

The Roundtable Notes

What's Next for Family Offices?

Last year's precipitous market decline and a spate of potential new regulations have prompted many wealthy families to re-examine their family offices — their structures, risk controls, and operations. We recently brought together a small group of family-office founders for a roundtable in New York to share experiences and perspectives. Moderated by five industry experts, the discussion focused on three fields that family offices should scrutinize closest: the changing regulatory environment, investment strategies, and staffing and governance. Below are the highlights of the discussion.

Panelists

Robert Elliott, Senior Managing Director, Bessemer Trust

Amelia Renkert-Thomas, Counsel, Withers Bergman

Theodore Beringer, Managing Director, The Beringer Group

Holly Isdale, Deputy Head of Family Wealth Advisory Services, Bessemer Trust

Kathryn McCarthy, Family Office Consultant

New Regulation and Administrative Challenges

Regulatory changes are coming, said Amelia Renkert-Thomas, and any future strategies for family offices will have to be seen through the lens of a potentially harsher regulatory and compliance environment. For instance, the IRS has already extended its reach toward ultra-wealthy taxpayers, as evidenced by its recent investigation of UBS clients. Several panelists said the most pivotal potential disruption for family offices could be from new federal legislation requiring them to register with the Securities and Exchange Commission (SEC) as either an investment advisor or fund. Currently, legal exemptions allow firms with a limited number of clients or fund participants to fall outside the SEC's purview. The new legislation would intensify compliance, recordkeeping, and reporting requirements — and their accompanying costs — for family offices.

There are four such bills currently being debated. Three of them would mandate that family office advisors register with the SEC, while the fourth would require the family office's *investment fund* to be registered. This fund-themed bill could cause "the most mischief" for families, Renkert-Thomas said, because it would likely expose families to the onerous nature of random SEC investigations and require significantly greater disclosure of confidential family information. "I think the fund bill may end up with legs," she said, "because it actually is aimed at the very systemic risk [the Administration] is concerned about." As such, families should consider doing the following:

- Taking an inventory of family members and pooled investment vehicles and ascribing economic value to each of them, so that once new legislation comes, offices are prepared to formulate the most appropriate disclosure strategies for each entity.
- Reorganizing the office to avoid unnecessary direct registration; in other words, offices should be prepared for potential new ownership regulations, and should consider how they might best protect the family's privacy using various ownership structures.
- Lobbying. Though public advocacy can bring unwanted exposure to families, currently there are family coalitions lobbying in this area, and the monetary threshold to get involved is relatively low. Supporting such an institutional campaign can give families a voice without necessarily compromising their private information.

Investment Strategies and Risk Management

Despite spending heavily on investment management, some family offices are now re-evaluating their investment objectives and strategies because of weak relative returns, liquidity problems, and poor risk management. Others were able to weather the market meltdown reasonably well. The panelists shared the best practices of these successful families.

They included:

- Having clearly defined investment policies and sticking to them
- Understanding the family's liquidity needs, and which investments were appropriate for them
- Having the resources to conduct appropriate due diligence and research in managing risk

The Investment Policy. Most families that were able to navigate market turbulence had a comprehensive plan for managing their assets. Having a plan did not mean they were immune to losses, but that their portfolios performed as expected and the family was prepared for the setback and attendant illiquidity of certain investments.

The use of investment policy statements varies. Holly Isdale referenced one recent survey from the Institute for Private Investors, which showed that fewer than half of family offices had any well-defined investment guidelines. Of those that had guidelines, fewer than half actually adhered to them in the recent crisis. According to Isdale, a well-crafted investment policy statement should:

- Establish the investment objectives for the family as well as for each entity (e.g., a long-duration trust)
- Specify liquidity requirements
- Outline appropriate asset allocation ranges and acceptable time horizons
- Set forth reasonable expectations for returns after fees, taxes, and inflation
- Address the legal implications for each entity in light of the heightened regulatory environment

A fundamental part of structuring the proper investment plan is asking some basic questions. Moderator Robert Elliott suggested they include: "What does the family need the assets for? What is their core purpose: cash flow, keeping pace with inflation, or protecting absolute capital levels?"

Stress-testing these policy guidelines is important. Isdale recommended using a variety of analytical tools, such as Monte Carlo simulations, cash flow analyses, and other "what if" projections to help fine

tune the proper level of risk and return acceptable for the family or entity. These projections, she said, can also help families better understand their own time horizons and those of specific investments, which helps them plan for everything from next week's liquidity needs to the best wealth vehicles for the sixth and seventh generations. And these models should factor in potential taxes, expenses, and other fees, said Theodore Beringer, so that they don't risk overstating the actual net returns that families might expect.

"It's not investment management, it's not wealth management — it's people management," said Isdale. "It's bringing all those different issues together and trying to create an articulate, thoughtful plan."

Liquidity. According to the panelists, another key consideration is the ability of families to turn assets into cash when necessary. While cash flow projections are important in any investment plan, the analysis should also reflect the liquidity assumptions and constraints for any investment.

Over the past several years, many wealthy investors adopted an "endowment model" of investing, attempting to replicate the returns achieved by Yale and Harvard. Alternative asset classes — hedge funds, private equity, real estate — began to proliferate in these portfolios, said Isdale, constituting anywhere from 50% to 90% of some. One premise of this approach was that alternative assets were inherently uncorrelated to public markets, and should therefore act as a natural hedge. A second premise was that capital commitments could be met with the returns of maturing investments from prior years, creating a "self-funding" relationship.

