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## The Northwood PERSPECTIVE

### Chairman's Message

*Tom McCullough*

Welcome to the Spring 2013 edition of the Northwood Perspective. There is lots going on at Northwood and we are enthusiastic about the positive developments.

We just returned from the Wigmore Association meeting in Frankfurt, Germany. (See related article in this newsletter.) It was particularly interesting for us to be in private meetings with European Central Bank authorities while the banking crisis in Cyprus was unfolding. This gives Northwood clients the benefit of the expertise of seven global family offices. We also used this trip to make a regular due diligence visit to one of our key global managers located in Europe.

We are still enjoying the results of the 2013 *Euromoney* Private Banking Survey released in February which once again ranked Northwood as the #1 family office in Canada. This public acknowledgment is both satisfying and humbling, and caps off a wonderful 2012 during which our clients had a fruitful year and our firm welcomed a significant number of new families.

We were also gratified to see the investment performance of our core global equity investment managers in the top 10%<sup>1</sup> of the 462 global investment managers over the past 7 years (to the end of 2012), a period which included the crash of 2008-09. Our Canadian dividend equity manager was also in the top 10% of all Canadian managers over the last 3 years since we initiated this mandate. We (and our clients) appreciate our relationship with these remarkable investment managers.

I will be co-chairing the Canadian Family Office Forum in Cambridge, Ontario in May, an exclusive discussion forum of 40 mostly single family office executives and advisors. In June, I will chair the 8th annual Canadian Family Office Summit in Banff, Alberta which welcomes a diverse group of family office leaders and tax, legal and family communication specialists to hear from a roster of experts of topics of interest to families and their advisors.

This year is Northwood's tenth anniversary and we are planning some celebrations over the next several months. It has been a challenging investment environment over those ten years but our practice has grown and prospered. We are grateful for the support and confidence placed in us by our clients, our colleagues and friends of the firm over the past decade.

All of the work we do, the people we meet, the advisors we evaluate and the learning we undertake serve to build our skills and experience. This, in turn, allows better serve our client families.

<sup>1</sup> eVestment Analytics Database, 2013



### How Much Should You Leave to the Kids?

*Scott Hayman, CA, CFP, TEP*



Deciding how much to leave your heirs is one of the most important questions wealthy families face, and one with the widest range of answers, literally ranging from 'everything' to 'nothing'.

Each family will have very different views on how much of the family wealth will be dedicated to funding activities of the current generations and how much will be left as a legacy for future family members. In some cases, this will be determined by the current generation's decision about how much they will need themselves, and what balance, if any, will be left to future progeny. In other cases, a family leader will have a specific vision for what money could do for the family or the community for many years to come and will create a broader and more inclusive strategy for wealth distribution both within and outside the family.

#### How Much and At What Age?

The words "I want to leave my children enough so that they can do anything, but not so much that they can do nothing" capture a spirit of balance that makes an interesting point of departure for any conversation about inherited wealth.

There are pros and cons of wealth, particularly when it is inherited and not earned. On the positive side, beneficiaries will benefit from a more comfortable life and may be freed up to pursue passions and interests that they might not have been able to do without the benefit of inherited family wealth. On the negative side, without good preparation and education, substantial inherited wealth can lead to entitlement, dependence, lack of motivation and poor self-esteem, not to mention financial stress.

Most families of wealth have some set of age-related and possibly capability-related tests. The most common age at which next-generation members begin to inherit is 25, with the possibility of some kind of phased approach up to age 35, or even beyond. By then most children will have finished their education, have taken a few steps toward their career goals, may have been forced to live within a budget based on their own after-tax earnings, and learned to plan accordingly before beginning to take on the benefits—and related responsibilities—of greater wealth.

#### Milestone Methodology

Linking the beneficiary's income and capital payments to key life-cycle milestones may help provide impetus and goals for the individual and can help motivate beneficiaries toward the energetic pursuit of achievements. For example, specific capital distributions could be provided for major life events during the crucial financial development years of 18 to 30, such as education funding, graduation capital, wedding capital, and home down payment.

