WHITEPAPER

FAMILY OFFICE
ASSOCIATION

Single Family Office: The Ultimate Wealth and Legacy Protector

Given growing global financial risks, families of exceptional wealth with their own dedicated, properly structured single family office stand the best chance of preserving and expanding their wealth over generations.

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ABSTRACT

The vast majority of the more than 56,500 families around the world with net worth of $100 million and up and more than 16,500 with upwards of $250 million[1] have yet to create a single family office (SFO). Many families understand that SFOs provide the ultimate in privacy, control and customization. Their resistance to creating one often stems from a mistaken belief that SFOs are exorbitantly expensive to operate than outsourced investing and other services.

In fact, the costs of starting and running a family office—especially one that primarily retains its own dedicated direct investment staff—can be much lower than outsourcing to investment professionals/managers. The risks and opportunity costs of not having a single family office, which could be devastating to a family's future wealth, dictate reconsideration of creating an SFO.

This White Paper ascertains risks that today's tumultuous global financial markets pose for families of exceptional wealth and identifies the many ways a properly structured SFO can best manage, if not mitigate, those risks.

[1] WealthX's "World Ultra Wealth Report 2014" https://www.private-banking-magazin.de/uploads/fm/1416410395.Wealth-X__UBS_World_Ultra_Wealth_Report_2014_Final.pdf (Ac-cessed May 21, 2015.)

RISKS TO RICHES

Families of exceptional wealth, especially if at the level of creating an SFO, are in the "stay rich business." Maintaining what they have and keeping pace with inflation (near nil now) and taxes requires building a moat around the capital to protect it first and foremost, hedge risk, and protect purchasing power.

However, many wealthy families and their advisors drastically underestimate risks that could devastate their assets, especially as they transition from matriarch/patriarch to the wave of generations to come. Six of the most perilous risks are:

Forgetting They Are in the "Stay Rich" Business

Over time, investments in fragmented, uncoordinated, vehicles and structures laden with fees and without regard to taxes will have a wealth siphoning effect. When a family of exceptional wealth trusts others (outsiders) to invest in what they as wealth owners truly don't understand, conflicts and lack of alignment of interests often result.

Lack of Transparency

The point of an SFO is to completely and totally have control of the family finances and other affairs. When the family doesn't know what it owns, it cannot have true control. In times of turmoil, lack of transparency results in irrational decisions.

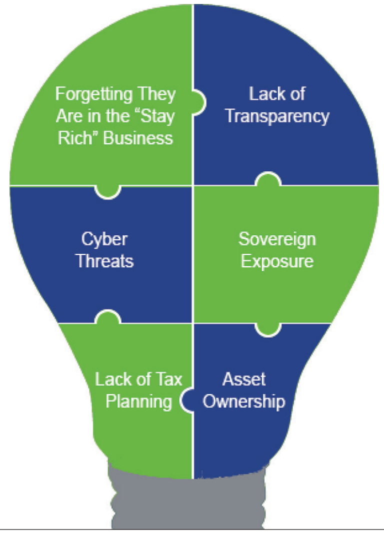
Cyber Threats

Former U.S. Secretary of State Condoleeza Rice, currently a political science professor at Stanford University and senior fellow at the Hoover Institution, told attendees of SkyBridge Alternatives (SALT) 2015 that the biggest global threat today is cyber security[2].

Recent breaches of hundreds of thousands of customer account and personal information by a top manager at Morgan Stanley, plus hacks into SONY and other major corporations' customer databases, indicate the seriousness of this threat.

Sovereign Exposure

Financial markets are subject to cycles, which history has shown will continue to occur indefinitely. In a worst case scenario, it may be a matter of if, not when, investors can reclaim what they own. Every asset class is at risk to the extent of where in the cycle it may be. Exposure as well as "asset location" affects the family strategy around generational transition, taxes, asset protection, political turmoil, systemic financial failures and even natural disasters. The institutions where cash is on deposit, the nations that issue the currency and the debt against which it's issued, marketable securities, as well as real assets such as jewelry, art, coins and precious metals could become subject to cyclical variations and sudden, unexpected shocks.



[2] SALT is the largest hedge-fund / alternatives conference in the world.

RISKS TO RICHES

Lack of Tax Planning

Lack of competent and proactive tax planning devastates investment gains and generational transition. A direct investing family office allows near complete control over the investment tax picture and potential for superior generational transition planning. Wealth owners should make it clear to their family office that proactive tax planning ranks in importance as high as investment management.

