

Investment Management for Family Wealth

The investment management needs and inter-generational dynamics of wealthy families, and how they differ from retail and institutional investors.



Executive Summary

Families of wealth have a unique set of investment management needs, and family wealth dynamics. While no two families are alike, common characteristics for families of wealth often include:

- The multi-generational time horizon of their investment activities
- The importance of tax considerations to their overall wealth
- Risk objectives to avoid permanent loss of capital, maintain investment income and generate long term absolute returns
- A contrasting view of wealth between first and subsequent generations of wealthy families and the dynamics around ongoing wealth creation, responsibility migration and risk.
- A strong sense of responsibility that significant wealth creates and consequently a need for heightened levels of control or oversight

Strategies to help meet these needs are largely absent from institutional and retail investment management services as their primary constituents and objectives are different. Private wealth managers may be an alternative for those families looking for greater levels of alignment.

Another dynamic which characterises multi-generational family wealth is the different approach to wealth first and subsequent generations take. These differences in attitudes towards risk and control mean the investment and risk management needs of each group are unique.

Finally, the control model families use to manage their wealth over time and in different asset types changes throughout their lifetime and with the transfer of multi-generational wealth. Understanding the different forms of control can better help family members fulfil their responsibilities in maintaining their wealth.

Background

In an Australian context, the needs of wealthy families have historically been addressed through high service levels; where wealthier investors received greater personal attention and more comprehensive advice on matters such as tax structures, succession planning, and utilisation of wealth towards achieving life goals or legacy building.

This approach undoubtedly adds considerable value at multiple levels.

However, at the investment management level, wealthy investors have often utilised services from either retail or institutional investment managers, where the investment objectives are substantially different - in many instances this has led to sub optimal outcomes as a result of misalignments.

Service models and product offerings often neglect the different approaches to wealth first and subsequent generations take and the dynamics of inter-generational wealth stewardship.

The Australian environment contrasts with the US and Europe marketplaces, where a large community of specialist advisors and investment managers are employed to serve the specific needs of wealthy families.

This paper has been prepared by Private Portfolio Managers (PPM). Although we believe the commentary provided is soundly constructed and does not carry undue bias, readers are advised of the nature of our business:

PPM is an independent investment manager of Australian shares utilising an Individually Managed Account (IMA) structure. Serving high net worth individuals, wealthy families, and charitable organisations; our business is singularly a funds management service.

Therefore, we work with other organisations including financial advisers, accountants, attorneys, private banks, philanthropy advisors, and family offices in fulfilling a component of a family's wealth management needs.

We aim to outline the dynamics of investment management for family wealth and assist families and their advisors in assessing the applicability of different service models. Understanding these models may help to identify those best suited to their objectives and identify where their objectives may be aligned or differ from their money managers.

We hope to build a foundation for discussion of these topics rather than provide an exhaustive analysis.

Wealth Management Objectives

What are the key objectives for different types of investment management?

Table 1 provides a concise summary of the different investment management models available to families of wealth, the objectives of each are detailed below.

Institutional Investment Management

Institutions have specific goals when investing, these may include:

- Achieving a relative return benchmark such as outperforming inflation, or to produce returns within a band of other investors
- An outcome based objective, such as managing their investments to fund insurance underwriting or treasury activities
- Maintain a certain level of satisfaction amongst a group of constituent investors.

Short to medium term investment returns usually drive their remuneration structures and benchmarking against peers is their ultimate measure of success; the so-called '***peer relative approach***' to investment management.

Many are listed organisations in their own right with profit expectations of their shareholders motivating their business and operational practices.

Retail Investment Management

Retail wealth management is focused on assisting large numbers of the public accumulate a pool of assets that can be used to fund their retirement.

Timing of investment cycles plays a major role in the success of this strategy for most investors, as the pool of assets needs to be sufficient to outlast regular draw-downs through retirement. Therefore, management of volatility is important and asset allocation is utilised to move toward more defensive assets as the investor ages.

