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What we can learn from the wealthy

Michael Nairne, Serious Money

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It's demanding enough to manage several million dollars properly but when the wealth climbs into the hundreds of millions or even billions, the challenges and complexity skyrocket. In recognition of this, many ultra-wealthy families set up what is called a single family office (SFO) to manage their financial affairs. A SFO is private organization that focuses exclusively on the comprehensive management and administration of a single family's wealth in a manner customized to their needs and long-term objectives.

With their strong desire for confidentiality, SFO's have operated for many decades outside the main stream of the wealth management world. However, recent surveys of a number of SFO's globally have shed more light on their organization and practices. Here are some of their best practices.

1. Integration. Integration. Integration. Managing substantial wealth involves a number of moving parts. SFO's are therefore staffed by full-time professionals, often combining investment, tax, accounting and legal expertise, who take an integrated and multi-generational approach to the management of the family's wealth.

In contrast, we've found that many wealthy Canadian families still work with their advisors in a silo fashion so that "the left hand doesn't know what the right hand is doing". For example, we've seen investment advisors implement strategies that duplicate assets held within life insurance policies overseen by the client's agent or recommend investment plans that fail to capitalize on tax planning opportunities suggested by the client's accountant. Fragmented wealth management breeds needless costs, risks, and taxes.

2. Preserving wealth is job one. A 2012 survey undertaken by J.P. Morgan Private Bank of more than 120 SFO's globally each with at least $100 million in assets found that 73% rated preserving wealth as the overriding concern in managing investments. In contrast, only 22% rated maximizing returns as highly important. For the wealthy, the pain of loss is far greater than the pleasure of gain and investment strategies need to be attuned to that reality.

3. Risk is the new four letter word. In keeping with the goal of wealth preservation, SFO's added risk management as one of their top five activities in 2012, according to a study by the Wharton Global Family Alliance. SFOs regularly put their investment portfolios through rigorous analysis that measures their exposure to turbulent events such as stock market crises, interest rate jumps, widening credit spreads, liquidity squeezes, energy shocks and plummeting commodity prices. Investment strategies and their ongoing implementation can then be refined to meet the risk profile of the family and shifting conditions in the capital markets

4. Hire a Chief Investment Officer. Most family offices have a Chief Investment Officer (CIO) who is responsible for the designing the investment strategy to meet the family's objectives; overseeing the critical asset allocation decision; assessing, selecting and monitoring investment managers; rebalancing and risk management; and reporting in a comprehensive fashion to the family. The CIO also works directly with other professionals to integrate investment decision-making with the family's tax and estate planning.

Since the annual cost of an experienced CIO and the supporting analytic and research tools can range anywhere from one half to several million dollars, many smaller SFO's outsource this solution using independent investment consulting firms. One survey by the Family Wealth Alliance found that about two-thirds of SFO's managing 500 million dollars or less used outsourced firms to act as their CIO. In

Canada, there is a growing number of independent investment counseling firms and financial advisors as well as private banks acting as CIO's, filling what has been a real void in the Canadian landscape.

5. Tap the full universe of investment management expertise. In their quest for diversification across a broad range of asset classes and strategies as well as a desire to access deep specialty expertise, SFO's use a wide array of investment managers. According to the Wharton study, nearly 60% of SFO's use ten or more managers while over 25% use thirty or more managers.

This makes eminent sense. An investment firm that excels at high yield bonds is unlikely to also shine at emerging market small cap value stocks or global managed futures or private mortgages. In our experience, many wealthy Canadian families place too many dollars with too few managers covering too few asset classes and strategies.

The lessons of the world's wealthiest are there for the taking. Fortunately, you don't need a billion dollars to emulate them.

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