

**ALSO IN THIS ISSUE:**

- What Risk and Return Can I Get From “The Market”? .....3
- Northwood Staff Profile – Mia Cassidy .....5
- The Deceptive Power of Compounding Interest .....6



# The Northwood PERSPECTIVE

## Chairman’s Message: Wealth of Wisdom

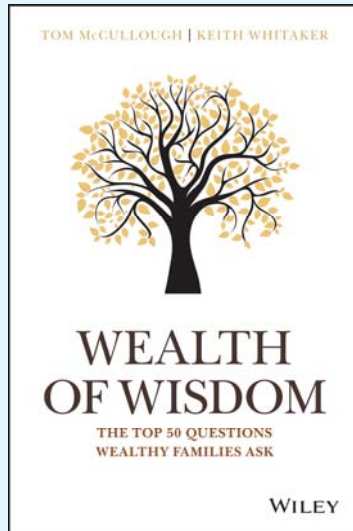
Tom McCullough



This year is Northwood’s 15th anniversary and one of my anniversary projects was writing a book entitled, *Wealth of Wisdom: The Top 50 Questions Wealthy Families Ask*. The book features insights from more than 50 of the world’s top thinkers and practitioners in the family wealth field, and is co-edited with Keith Whitaker, president of Wise Counsel Research in Boston and author/ co-author of six books himself. It is published by John Wiley and Sons, and will be released in mid-November 2018. Here’s a quick Q&A with the main details:

**Q: What is this book about, and why did you decide to create it?**

A: In our travels around the world, speaking with thousands of families of wealth and advisors to families, we have heard many questions about the issues that confront them every day. Often these questions are tinged with a sense of hopelessness and frustration, reflecting the number of times that the questioners have tried to find good solutions and have come up empty.



Hearing such questions repeatedly led us to think about how we could bring answers to these families in a way that would be helpful, practical and easily accessible to them. There is a lot of information already written on some of these topics (and very little on others), but it can be hard to find, is typically too general, and is definitely not all in one place. We decided to pick the top 50 questions families ask and pull the answers all together into one volume so a family leader, family member or family advisor can sit down and review all of them at one time.

**Q: Why did you decide to invite essays from multiple contributors?**

A: We really wanted to offer families a diversity of perspectives, tone and experience. In our travels, we have also had the privilege of meeting and getting to know an amazing group of people who regularly work with wealthy families on these key issues.

So we set about finding one or two uniquely talented and experienced people to answer each of the 50 questions. The people we found are business advisors, professors, consultants, speakers, and / or family members themselves. They are all leaders in their respective fields, have significant practical experience and have earned the respect of their peers and the appreciation of many families who have benefited from their wisdom over the years.

**Q: What are the questions and who are the contributing authors?**

A: There are nine sections in the book, with 4-8 important questions in each section. Here is a list of the sections, with sample questions and contributors for each section.

**Section 1 - Thinking Through What Matters Most**

- What are the most important factors in living well?  
(Scotty McLennan)
- What are the key considerations in crafting your legacy?  
(Thayer Willis)
- What does passing values to the next generation really look like?  
(Ellen Perry)

**Section 2 - Planning Thoughtfully**

- What is the right balance of spending and saving in retirement?  
(Meir Statman)
- What’s the best way to think through the pre-nuptial process?  
(Charles Collier)
- How can you preserve a beloved family vacation home or estate?  
(Jamie Forbes)
- How can you prepare for longevity and mental incapacity among family members?  
(Patricia Annino)

**Section 3 - Investing Wisely**

- What return should you expect from your investments?  
(Christopher Brightman)
- What should your asset allocation be?  
(Jean Brunel)
- What is the most useful definition of 'risk' for family investors?  
(Howard Marks)
- Is active management still worthwhile?  
(Charley Ellis)

**Section 4 - Raising the Rising Generation**

- How do you raise responsible, independent and productive children vs. entitled trust fund babies?  
(Jill Shipley)

How much money should you leave your children, and when?

(Peter Evans)

How can you avoid the negative impacts of giving money to family members?

(Lee Hausner)

How can you help your children both be independent and stay connected to the family?

(Kelin Gersick)

### Section 5 – Making Shared Decisions

What are the best ways for a family to make decisions?

(Barbara Hauser)

How can you improve family communication?

(Jennifer East)

Should you have a family meeting?

(Mary Duke)

How do you manage conflict in your family?

(Blair Trippe)

### Section 6 – Combining Family and Business

How can you engage your children in the management of your family wealth or business?

(Dennis Jaffe)

How can you ensure the success of your successors?

(Dean Fowler)

Why is family unity so important and how can you achieve it?

