FINANCIAL POST

Saturday, January 7th, 2012

The five biggest pitfalls to staying rich

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Chris Ratcliffe/Bloomberg

There are five pitfalls to avoid if you want to preserve your wealth.

When it comes to wealthy families, the expression “easy come, easy go” is more aptly rephrased “arduously earned, easily extinguished.” Serious wealth typically arises from decades of hard work, investment and calculated risk-taking. Yet, hard-won wealth easily dissipates if it is not managed properly.

In fact, JPMorgan Private Bank studied the ultra-wealthy Forbes 400 Richest Americans and found that fewer than 15% of these multi-millionaires stayed on the list over a 21-year period. The majority saw their wealth stagnate or, worse, watched it decline. By delving into these experiences, JPMorgan identified the primary pitfalls in preserving wealth as well as the antidotes. Here are the top five.

1. Excessive concentration in a particular asset is the foremost pitfall. Wealth concentration in a single stock, even one of a large company, exposes an investor to a host of risks that can permanently impair capital. Whether it’s due to the fading fortunes of an entire industry, management pratfalls or a changing competitive landscape, any single investment can easily lose value, sometimes precipitously. How many Research in Motion Ltd. multi-millionaires are no longer “multi” as a result of this stock’s dramatic fall from grace?

Unfortunately, many wealthy families get caught in the trap of overconcentration and never implement the solution — broad asset class and security diversification. The memory of past successes, the prospect of a nasty tax bill on gains and excessive optimism encourage inertia. Some are lucky and see things turn out well, but many aren't so fortunate.

2. Too much leverage. Borrowing magnifies gains, but it also dramatically amplifies losses. The impact of excessive leverage is particularly pernicious during bear markets, when falling values can trigger margin calls in brokerage accounts or demands for additional collateral on bank loans. These can result in the forced liquidation of investments at fire-sale prices.

Unfortunately, in the blind pursuit of more money, many affluent individuals forget their paramount goal is to stay wealthy. The use of leverage needs to be judicious. In particular, the amount and terms of any borrowing should be fashioned such that the family's wealth remains fundamentally intact should a "worst-case" scenario play out. Many family fortunes were destroyed in 2008 and 2009 due to the failure to recognize that severe recessions and deep bear markets are inevitable — only the "when" is uncertain.

3. Chronic overspending is the third main pitfall. In my experience, most wealthy families do not budget. This is rarely problematic when times are good and money is rolling in, but in periods of lacklustre returns, excessive spending can outstrip returns and erode capital. Some families then get caught in a downward wealth spiral, withdrawing an ever-growing percentage of their capital as incessant spending depletes their portfolio.

Wealthy families need to scale their spending to their capital base. Those focused on long-term wealth preservation should keep annual spending at no more than 3%-4% of their portfolio value. Monitoring spending is also critical.

4. Taxes are the fourth major cause of wealth destruction. Unfortunately, many high-net-worth families fail to fully integrate their investment, tax and estate planning to minimize this drain. Savvy families and their professionals take an integrated wealth-management approach to their finances.

5. Finally, family dynamics can impair wealth. Discord among family members, often after the death of the parents, can lead to intemperate decisions about the family business and other assets, or costly and protracted litigation. Another classic fiasco is the squandering of wealth by spendthrift children who were never educated in the stewardship of the family fortune.

Forward-thinking wealthy families have implemented formal governance structures, including regular meetings, co-operative decision-making, family philanthropic projects and financial education to better prepare the next generation for the responsibilities of wealth.

Many a wealthy family has found that preserving wealth can be as challenging as creating it in the first place.

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