Asset Ownership

The strategic choice of which family entities and legal structures will own assets is woefully overlooked. It's important to consider what is best owned onshore, offshore, through a trust, GP/LP structure, corporation or limited liability company (LLC), etc. In other words, it's not enough to know what one owns (as discussed earlier); knowing *how* one should own various assets will impact asset protection, taxes and privacy.

A related reality, which is also poorly understood by the vast majority of even exceptionally wealthy families, is *rehypothecation*, which allows brokerage firms to hold public securities such as equities—that they purchase on investors' behalf through wire houses—in street name (a/k/a, an omnibus account). In other words, the direct owner of that security is not the investor, who only has a ledger entry legal agreement with the brokerage firm. The actual owner of the security is the brokerage firm, which holds it for the investor in "street name."

The United States' constitutionally protected property rights do not shield owners of public securities from margin risk due to rehypothecation. There are many legal repercussions, but the ownership issue alone sufficiently justifies placing assets inside firms that ensure your assets are titled and owned by you, not the street name. The impact that custody can impose on property rights makes it imperative to diversify the underlying custodians of securities by institution, by jurisdiction and by currency. For instance, wire houses are permitted to use shares owned by a client as collateral, even for the banks' own proprietary trading. This could, at times, result in a conflict and in some cases to the breaking of segregation rules (this is what brought down MF Global and many of its clients). Investors can, in some cases, request that rehypothecation be disallowed in their account. Better still, use a delivery-versus-payment (DVP) account and send the physical securities to a custodian of choice.

SFO SOLUTIONS

These six high wealth hazards can be monitored and mitigated to a large extent by a dedicated internal team with experience in global finance, cyber security and tax planning, to keep careful watch on geo-political and financial threats that can jeopardize the family's assets. That team is called a single family office.

Those who already have an SFO in place are among the minority of rarified wealthy families that have acted to protect their assets for current and rising generations. However, just having an SFO does not guarantee that it will be successful at safeguarding the families' interests. The majority of SFOs are vulnerable to one or more structural inefficiencies that can undermine even their best planning efforts.

Culture, then Structure

Peter Drucker reportedly said, "Culture eats strategy for breakfast." No matter how brilliant an organizational structure, it is often quickly and irreversibly undermined by wholesale failures of the cultural capacity, engagement or alignment of the vast majority of those who are supposedly being led.

Matt Wesley, founder of the wealth management firm The Wesley Group, recently asserted in his blog post, "culture eats *structure* for breakfast."[3] He explains, "Trusts fail and litigation ensues. Family behavior undoes financial plans. Tax strategies sit on the shelf because of lack of political will. Family feuds destroy otherwise healthy businesses. And the structural work of family governance specialists is a hollow shell that does not begin to address the family dynamics that, as it were, stand back, smirk, and then eviscerate all of this good work."

The SFO not only must have the right people who thoroughly understand the family's culture and have the right information to make intelligent decisions. The best family offices are built around owning the family's vision and values about generational wealth and legacy. They also make sure that required structures reflect the family's culture in order for the SFO to serve and thrive across generations.

One of the first cultural concerns for the SFO to understand is, what is the wealth for? The wealth creator and his or her family need to define and communicate their values, vision, and the legacy they want to leave. Good governance at the family level will guide them to draft a family mission and a family constitution, and develop a board or council that will address issues such as generational planning for all ages. Many families lack structural policies and procedures and fail to follow best practices that can mitigate risk and leverage what's available to them.

When the SFO is not built around the family's culture, the talent will have no direction, generational leadership or consistent message.

[3] "Culture Does Indeed Eat Structure for Breakfast," Family Wealth blog post Dec. 1, 2014 (http://www.thewesleygroup.com/blog/?p=609). Accessed 20 May 2015.

SFO SOLUTIONS

Direct versus Allocation Investment Models

On the investment side, there are two types of family offices: *allocators* that use the endowment model and allocate investments to outside managers, and *direct investors*.