(John Davis and Andrew Hier)

Can a family stay together after the operating business is sold?

(Alex Scott)

### Section 7 – Giving Well

What is the difference between charity, philanthropy, strategic philanthropy and impact investing?

(Ellen Remmer)

How can you encourage generosity in your family?

(Alasdair Halliday and Anne McClintock)

### Section 8 – Seeking Sound Advice

How can you find trustworthy advisors?

(Philip Marcovici)

How can you avoid the next Bernie Madoff?

(Stephen Horan and Bob Dannhauser)

How do you choose a good trustee?

(Hartley Goldstone)

### Section 9 – Facing The Future

What does the future hold for families with significant wealth?

(Jay Hughes)

How do you balance family stability with resilience over the generations?

(Jim Grubman)

#### Q: How do you hope families will use *Wealth of Wisdom*?

A: This book is intended to be a practical, on-the-ground, how-to guide that will answer the key questions that every family of wealth wrestles with on a regular basis, and provide common lessons and practical steps that families can take away and employ today. It brings together the most creative ideas and insightful thinking from the best minds in the world on topics of wealth and family. It also provides additional resources that families can access if they want more information and depth on a particular topic.

We asked each of our contributors, to add 3 or 4 Questions for Further Reflection at the end of their essays so that readers could further explore the topics addressed in that chapter. We hope these questions will help readers apply the lessons in the book to their own families, and encourage family-wide discussions on relevant topics. In addition, we asked each contributor to include a list of books and articles on their topic, so that readers could go deeper on any particular issue if they so desired. The result is a rich set of resources that every family can tailor for their own use.

It has been a great experience to work on the creation of this book over the past year in anticipation of Northwood's 15th anniversary. Keith has been a fantastic co-editor and the best-possible partner on this journey. I have learned a lot from him and from all of our amazing contributing authors. I hope you all get a chance to read the book and I look forward to your feedback.



## Further Details on *Wealth of Wisdom*

'*Wealth of Wisdom: The Top 50 Questions Wealthy Families Ask*' will be published in mid-November 2018. We are excited to announce the following updates:

- *Wealth of Wisdom* now has an Amazon page! Click the below link to read a description of the book and pre-order copies. <https://tinyurl.com/y8vnfgrj>
- *Wealth of Wisdom* will be published by John Wiley and Sons in time for the holidays. In anticipation of the book's release, we will be launching the *Wealth of Wisdom Podcast* in October. Each podcast episode will feature an interview with one of the book's contributing authors where they will expand on the ideas they touched on in their essay, talk about their careers, and share other practical ideas. Stay tuned!

## What Risk and Return Can I Get From “The Market”?

Russ Rodrigues, CFA, CIM, MBA



*This is the second installment in a series that explores a number of finance and investment concepts in both theory and in practice.*

Last quarter we explored the textbook concept of a “risk-free” investment return (or “ $R_f$ ”) which, in the real world, is typically insufficient to preserve the investor’s after-tax purchasing power.

We concluded that if an investor wants to merely break-even, then accepting some investment risk is unavoidable. In this installment, we will focus on the market level relationship between risk and expected return.

The academic field of financial economics shaped the concepts of “market risk” and “market return”. In the 1950s and 60s, three individuals, each of whom would later be awarded the *Alfred Nobel Memorial Prize in Economic Sciences*, published landmark academic papers, which together laid the foundations of the analytical framework at the core of modern finance.

[Harry Markowitz](#) was a co-recipient of the [1990 Prize](#) for his pioneering 1952 paper “[Portfolio Selection](#)”. Markowitz began with the uncontroversial assumption that investors simultaneously desire higher expected returns and lower variance of returns (or risk). He showed statistically how any number of risky securities (given their expected returns and covariance) could be combined into an “**Efficient Portfolio**” that offered either the highest expected return for a given risk, or equivalently the lowest level of risk for a given expected return. Simply by efficiently diversifying their investment portfolios across securities with low correlations to one another, investors could either earn higher returns or enjoy lower risk. Markowitz called this efficient diversification “*the only free lunch in finance*”.

[James Tobin](#), who was awarded the [1981 Prize](#) for his many contributions to the field of economic research, advanced on Markowitz’s work in his 1958 paper “[Liquidity Preference as Behavior Towards Risk](#)”. Tobin showed that if investors could choose how much they invested in a Markowitz efficient portfolio of risky assets vs. how much they reserved in cash, they could potentially achieve a portfolio even more desirable than the efficient frontier (depending on their own personal preferences for risk aversion or return-seeking). More importantly, Tobin concluded there was only one “**Optimum Portfolio**” on the efficient frontier, that all investors should hold in combination with the riskless asset. What exactly was in this Optimum Portfolio? That was beyond the scope of Tobin’s theory. He only demonstrated that such a portfolio theoretically exists, but his work gave no indication on how to construct it, or if any investors actually owned it.

