal of trust does create a lot of angst, so it is critical that investors take referrals from friends and family before choosing a financial adviser. Unfortunately, a lot of investors choose their financial advisor based on the — price — the cheaper the better, which is contrary to what they do when they buy other products where the belief is that the more expensive the product, the better the quality.

Once the due diligence on the advisor has been done, what can an investor do to protect oneself:

■ As investors seek new products, financial product manufacturers tend to create exotic instruments to fulfill that need. Investors need to stick to products that are more transparent and where risks are clearly understood. Remember the mortgage backed securities in the US a couple of years ago that took some big names down with them or guaranteed return products that did not even return the principal, forget the guaranteed returns.

■ Multiple products today use back testing data, which essentially demonstrates how the product would have performed over different time frames.

This is different from actual performance and is exposed to the risk of data selection bias. Ideally, the track record should be independently verifiable. For example, mutual fund performance data is available on independent websites, so investors can do their own verification of performances and track records.

■ Any product that offers returns that are completely out of sync with competing product returns needs to be closely subscribed. In an era, where fixed income returns range between eight and ten per cent, a guaranteed return of more than 15 per cent should definitely cause you to do a significant amount of homework.

■ While time is definitely at a premium for everyone in today's busy world, time spent on understanding where you're putting your money is definitely time well spent. Avoid signing blank documents and cheques just because you don't have time.

■ Many investors have small sums of money in multiple investments making them very difficult to track.

With larger chunks of money in each investment, you will tend to give it more thought both at the time of investment and also monitor it on an ongoing basis.

- Buy what you clearly understand.
- Seek a track record over a long period of time.
- If something sounds too good to be true, it probably isn't true.
- Don't risk what you cannot afford to lose.
- Put larger amounts so that you spend more time on it.

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