The vast majority of SFOs are allocators: who scour the landscape for best of breed managers from long only, to hedge funds, private equity funds and venture funds. Wealth owners often greatly underestimate the cost of being an allocator (fees and net of taxes returns). In today's public markets, there is less need for wealthy investors to settle for the underperformance of many active managers (particularly alternative managers), whom Ashby Monk and Daniel Nadler refer to as "fee machines." These fee machines enable—in fact, invite—investors to challenge the model of outsourced investment managers, explain Monk and Nadler (executive director of the Global Projects Center at Stanford University and director of research for financial technology at Stanford University's School of Engineering, respectively) in their recent *Institutional Investor* article[4], (we highly recommend reading the complete piece).

With the *direct investment* model, the SFO sources and invests directly in public and private securities, as well as other investments such as real estate (and of course cash instruments). The family that directly invests completely, will unequivocally know what it owns (transparency), and achieve greater privacy, security, fee clarity, and far greater tax control. Direct investing enables the family to understand and control its liquidity and its ability to make internal direct hedging decisions based on these holdings. These are significant advantages. Direct investing in private companies is admittedly more complex than other assets to execute in terms of internal talent, resources and capital, but their benefits can exceed their challenges.

Even the best-of-breed outsourced managers will increasingly find it tough to justify their cost, as "technology has reached a tipping point in finance," insist Monk and Nadler. They note "smart financial intermediaries have used technology in the past few decades to obtain higher 'rents' and reinforce their competitive advantage within uncompetitive markets. … Indeed, to access the most powerful technologies, institutional investors and others (family offices) have had to work with the most expensive gatekeepers."

That model is morphing, to the disadvantage of Wall Street firms and the advantage of investors. "Over the past 30 years," say Monk and Nadler, "advances in technology have served to empower financial intermediaries. Going forward, technology may threaten their existence. It means the private club of hedge funds, which you happily paid 2 and 20 to join, won't be as exclusive as it used to be. It means the mythical 'black box' that some asset managers use to drive outperformance—and reinforce their own market power—will be democratized. It means we will see a gradual emancipation of allocators from high cost intermediaries and a dramatic move on the part of institutional investors toward much more flexible and affordable technology companies."

[4] "The Rise of the Tech Model May Soon Make You Obsolete," Institutional Investor, March 25, 2015
http://www.institutionalinvestor.com/Article/3439375/Asset-Management/The-Rise-of-the-Tech-Model-May-Soon-Make-You-Obsolete.html?ArticleId=3439375&LS=EMS1150282&single=true#.VV4jLmDtJjE
(Accessed May 21, 2015.)

SFO SOLUTIONS

Monk and Nadler also note that the convergence of technology, AI and fintech entrepreneurs that are disrupting old models, now enable SFOs as never before to “match” investors with very specific deals. Sourcing deals is of course only part of the equation. Diligence on private companies and the complexity, time and capital needed to go from interest to investment is far more complex than buying public securities. Many deals an SFO spends time and diligence capital on, however, may not close, of course. Even when invested, private company transactions require constant attention.

Another trend that will mitigate the complexity and cost of direct investment is the explosion of interest among SFOs to band together to do “club deals.” Participating SFOs in club deals share the tasks and costs of scouring the world for opportunities, as well as diligence and funding the investments. The collective approach of multiple SFOs sharing the vetting, co-investing with and monitering of private investments can be very valuable. Underlying families behind the SFO, especially those newer to wealth after exiting a specific industry, can bring connections and expertise in specific verticals. By combining the knowledge and resources of a variety of families into a collaborative effort.

Investing in private companies through private equity funds is another way to gain exposure to the inefficiencies and henceforth opportunities in the private markets. PE funds also may promote more diversification than a family doing one-off transactions. Despite the effects of the common 2/20 PE compensation model (see below) and the other limitations through funds, wise SFOs explore and understand all their options.

Aligning Family and SFO Interests

Families often fail to align their interests with incentives for their SFO executives. Executives simply follow their orders and mandates that the family gives them. It’s up to the family to set the culture of the family office, put governance and structures in place and provide an environment with resources and technology for the talent to do their job as best as possible.

Especially at the CIO level, compensation and bonuses are often tied to gross returns. Instead, motivating top talent to be dedicated to your family legacy and generational finances requires providing incentives to minimize taxes and maximize the true net return. While not the norm, smart compensation must also incentivize the CEO/CIO to achieve hedging, jurisdictional diversity, and proper asset location and allocation. This is not something to do on the “cheap.” Base pay, bonus and benefits for top-tier talent must be competitive. This is best accomplished in coordination with a compensation expert experienced with SFOs.