[William Sharpe](#), who shared the 1990 Prize with Markowitz, made a major advance in Modern Portfolio Theory in his 1964 paper “[Capital Asset Prices: A Theory of Market Equilibrium under Conditions of Risk](#)”. Sharpe started with Markowitz’s & Tobin’s models for the optimal investment portfolio for an individual. On top of that he overlaid a market equilibrium theory (based on competition among individual investors impacting security pricing). In other words, if all individual investors sought to own the specific securities that comprised the “Optimum Portfolio”, then (under a particular set of idealized assumptions ignoring taxes, transaction costs, etc.) investors would bid up the price for those securities, which would lower their expected returns, and bring the return expectation of the Optimum Portfolio back down toward that of the other securities. Conversely, those securities not represented in the Optimum Portfolio would see less investor demand, causing their prices to fall and their return expectations to rise closer to those of the securities in the Optimum Portfolio. Sharpe concluded that these changes to securities’ return expectations would, in time, result in EVERY available security converging toward an equilibrium such that they would achieve a risk-adjusted return proportional to that of the Optimum Portfolio. Phew!

Not every investor had to hold exactly the same securities, but according to Sharpe’s theory, their portfolios would all achieve proportionally equivalent risk-adjusted returns, based on how much “systematic risk” they held relative to “**the Market Portfolio**”... essentially a market-value weighted combination of every investable asset. Each individual security would naturally settle to an equilibrium, a price where its expected return was equivalent to the amount of “market risk” it carried (not the amount of total risk). Sharpe argued that the remaining risk component, or “unsystematic risk”, being uncorrelated with the market, should carry no return expectation.

If we combined every single investor’s portfolio in to one gigantic pooled fund, then that hypothetical portfolio would be, by definition, the “market portfolio” and the Market Return expectation (“ $R_m$ ”) would simply be the weighted-average expected return of every single investable asset in the world.

That’s all great in theory, but in practice, this approach seems a bit circular and not particularly useful. If the market portfolio is optimally efficient, and if every security in the market is priced in equilibrium with the market portfolio, then literally any sufficiently large combination of randomly-selected securities could plausibly be called an “efficient portfolio”. What practical use is that?

Adding to the impracticality, the “market portfolio” would have to include every single investable asset—listed or unlisted—on the planet. But constructing such a portfolio would be effectively impossible, as would measuring its performance over any given

time period, or estimating its expected return going forward. The only thing one could be certain of is that the expected return of the market (“ $R_m$ ”) must be higher than the risk-free return (“ $R_f$ ”).

In the real world, finance professionals have adopted a practical shortcut to help resolve this situation.

In 1957, around the same time as the aforementioned academic research was being published, the Standard and Poor’s Corporation created and began publishing a market-capitalization weighted index consisting of 500 large companies whose shares were publicly listed on a US stock exchange. The [S&P 500 Index](#) was the first broadly diversified stock market index, and has eclipsed the older and narrower Dow Jones Industrial Average (30 stocks, price weighted) as the standard reference for “the market” in most analytical work, as it captures around 80% of the investment value of the entire US equity market.

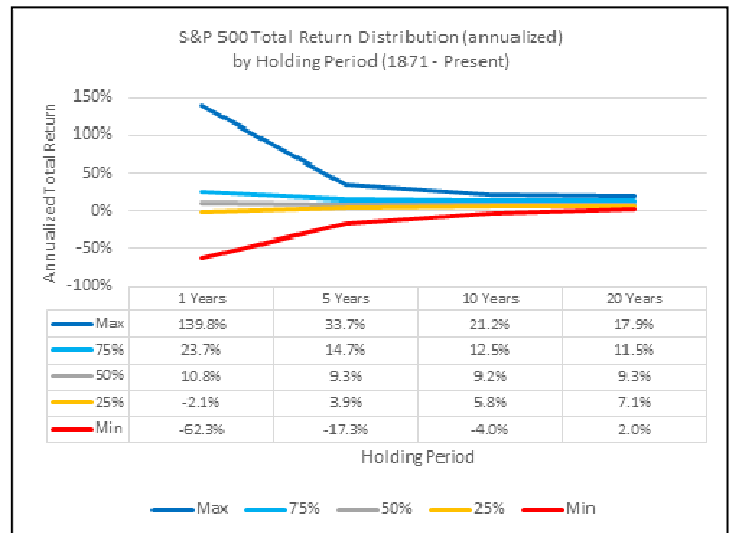
There are a number of reasons that professionals like using the S&P 500 index.