Like institutional management, short to medium term investment returns drive remuneration structures and relative benchmarking against their peers is their ultimate measure of success.

Product and service offerings are commoditised for the adoption of large numbers of investors and there is no effort to meet the needs of individual investors at the product level.

Private Investment Management

Wealthy families may have a variety of objectives in mind when making investments but generally aim to preserve and grow wealth for the long term. Therefore, the management of private wealth is generally regarded as a perpetual exercise.

For many wealthy families the generation of income streams that do not draw-down capital, or establishment of an endowment can also be objectives.

Because funds are managed for the long term, asset allocation and investment strategy do not necessarily become more defensive over time. Instead, these strategies can be used dynamically and/or to implement an appropriate risk profile for the family.

Consequently, long term investment returns are a private investment manager's objective and comprise the basis for remuneration. Generally, the brief to those engaged in the affairs of families of wealth is wealth preservation and absolute return generation across a range of asset classes.

Bespoke solutions are very often required to meet a particular investment objective, achieve better returns, help manage risk, or to solve a particular investment management problem (often tax or lifestyle related).

Wealthy families expect access to, and a high level of service from, the investment professionals managing their portfolios, giving them confidence that their objectives are being met and helping fulfil the family's responsibly for oversight.

Charitable Investment Management

Endowment portfolios for charitable organisations and foundations generally have similar long term objectives to private family wealth, and may include other factors such as specific income requirements, capital growth to fund new projects, or ethical investment considerations.

In an Australian context, maximising the tax free status of not-for-profit organisations is a key objective and can create a substantial value add.

Private Wealth Factors

What are the unique elements of investment management for wealthy families?

Time Horizon

The often perpetual nature of private wealth is perhaps its most important characteristic. This perpetuity introduces freedoms and opportunities that other investors do not enjoy.

A long term approach provides the ability to purchase assets when they are cheap or mispriced and there is no obvious short term price catalyst. This '*intrinsic value*' approach is a common thread among the world's most successful investors including John Templeton and Warren Buffett.

Most business owners understand the value of the long term perspective within their private businesses as it allows them to invest in and develop opportunities that simply would never come to fruition if they were constantly focused on maximising their short term profits.

The same principle applies to investment decision making, however mass media can perpetuate a short term view of investment markets that can be difficult for even professional investors to see beyond.

While many retail and institutional investment managers would represent their offerings as long term in nature, their remuneration structures and business drivers provide strong incentives for short term behaviour. An examination of their actual investment activities often illustrates this.

Tax

Tax is a critical component in the effective management of private wealth, particularly in Australia, with its high tax rates. Specific to the Australian environment is a superannuation and imputation system that provides scope to create substantial differences between pre and post tax returns.

Tax is likely the single area where those families with effective strategies will be far better off than those without.

Holistic tax management covers a host of considerations from ownership, to legal structures, charitable giving and individual tax strategies. At the portfolio management level effective tax management can contribute about 2% per annum to real returns¹.

¹ Is your alpha big enough to cover your taxes? T. Jeffrey, R. Arnott, Journal of Portfolio Management

Given that average long term Australian equity returns are about 10% per annum, a tax effective strategy would seem the easiest means to contribute to real returns, without increasing risk.

This contrasts with most retail and institutional fund managers who focus on headline returns rather than after tax returns.

This focus on pre tax returns prevails because an after tax approach is only measurable at the individual investor level as each tax circumstance is unique. Therefore, it's impossible for managers who pool different investors into the same fund to assess the overall tax effectiveness².

Fund structures also create significant tax distortions, including in many instances investors paying tax on the gains of other investors and limited ability to integrate tax strategies across different investments³.

Finally, investment professionals managing retail and institutional funds are remunerated on pre tax performance creating a strong incentive to create pre tax returns, often at the expense of real after tax returns.

Risk Objectives

For private wealth, the predominant risks often relate to permanent loss of capital or reduction in income from an investment portfolio.