SFO SOLUTIONS

Hedging: Against Political Turmoil, Systemic Financial Crises and Natural Disasters

A well rounded plan for a family of great resources must include a plan to hedge and manage generational risks. Global banks, wire houses and custodians all play relevant and important roles for the wealthiest families. It is worthwhile to keep relationships with multiple top tier financial institutions as your net worth permits. The wealthiest families should explore country and institutional diversification. The U.S., Canada, Cayman, Bahamas, Uruguay, Switzerland, Singapore, Dubai, Hong Kong, Norway and Australia may make fair choices depending on the needs and exposure of each family.

Foundational holdings among many of the world's largest and most savvy generational families include income producing private businesses (opportunistic in land, agriculture, water and energy), real estate and real assets.

Certain real assets, such as gold, art, jewelry and land, may be limited as pure investments, yet offer excellent market hedges (if directly owned). Such hedges can protect assets and purchasing power. Therefore, an exceptionally affluent family should not be dissuaded from direct investment in these assets even though they may place a drag on income and perhaps short term asset appreciation.

Cash and marketable securities (public equities and fixed income) are also foundational holdings for families of exceptional wealth.

Costs: SFOs vs. Allocation

Given the many serious risks to riches and the ability of SFO professionals to devise and implement solid solutions, exceptionally wealthy families, with so much to lose, would be wise to consider creating their own family office.

Contrary to their resistance, based on a misperception about the cost of developing and running an SFO, many fail to understand that investment advisory/consultant and third party manager fees (in certain long only funds and near all alternative funds, performance fees) are often far higher than the cost of building and running a direct investing SFO. In fact, an outsourced investment advisory, coupled with an endowment model of choosing active managers and heavy exposure to alternative managers, can be very expensive net of fees and taxes.

Let's do the math. Investment consulting companies typically charge 40 basis points (bps) per year. For a family with $500 million to invest, that comes to $2 million a year, leaving $498 million to invest. Such consultancies are likely to recommend investing your money in hedge funds, private equity funds and venture capital funds that fold in another significant layer of costs, known as "2/20":

2% represents fund management expenses at the start of investing in the fund based on net assets invested ($498 million).

20% represents performance success fees is based on assets net of the 40 basis-point consulting fee ($498 million) plus 10% growth ($49.8 million), minus 2% management expenses ($9.97 million):

$498 million (assets net of 40 basis-point consultancy fee)	▶	$49.8 million (10% growth)		
$498 million	x	2%	=	$9.97 million (2% management expenses)
($49.8 million - $9.97 million) (growth) (2% management expenses)	x	20% (performance rate)	=	$7.97 million (performance fee)

For the $500 million net worth family, the 2/20 fees would come to another combined $17.9 million, assuming 10% gross investment returns:

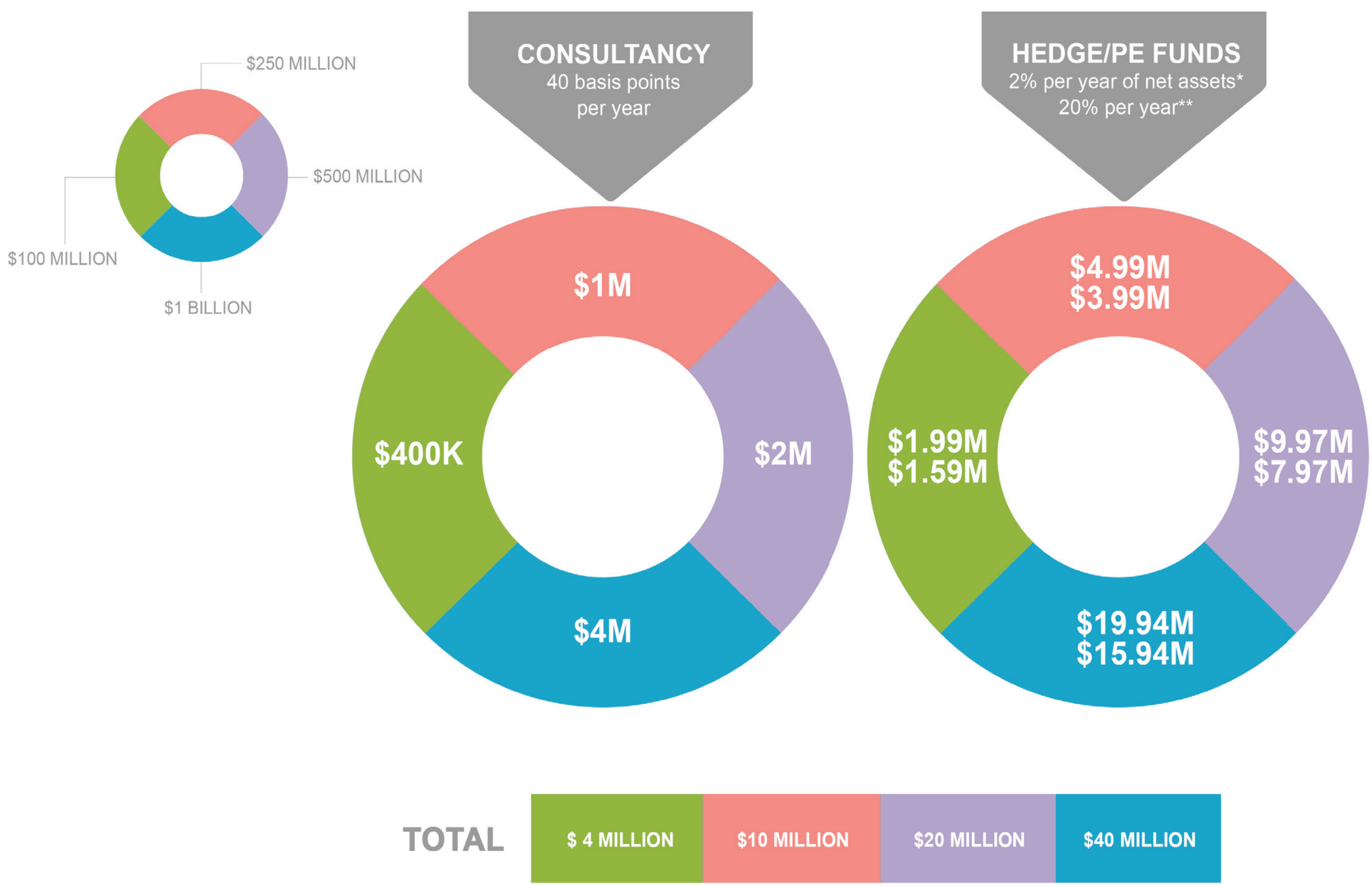
$9.97 million	+	$7.97 million	=	$17.9 million

Costs: SFOs vs. Allocation

Table 1 presents fees for families with $100 million, $250 million, $500 million and $1 billion in gross assets, rounded to the nearest decimal point.

** Net assets = investable assets minus 40 bp consultancy fee.*
*** Assumes a hypothetical 10% return on year end assets, less 2% management expenses.*

