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You may not be as rich as you think

Michael Nairne, Serious Money

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The problem is that large, liquid portfolios create a false sense of abundance.

For business owners who ultimately decide to liquidate the business they toiled away for decades to build, the influx of a multi-million-dollar portfolio can be quite liberating. There is now time to stretch one's wings and fulfill those many dreams there was never room for before.

I recall one business owner who, upon closing the sale of his business, departed directly from his lawyer's office for the airport for an extended tour abroad with his wife.

But within a few years, some of these wealthy families can find themselves quickly eroding capital as expenses overwhelm their investment income. The problem is that large, liquid portfolios create a false sense of abundance.

Often, there is failure to seriously consider the loss of salary that accompanies the business sale. Some former owners get a transitional consulting package, but once that is over, the investment returns on the after-tax sale proceeds not only have to replace the dividend stream that previously came from the business, but also need to replace the salary.

Ignoring inflation is also a big problem. What is a couple of percentage points a year when you have millions? The reality is that a 2.5% inflation rate means that a $10,000,000 portfolio has to grow by $250,000 in the first year just to maintain its real value. And inflation compounds - 10 years at this same inflation rate means the portfolio will have to grow to $12,800,000 to preserve its purchasing power.

And for those with champagne tastes, rising prices are even more of problem. According to the Forbes Cost of Living Extremely Well Index, the inflation rate for luxury goods runs about 60% higher than consumer inflation.

The costs of managing the family wealth are also not fully appreciated. First, there are the professional fees and costs associated with maintaining holding companies and various trusts, as well as ongoing tax planning and compliance. And the unexpected always seems to rear its head. One of the children moves to the United States and suddenly there is an unanticipated bill as tax specialists and estate planners wade into cross-border planning. Or an audit of a tax shelter results in a reassessment by the CRA. Then there are fees and costs for investment management itself - hedge funds and private equity managers in particular can charge hefty fees.

The corrosive impact of taxes is typically glossed over. Most investment managers live and report in a pre-tax world. The tax drag on the investment returns is computed by the accountant once a year, railed against and then quickly repressed. Yet, the wealthy see a much higher proportion of their income taxed at top marginal rates, so their after-tax investment returns can be much lower than the pre-tax numbers.

The false sense of abundance isn't just ignoring the toxic troika cursed by inflation, wealth management costs and taxes. Spending patterns can also pose a serious threat. Just like a business, the big items are space and people. I worked with one wealthy family where it wasn't just the costs of the Los Angeles home, New York condominium, overseas residence and oceanfront vacation property that weighed down the family's finances, it was also the cost of the staff to manage, clean and maintain these properties. Spending problems typically creep up; in this case, each property had been bought separately over the years until the total outlay became unmanageable.

The solution for the multi-millionaire is much the same as it is for any family: They need a long-term financial plan that clearly identifies the expected return levels from their investments and the volatility of that return. Tax costs have to be identified and deducted. Trade-offs - more risk for higher returns, different spending levels and different capital depletion rates - need to be discussed. An annual cash-flow plan needs to be established and monitored.

The truth is that resources are always relative to outflows and unless a family's finances are properly managed, even multi-millionaires will face a squeeze.

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