- The simple index construction methodology has allowed researchers to reliably calculate monthly [index values going back to 1871](#) from historical stock prices, providing a uniquely long time series of performance data to analyze.
- The index is currently updated and published every 15 seconds during trading hours, allowing highly granular analysis of intra-day events.
- In addition to the price index, S&P calculates a “total return” index, which is adjusted to include the contribution of dividends to investors’ returns. (This is a more appropriate index to use for performance benchmarking.)

Despite all of the positive attributes of this particular index, the somewhat arbitrary decision to use the S&P 500 index as a proxy for “the market” has some significant shortcomings.

- First, this index has a singular focus on the USA, perhaps understandable as most of the academic research came out of the United States, but not ideal for investors. There are other global indices that we can resort to if we require a broader view (e.g. the [MSCI ACWI Index](#)) though in practice, all large cap equity indices tend to be highly correlated.
- Second, the S&P 500 is entirely limited to publicly listed equity securities, and ignores every other asset class. A broadly diversified portfolio (including the much larger bond market) would likely have a more moderate risk-return profile than that of the equity market.
- Third, the S&P 500 index is market capitalization weighted. That means that large companies are more heavily weighted in the index than small companies. But that isn’t necessarily the best way to allocate capital to create an efficient portfolio (unless all of William Sharpe’s idealized set of assumptions were to hold true.)

For better or for worse, any mention of “the market” has effectively become a shorthand for large cap public stocks. But while we’re focused on the equity market, let’s explore the S&P 500’s historical risk-return profile since 1871. We’ll look at an investor’s range of total returns (including dividends) for 1 year, 5 year, 10 year and 20 year holding periods. The average annualized return (“ $R_m$ ”) has been pretty consistently around 9-10% per annum, but the range of returns (what one could consider “risk”) narrows significantly as the holding period increases. The range of 1 year returns spans from -62% to +140%, but over a 20 year holding period, the range of annualized returns was, in every instance, between +2% and + 18%, and half the time was between 7% and 11.5%.



Data: S&P, Shiller. Calculator: DQYDJ.com

So, what return should we expect from “the market” going forward? That greatly depends on our expected holding period.

Markets tend to be cyclical, and we’re probably closer to the peak of a cycle than a trough. The “markets” have rarely been as expensive as they are at the moment, and higher prices today necessarily imply lower return expectations in the future.

We believe that for shorter holding periods (~5 years or less), market return expectations should be biased toward the lower end of their historical range—a range that includes the potential for significant losses (e.g. the lower rows of the second column in the above table). Over the longer run (~10 years or more) as cycles tend to normalize, we would expect the market’s return to be closer to the middle of the historical range (e.g. +6 to +10% per annum).

Next quarter we’ll explore “volatility”, which is the finance industry’s favourite measure for quantifying risk, but not necessarily the most relevant metric for investors. 🌲

## Northwood Staff Profile – Mia Cassidy



*In this quarterly feature, we help our readers to get to know some of the people who work at Northwood Family Office. The 'Northwood Staff Profile' consists of an interview with a key team member at Northwood. This quarter, we introduce Mia Cassidy, who started at Northwood in 2006.*

### 1. What do you do at Northwood Family Office?

My role at Northwood is Office Manager/Executive Assistant. My primary responsibility is to provide administrative support to the team and help ensure day to day operations run as smoothly as possible.

An office manager is a jack of all trades, who wears many different hats. Things change quickly, so you have to think on your feet and be proactive about getting things done. You have what seems like a million different things going on at once and you have to make sure that all of them get dealt with.

I have worked at Northwood since 2006, and have seen the firm and our client base grow significantly over the last 12 years. I've also really enjoyed getting to know and work with our clients over the years, and becoming a resource that they can rely on when they need something from Northwood.

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*“An office manager is a jack of all trades, who wears many different hats. Things change quickly, so you have to think on your feet and be proactive about getting things done. You have what seems like a million different things going on at once and you have to make sure that all of them get dealt with.”*

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### 2. What did you do before you joined Northwood?

Life before Northwood was in a very different “field”, so to speak, but in many ways was a great preparation for my life here. I competed at the highest level as a three-day event rider, earning a spot on the long list for the Canadian Equestrian team, while running a successful riding school. I married my husband in 2006 when he was General Manager of E.P. Taylor’s famed Windfields Farm, and we now live on the thoroughbred farm he manages in King Township.