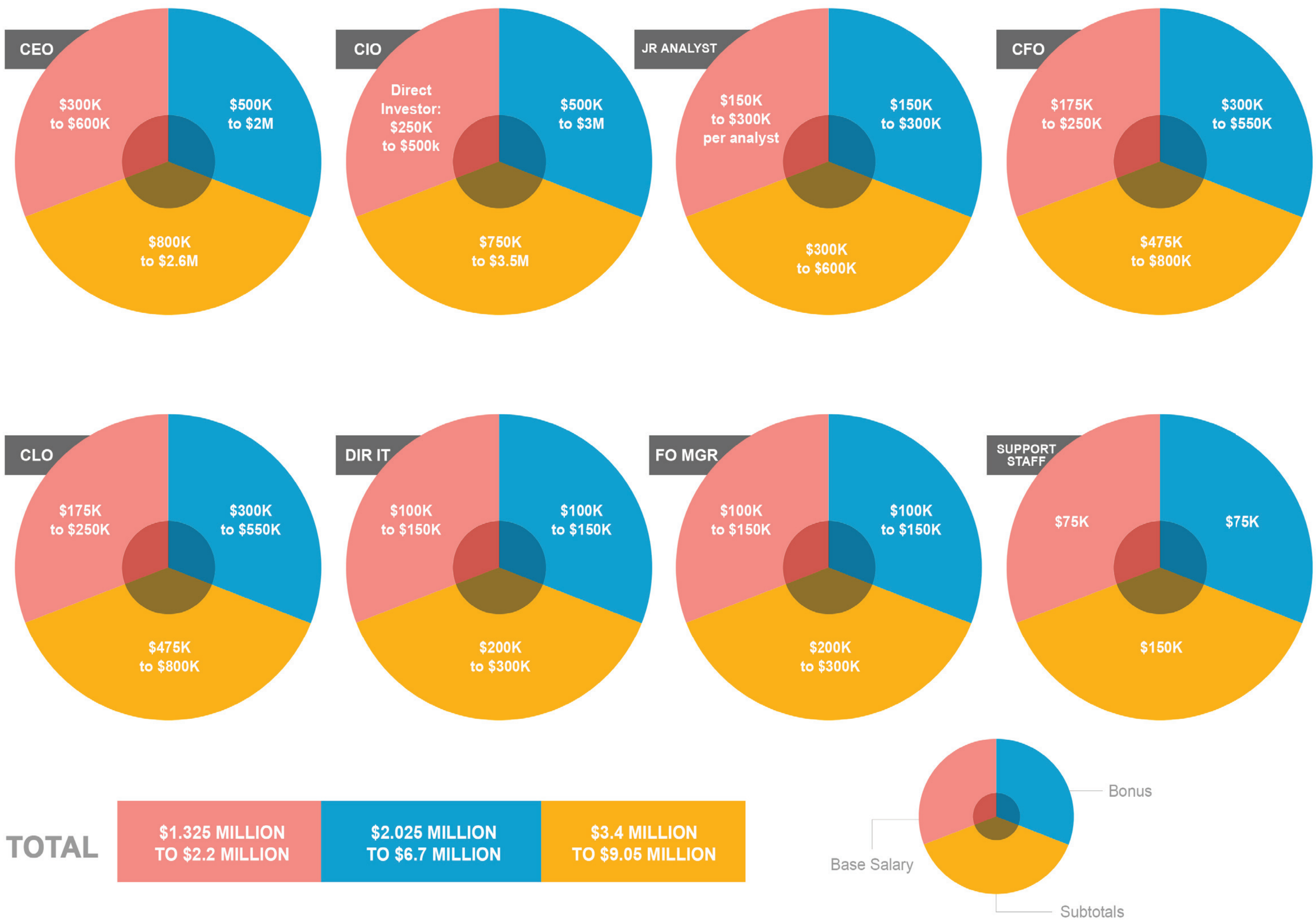
Table 1: Annual Consultancy and Investment Fees
INVESTABLE ASSETS



Costs: SFOs vs. Allocation

In comparison, a great SFO with top talent may cost between $3.35 million and $9.05 million a year.

Table 2: Annual Salary/Bonus Ranges for SFO Executives



Costs: SFOs vs. Allocation

Psychologically, it may feel harder to pay SFO executives and employees than to pay fees for investment consultants, advisors and funds. That's because with the SFO the family pays salaries and bonuses directly from the family's accounts, in most cases, so it feels more personal, while consultancy fees are often debited from a custodial account set up by the family and fund fees and performance are debited directly by the fund.

Another factor that has inhibited many families of exceptional wealth from organizing an SFO is the fear from their current advisor network, which may feel threatened by the buffer between them and the family of an SFO. Investment advisors of all stripes are painfully aware of how fintech and AI have disrupted the brokerage industry by disintermediation. Individual investors and SFOs no longer need middlemen as frequently as in the past to research opportunities and make investments directly.

IN PARTING

There has never been a better time for the wealthiest families to create an SFO—or for families with an existing SFO to reflect and possibly reorganize.

No bank or outsourced provider can innovate, collaborate or flourish as well as a new era family office that is streamlined and efficient, deeply rooted in the family's culture, serving an empowered family that works to inspire its talent. There has never been a better time for the wealthiest families to create an SFO, or for existing families with an SFO to reflect and possibly reorganize based on emerging trends.

The stakes are high, as many families could lose their wealth as they transition to future generations. The Family Office Association (FOA) is here to help new and existing members keep abreast of developments in the world of family offices and develop the "right" culture fit, leadership, talent, structures and technology to navigate such risks most effectively.

Author

Angelo J. Robles

Angelo J. Robles is Founder and CEO of the Greenwich, Connecticut based Family Office Association (FOA), a global membership organization that delivers private educational and networking opportunities, proprietary research, and access to salient thought leadership to multiple generations of wealthy families and the professionals who run their single family offices.