Yet when equity markets collapsed in 2008, alternative assets also suffered, correlating strongly to the overall market and failing to provide the expected hedge. Moreover, the expected "self-funding" nature of these investments failed. Many families

found themselves in an unexpected liquidity crunch and were forced to sell equities and other liquid assets to meet short-term cash needs. That's why, Isdale said, mapping out an investment's liquidity characteristics is as important as understanding its tax ramifications or return potential.

Managing risk. This unknown — or underestimated — liquidity risk highlighted for family offices that the best strategic plan is only as good as its implementation. Some realized they had conducted inadequate due diligence or had adopted poor tactical asset allocation with an overweight to illiquid investments. Others found that they had failed to recognize asset-class interdependencies or challenge widely held assumptions when building portfolios. Managing for the “unknown unknowns” — those events that lie outside of the scope of normal economic cycles — requires an ability to challenge and question popular assumptions.

The financial crisis reinforced the notion that conducting rigorous research with exhaustive due diligence is necessary with complex investments. Yet, as Kathryn McCarthy said, “A lot of the family offices are not staffed to take on investment portfolios that are high-risk.” This requires considerable time, talent, and analytical tools for an investment team.

Staffing and Governance

Investing in a variety of asset classes and allocating them appropriately raises important questions for family offices: Who should manage which aspects of the family's wealth? How are decisions made? Who governs the office? What is the office's succession plan?

Despite the downturn, the requirements of family offices have actually increased, said Elliott. Services like next-generation education, estate planning, and accounting have only become more necessary and complex as families grow, he said, using the example of Bessemer's original single-family office before the Phipps family opened the firm to outside families in 1975. At that point, the office faced the same dilemma

many offices face today: having a limited asset base (\$1 billion) with an ever-growing family (over 100 family members) and an inefficiently sized staff.

Staffing. According to McCarthy, to be most efficient, family offices should identify which services are most critical to them and decide whether it's more advantageous to outsource them or manage them within the office. Generally, she said, services like budgeting, wealth advisory, and overall planning are managed by the internal staff, while investment and tax compliance services are outsourced. Family offices can prepare for unexpected events by making sure their external advisors have the depth to conduct extensive due diligence on investments but also the breadth to offer sound advice on complex tax issues or estate planning.

“As families move from the first generation to the second or third, governance has become a bigger item,” said Elliott. “How do you embrace the next generation? How do they feel engaged?”

Equally important is that offices receive unbiased advice that isn't motivated by a desire to sell investment products. And, for those offices that employ both an internal staff and outside advisors, it is important to establish how investment decisions are made and who bears ultimate responsibility for them. Isdale said that families can accomplish this by setting specific procedures and protocols to be followed in arriving at decisions. A set of formal guidelines can give committees and outside advisors the proper direction to make decisions catered to the family's ultimate goals.

Beringer recommended that families who utilize external advisors or look to join multifamily offices consider the comprehensive nature of wealth. “What you need to be a trusted advisor for a family is to have investment skills *and* family dynamic skills,” he said, “and very often those two don't mesh.” That's why it's

imperative for families to ensure that external advisors understand and sympathize with their overarching goals and family needs. By clearly defining the family's multifaceted objectives — whether they relate to family values, wealth, philanthropy, community legacies, or education — a family can determine what type of staffing structure will help them best achieve these goals.

Governance. Family offices were created to insulate the family from conflicts by establishing a clear decision-making structure, yet the market decline has prompted a re-examination of potential conflicts. For some families, the cost of maintaining the office has become excessive, leading them to consider downsizing, partnering with other families, or outsourcing certain functions. Other families are now adding a chief investment officer to oversee all their investments and help them avoid becoming over-invested in any one asset class. Some families noted that the pay structures they had set up for family office staff were problematic, placing more focus on return than on risk management or the proper alignment of interests. As a result, many families are using the changing environment to engage in “SWOT” reviews, laying out the Strengths, Weaknesses, Opportunities, and Threats to the survival of the family investments as well as the family office.

Besides poor investments, one of the greatest threats to a family office's survival is a lack of family leadership. “As families move from the first generation to the second or third, governance has become a bigger item,” said Elliott. “How do you embrace the next

generation? How do they feel engaged?” Services like financial education and firsthand experience in the office, along with meeting facilitation, have become increasingly important for offices merely trying to survive. Said McCarthy: “You can't have a family office without the ‘family.’”

“What you need to be a trusted advisor for a family is to have investment skills and family dynamic skills,” [Beringer] said, “and very often those two don't mesh.”

The panel also discussed the importance of having the appropriate legal support in governing the office. If the individual(s) making decisions can't understand the legal requirements of the entity, they need to consult either a well-crafted investment policy guideline or appropriate counsel to ensure that investment or distribution decisions comply with legal requirements.

Summary

Overall, the panel emphasized the theme of comprehensive wealth management — that families are re-evaluating their family offices by considering what their wealth is for, who it is designed to support, what values it represents, which investments will best align with those objectives, and who can best decide how to manage it. “It's not investment management, it's not wealth management — it's people management,” said Isdale. “It's bringing all those different issues together and trying to create an articulate, thoughtful plan.”

This material reflects the views of Bessemer Trust and is for your general information. It does not take into account the particular investment objectives, financial situation, or needs of individual clients. This material is based upon information obtained from various sources that Bessemer believes to be reliable, but Bessemer makes no representation or warranty with respect to the accuracy or completeness of such information. Opinions expressed herein are current opinions only as of the date indicated, and are subject to change without notice. Forecasts may not be realized due to a variety of factors, including changes in economic growth, corporate profitability, geopolitical conditions, and inflation.

Atlanta • Boston • Cayman Islands • Chicago • Dallas • Denver • London • Los Angeles • Miami
Naples • New York • Palm Beach • San Francisco • Washington, D.C. • Wilmington • Woodbridge

Visit us at www.bessemertrust.com.