### 3. What do you enjoy most about working at Northwood?

I really enjoy the variety that my role offers, and the many challenges of supporting an office of diverse people in a dynamic and fast-paced environment. I work on a lot of different projects which makes each and every day unique. I have really developed the ability to multi-task and work efficiently, in order to stay on top of all of my tasks and interact with our clients.

### 4. What are your favourite things to do outside of work?

There is nothing better at the end of the day than to go home to a beautiful peaceful property and get away from the hustle and bustle of Toronto.

My husband is a PADI (Professional Association of Diving Instructors) dive instructor on the side, and I’m working on joining the PADI pro ranks as a Divemaster shortly. We love to travel to exotic places and experience new dive destinations.

Our children are all four-legged and while we love our time on the farm, we also love spending time with family both here and in Ireland where my husband was born.

At present, I’m also working on running my second marathon.

### 5. Would you consider ‘getting back on the horse’ and competing in equestrian again?

You may see me out competing in the next few years on one of the retired racehorses. 🌲🌲

## The Deceptive Power of Compounding Interest

Scott Dickenson, CFA, MBA



In the last edition of The Northwood Quarterly Reading List, our CEO Tom McCullough highlighted a recent piece titled, 'The Psychology of Money'. Written by Morgan Housel, this article details 20 flaws, biases and causes of bad behaviour that people often exhibit when dealing with money. The whole article is worthy of your time (and linked to below), but today I want to focus in on one specific flaw that Housel's outlines in his article. In his words, it is:

"Underappreciating the power of compounding, driven by the tendency to intuitively think about *exponential* growth in *linear* terms."

**Article Link:** <https://www.collaborativefund.com/blog/the-psychology-of-money/>

As humans, we find it easy to think in linear terms, and much harder to understand and quantify exponential growth. Housel illustrates this concept in the article by noting the difference in time it would take for you to mentally calculate the answer to  $8+8+8+8+8+8+8+8$  (72), and  $8 \times 8 \times 8 \times 8 \times 8 \times 8 \times 8 \times 8$  (134,217,728). The same sort of mental gymnastics are required to think about the growth in value of an investment portfolio over a long-term time horizon.

For example, if you simply saved \$50,000 per year for 30 years, it is easy to determine that, you would have \$1.5 million in the account at the end of the period ( $\$50,000 \times 30$ ), not including any interest you might earn in a savings account. However, if you invested that \$50,000 each year and earned a 6% annual rate of return, you would have just shy of \$4.0 million at the end of the period. Earning a 6% annual rate of return, and compounding that return, generates an extra \$2.5 million after 30 years.

Of course, these numbers become even more impressive over longer time frames. Using the same assumptions as above, the \$50,000 annual investment becomes \$7.7 million after 40 years,

and \$14.5 million after 50 years. For some, 50 years may seem like an impossibly long timeframe, but with increasing human longevity, it will not be unusual to have an investment portfolio that lasts for 50 years (or even longer!).

At Northwood, we've recently added a few family office clients in their mid-thirties. In the long term cash flow projections that we run for all of our clients, we conservatively assume that each client will live to age 95. This means that someone who is currently aged 35, will have a 60 year runway for their investment portfolio to grow. This is where the power of compounding truly becomes mind boggling. As a thought experiment, imagine a 35 year old with a \$10M investment portfolio. Let's assume that this person never saves any additional money, but also never withdraws funds for spending over the next 60 years. Before looking at the next paragraph, try to guess what the value of this \$10 million portfolio would be after compounding at a 6% annual rate of return for 60 years.

"For some, 50 years may seem like an impossibly long timeframe, but with increasing human longevity, it will not be unusual to have an investment portfolio that lasts for 50 years (or even longer!)"

If you guessed \$330 million, you are correct! (I also assume you cheated and used a calculator). As you can see, there is a reason why Albert Einstein reportedly once described compound interest as, "the most powerful force in the universe."

This example is illustrative of a larger point that we often emphasize when discussing investments with our clients. Good investing isn't simply about earning the highest possible return. Good investing is really about earning reasonable returns that you can consistently achieve for long periods of time. If you can do that, compounding will take care of the rest. 🌲

### Who is Northwood Family Office?

Northwood Family Office is an independent, privately-owned boutique family office which provides comprehensive Net Worth Management™ for wealthy Canadian and global families. Northwood clients have significant family net worth, typically \$10M+. The firm acts as a Personal CFO or Chief Advisor to client families using a dedicated team of professionals who oversee and manage their integrated financial affairs. Northwood Family Office is Canada's leading independent multi-family office and has consistently been ranked the '#1 family office in Canada' in the *Euromoney* Global Private Banking survey. For more information, visit our website or contact Tom McCullough for a confidential conversation.



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