Because of the generally long-term time horizon of wealthy families their risk measures are unique. In theory, this time horizon would lead to a greater risk tolerance. However, risk tolerance and the associated risk/reward relationship is an inherently complex and individual factor than cannot be explained by time horizon alone.

Market fluctuations may be ridden out by a patient investor with a long term focus. Alternatively, managing price movements can add value and comfort depending on individual preferences and objectives.

A long term approach reduces the chance emotion may trigger the sale of an intrinsically valuable asset at precisely the wrong time - resulting in a permanent loss of capital - the true threat to family wealth longevity.

This contrasts with the risk measures of most retail and institutional money managers, where the primary risk concern is managing short term portfolio volatility, not preservation of capital and income.

Their approach to managing volatility is to select assets with inverse correlations and diversify across a large number of securities.

² Consult *Investment Structures Matter* for additional information

³ Consult *Investment Structures Matter* for additional information

In general, these measures do aid in reducing the total price fluctuations experienced by investors, but often at the expense of diversifying into companies and sectors where there can be greater potential risks.

This often obsessive focus on diversification creates less scope to generate exceptional returns as diversification reduces volatility while it also reduces potential returns; sometimes referred to as '*diworsification*'.

Diversification strategy comes from Modern Portfolio Theory, developed by economist Harry Markowitz in 1959. Sometimes interpreted as more diversification is better, the theory and its supporting research point to little benefit in diversification beyond 30 assets or 4 asset classes⁴.

Generally, diversification beyond this level will see the investment portfolio mirror the market – a concept known as '*closet indexation*.' Over diversification can lead to other consequences such as high complexity and administrative burdens or unnecessary expenses.

The other risk management method employed by retail and institutional money managers is business risk mitigation. Fund managers with returns below the benchmark index have difficulty attracting new money.

Therefore, the incentive is to hold assets that approximate the returns of the index, trying to add value by taking moderate 'overweight' or 'underweight' positions in an attempt to produce moderate outperformance while managing the business risk of underperformance.

Control and Oversight

There is a strong sense of responsibility most families feel toward competently managing their financial affairs, often out of great respect for the effort required to acquire the wealth. The role of control and oversight in wealth management is critical toward fulfilling that responsibility.

It is also an important component of the family's satisfaction and assessment of any service providers' value.

This participation can take several forms, from outright control of their investment portfolio, a consultative approach, collaboration with service providers, or by delegating and then acting in an oversight capacity. Table 2 provides more detail on these models.

Generally, first generation wealth owners have a tendency toward control while subsequent generations can be more inclined to allow advisors more discretion – whilst there is no 'rule' in this regard it is fair to say that as trust builds, the need for control often diminishes.

⁴ Managing the Asset Allocation Decision, UBS

The control model used may also be different for different asset types or different elements within the structure of the family's wealth. For those activities where the family has strong domain knowledge, the family will naturally maintain greater levels of control.

The control mode utilised may also change with time and through an effort to transfer wealth and responsibility across generations.

Both retail and institutional investment management offer limited possibilities for control, consultation, or collaboration as they are standardised offerings without the ability to interact with the investment professionals in a meaningful way.

At an oversight level, investors ultimately make an assessment on participation in their offerings. However, there is little opportunity to assess, query or understand the individual decisions of their investment managers with depth or intimacy, as the family might desire.

Tailored Solutions

Wealthy families often have particular and specific investment circumstances, objectives, or problems that are best managed on an individual basis. The size of their investment portfolios generally means bespoke solutions can be economically implemented.

These bespoke requirements can take a number of forms, including:

- Management of a tax sensitive portfolio such as an existing investment portfolio with large unrealised capital gains or a holistic tax strategy that involves harvesting capital gains or losses
- Particular investment preferences such as ethical investments or exclusion of particular securities or industries
- Simple or sophisticated risk management techniques to address the specific risks of the family's investment portfolio
- Excluding investments in areas where the family already has considerable financial interests. For instance, families owning resources businesses may choose to exclude the sector.