A member of the Princeton Council on Family Offices Mr. Robles has a long record of leadership positions at top financial service companies, including UBS. Before launching FOA, he founded and ran several successful entrepreneurial ventures: He served as President of the New England chapter of the Hedge Fund Association, and pioneered online retirement planning for Fortune 1000 executives with two Internet startups - 401KRollover.com and IRARollovers.com.

In FOA, Mr. Robles has created a resource unique in the family office world: a font of keen insights into strategic investing delivered personally by some of the world's top investors coupled with servings of thought leadership typically confined to gatherings like World Economic Forum and the Milken Institute Global Conference. It's a mix that avails his members of many of the world's sharpest minds: from David Rubenstein, Co-Founder and Co-CEO of The Carlyle Group, to PayPal Co-Founder Peter Thiel; from James Chanos, Founder and President of Kynikos Associates, to Irish born Walter O'Brien, a scientist so vital to the future of artificial intelligence that the U.S. fast-tracked his visa application the way it did for Albert Einstein.

Through this aggregation of many of the world's finest thinkers and doers, Mr. Robles offers his members an enviable look into the future of global business and finance, health and social trends, technology, and philanthropic opportunities most likely to make an impact. And all to advance interests unique to wealthy families and the professionals who serve them: wealth protection and growth, philanthropic impact, and the use of technology to address concerns across the board financial, legal and social.

Mr. Robles has appeared on Bloomberg Television and Radio, and has been quoted in the Wall Street Journal, Thompson Reuters, Institutional Investor, Opalesque, Registered Rep, HFM Week, Investment News, EurekaHedge, The Luxury Institute, Private Asset Management and many other media outlets.

Contributor

Arie Y. Levy-Cohen

Mr. Levy-Cohen is a thought leader in the field of wealth preservation and tail risk positioning of investment portfolios and more recently since 2010 in the Bitcoin / blockchain space. Arie started his career as an international entrepreneur based out of Barbados and later moved to New York where as a Venture Capitalist he participated in the emergence of the Internet. He later worked as a private banker in Zurich Switzerland where he honed the skills that ultimately landed him at Morgan Stanley, where he acted as Financial Advisor, International Client Advisor and Private Banker running both The Levy-Hafen Group and The WMO Group.

As a dual licensed Financial Advisor formerly working for both Morgan Stanley Wealth Management and the Morgan Stanley Private Bank N.A., Arie serviced institutional and ultra high net worth clients, focusing custody of all multi-currency fiat currency holdings through its Wealth Management Global Currency Platform, Precious Metals services through the MS Commodity and Precious Metals desk in addition to all value added services available to institutional wealth management clients.

In his role at Morgan Stanley, he also served as an investment advisor to a number of think tanks, incubator groups, venture capital funds, business development companies, private equity ventures & single family offices. More recently Mr. Levy-Cohen has been most interested in identity management and security as it applies to Wealth Management and has been instrumental in the shaping of several digital currency enterprises based in New York, including a non-profit leading capital markets team of professional peers.

Currently Arie is exploring distributed ledger applications and use cases for global financial services firms whilst keeping to his roots in Int'l Banking, Wealth Management & Precious Metals. With access to a highly qualified team of FinTech and Crypto professionals, Arie's extended focus will center around Identity and Cryptographic Security.

Contributor

Richard A. Ross

Richard A. Ross is Co-Founder and CIO of CC Family Office. He is also Founder of Family Office Technologies, which has developed and patented new financial models and technology to solve problems of tax- and fee-inefficiency in the family office investment process, and he is helping a friend -- a significant art collector but novice investor -- develop a family office in CT.

Prior to launching his current endeavors, Mr. Ross worked at Summer Road (a family office) in risk management and hedge fund due diligence. He has also consulted to hedge fund Bridgewater Associates and European financial services firm Six Telekurs, and licensed technology to Morgan, Stanley and Merrill, Lynch/Bank of America.

Prior to working in finance, Mr. Ross founded venture-backed startups in northern California for 25 years. One of his firms was acquired by HP; the technology is in your laser printer. Many years ago, he was the second engineer on Lotus 1-2-3, where he invented the “natural order recalculation” technology that made it the performance leader of its day, as well as other personal computer software innovations.

Mr. Ross has undergraduate and graduate degrees in Computer Science from MIT, where he also studied public policy/political economy, with an emphasis on tax law and innovation. Additionally, he holds a Certificat de Cuisine from Cordon Bleu in Paris.

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