Due to pooling of investors in fund structures neither retail nor institutional investment managers can provide tailored investment management.

See PPM's *Investment Structures Matter* paper for more information about the implications of pooled funds and other investment structures used to provide investment management services to investors.

Differences in Wealth Attitudes by Generation

What distinguishes the needs of first and subsequent generations of wealth owners?

First Generation

For the first generation wealth owner, their wealth has often come through the creation of a successful business, and as the 'founder' they think differently about the management of family wealth.

Initial wealth creators may view investment risk in a similar light to the business risks they successfully managed and view their investment activities as building on the business wealth they created.

Often their business wealth has come partly through taking risks and therefore they have a heightened understanding of the wealth generation potential of risk taking.

This dynamic creates both substantial opportunities and a risk for first generation wealth creators. The risk appetite of some first generation wealth owners means they are less likely to manage their affairs in a passive manner and suffer from risk aversion paralysis.

However, this risk appetite may see a higher probability of wealth destruction if inherent investment risks are not understood and managed.

First generation wealth holders are often attracted to create investment wealth in their area of business activity. Aided by considerable insights, access to opportunities, and business relationships to leverage off, they expect superior returns when investing within their expertise domain.

Against this backdrop, the first generation wealth holder faces a dilemma - they wrestle with the prudence of diversifying (and de-risking their overall portfolio), against applying their wealth to areas where they have achieved previous success and know intimately.

Some wealth holders may recognise that the skills required to grow a business and manage investments can be different and successful business owners may not prove equally adept at investment management outside the area of their domain knowledge.

Subsequent Generations

For subsequent generations, the risks can be different and include becoming disinterested in wealth generation, extreme risk aversion, and herd mentality investing.

The lack of a strong stimulus to create additional wealth can lead to diminished know how and confidence in creating future wealth for the family. In some instances this results in poor decision making, appointment of inappropriate advisors and atrophy towards wealth.

Second and subsequent generations can also suffer from risk paralysis -- the fear of taking on any risk for fear of being responsible for losing the family fortune. This can lead to poor investment performance and the erosion of wealth over time through inflation.

Another common risk is investing in the popular 'hot' areas where the family takes comfort as others are investing, but there is no long term wealth generation or investment strategy.

This herd mentality investment approach often leads to substantial losses of capital as the risks may not fully understood and the family's wealth may be exposed to speculative investments where there is potential for significant losses.

Subsequent generations may also prove excellent wealth stewards where they have applied a prudent and disciplined approach, defined their objectives and applied appropriate skills and experience to each area of their wealth management activities.

For many wealthy families their ability to transition from skilled business operators to skilled wealth stewards over generations has proven the key to their long term ability to maintain and grow the family's wealth.

Transitioning Wealth Stewardship

Migrating responsibility from one generation to the next is an important challenge for every wealthy family.

Defining each family member's current and future roles in the control and oversight spectrum (See Table 2) can provide a model for fulfilling family members' roles as responsible wealth owners.

This can be done against each asset type, investment/business activity, or ownership structure the family is engaged in, providing clarity and a clear succession path for the responsible maintenance of family assets.

Once a family member knows where their current and future position lies on the control spectrum, appropriate action can be taken toward providing the necessary skills towards fulfilling that role.

Among other development areas, financial training for family members is, therefore, critical to wealth longevity.

Future Implications

Given the growing size of the Australian family wealth market we expect to see additional sophistication and targeted offerings in the space.

According to Capgemini, Australia's 174,000 highest net worth investors are demanding more specialised (tailored) services and greater independence (freedom from conflicts of interest)⁵.

We concur with their conclusions and foresee several trends in Australia:

1. An increasing understanding of the unique objectives of family wealth will see families and their advisors search for new investment management alternatives to traditional retail and institutional offerings.
2. Following from the first point, there will be growth in the size and range of service providers who aim to specifically service the needs of wealthy families.
3. This development will see the Australian marketplace better mirror the North American, and European markets where the community of specialist private investment managers, family offices and multi-family offices are already well established.
4. An increasing understanding of the different wealth management needs of first and subsequent generation wealth holders and additional tailored service offerings around these differing needs.
5. The research models used to evaluate private wealth investment managers will evolve and differ substantially from those used to evaluate retail and institutional managers. This may result in new offerings from boutique providers, should the established funds management research houses fail to adapt to the market.
6. More focus on the business sustainability of service providers. As the GFC revealed, organisational greed can lead to imprudent business risk taking resulting in the failure of organisations. The substantial financial and confidence damages caused by these failures will continue to influence the thinking of wealthy families.
7. Independence as a key differentiator among the range of service providers who target families of wealth will take on increasing importance. As the sector grows and spawns new service offerings, many of these providers will position themselves as independent (free from conflicts of interests). Those that are not independent may be at a competitive disadvantage.

⁵ Capgemini World Wealth Report 2011

Table 1 – Investment Managers Summary

	Institutional Investment Managers	Retail Investment Managers	Private Investment Managers
After Tax Focus	None to Moderate Not Integrated	None to Moderate Not Integrated	High Integrated
Key Stakeholders	Asset Consultants Superannuation Funds Pension Funds	Fund Researchers Distribution Platforms Financial Advisors	Investors Family Offices Financial Advisors Accountants
Business Driver	Scale	Distribution	Relationships
Primary Risk Focus	Volatility reduction through diversification	Volatility reduction through diversification	Preservation of capital through different market cycles
Time Horizon	Short to Medium Term	Short to Medium Term	Mostly Long Term
Staff Remuneration	Short to Medium Term	Short to Medium Term	Mostly Long Term
Service Delivery	Commoditised or Tailored (above \$20 million)	Commoditised	Tailored
Indicative Number of Holdings	40-250	50-250	15-35
Target Investment Size	\$20 million plus	\$10,000 to \$250,000	\$1 million plus
Performance Benchmark	Peer Relative & Index	Peer Relative & Index	Absolute Return & Index
Access to Investment Professionals	Good	Poor	Excellent
Ownership	By large Institutions	By large Institutions	By employees

Table 2 – Family Wealth Control Spectrum

Absolute Control	Family member or members make all decisions regarding investment activities of the family. Generally investment activities are focused on areas where the family has considerable business expertise. Service providers play a limited role in providing administration and compliance activities.
Consultation	Family member or members make investment decisions with the input of trusted advisors or business associates. Evaluating opportunities away from the family’s domain knowledge have greater emphasis placed on trusted expertise of others. Service providers assist in advice, implementation and structuring of activities.
Collaboration	Family member or members work in conjunction with trusted advisors, service providers and business associates but ultimately guide most decisions. Ongoing communication between the family and their team of associates is critical. Investment activities beyond the expertise of the family may be outsourced to third party providers and are closely monitored.
Oversight	Family member or members set the overall wealth objectives and strategy whilst providing some discretion in investment activities beyond their domain knowledge. The activities and decisions of advisors and other service providers are monitored, discussed, and verified to ensure continued alignment with objectives, and ongoing value add.

Additional Sources of Information

Preserving Capital and Making it Grow, John Train, Penguin

Looking for the 'Value-Add' Private Advice Needs of High Net Worth Australians, Dr Kym Madden & Dr. Wendy Scaife, QUT

<http://eprints.qut.edu.au/15426/1/15426.pdf>

Family Wealth – Keeping it in the Family, James Hughes, Bloomberg

The Intelligent Investor, Benjamin Graham, Collins

Capgemini World Wealth Report 2011

<http://www.capgemini.com/services-and-solutions/by-industry/financial-services/solutions/wealth/worldwealthreport/>

The Dilemmas of Family Wealth, Judy Martel, Bloomberg

Private Banking in Australia, Australian Trade Commission

<http://www.austrade.gov.au/ArticleDocuments/2792/Private-Banking-in-Australia-Publication.pdf.aspx>

Investment Structures Matter

<http://www.ppmfunds.com/>

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