*Continued*

### Developing Responsibility and Self-Esteem in Beneficiaries

There are many benefits to allowing beneficiaries to “make their own way,” not the least of which is the satisfaction and self-esteem that they develop over their lifetimes from their own successes. Inheriting too much too early can get in the way of this sense of accomplishment. Phasing as well as conditionality can provide useful input to balanced wealth-life management.

Experience with wealthy families provides a few general guidelines when it comes to considering distribution policies:

- **Allow people to develop normally.** People are better off when they have some purpose in life and some control over their own destiny. Too much money can eliminate these opportunities.
- **Less is more.** Giving beneficiaries “too little money” won’t allow them to have a more comfortable lifestyle. And “too much money” can create entitlement and dependence. Each family has to find the right balance, but in many cases “less is more.”
- **Later is better.** Giving significant amounts of money later in life allows time for people to start to build their own lives. Giving money too soon can stunt their individual development and life experience.

- **Responsibilities as well as rights.** There should be some requirements or responsibilities expected from the people receiving money. A simple handout can feel like charity and devalue the recipient’s experience as an active and valued participant in the family.
- **Magic moments.** There are certain key times in life when extra money will be greatly appreciated (e.g., education, house purchase, raising children, etc.). Matching the funds with those ‘magic’ financial moments can be a good way to help at critical times, yet still allow independence and self-reliance.
- **Careful communication.** Thoughtful preparation and execution of a plan that sets out the timing, context, and messages being sent is critical. Long before informing intended heirs and heiresses of “the number” of total family wealth and their share in that wealth, a phased program of communication (which involves both talking and listening on both sides), a discussion of the general benefits and burdens of wealth and the family’s specific values and policies may be among the most important factors in a successful wealth transfer.

While each family has its own unique culture, financial resources, and philosophy, each one faces the challenge of helping their beneficiaries develop the independence and motivation that will allow them to succeed in life. 

## Wigmore Association: A European Vantage Point

*Tom McCullough, MBA, CIM, CSWP, CFBA*



As many regular readers of this newsletter know, Northwood Family Office is a founding member of the Wigmore Association, a global collaboration of chief investment officers from seven leading family offices from around the world -- HQ Trust (Germany), The Myer Family Company (Australia), Pitcairn (US), Progeny 3 (US), SandAire (UK), Turim Family Office & Investment Management (Brazil), and Northwood Family Office (Canada).

Its goal is to further each other’s understanding of issues that are important to the families we serve. The Wigmore Association meets twice a year in key cities around the world, most recently in Frankfurt, Germany in late March 2013.

The CIOs discussed investment strategy, global economic developments, and investment products and strategies designed to improve the return and risk profile of our client families. We also held private meetings with a number of experts who brought further insight to the issues at hand and the potential investment solutions. The European location was a particularly relevant one this year. In fact, the gathering in Frankfurt epitomized why we initially formed Wigmore. The Wigmore member CIOs were at the epicentre of a

financial crisis (Cyprus) as it unfolded, gaining insight from the European Central Bank (ECB) officials and other financial and economic experts.

Despite the still tenuous backdrop in Europe, the specific problems in southern Europe and the risk of bank-run contagion spreading throughout the region, the Wigmore CIO’s were generally positive about the economic progress in the U.S. and other global regions and the activities of the Federal Reserve to stimulate that growth. Wigmore members generally believe that there is a lessening of the fear of the financial markets by investors around the world and that the global debt crisis is closer to the end than the beginning.

The Wigmore CIO meetings provide each member firm with a more global perspective in shaping client portfolios, regardless of the market of origin. All CIOs came away from the Frankfurt meetings with an increased level of insight into the European debt situation and global capital markets, and some fresh approaches to managing the wealth of our client families.

The Wigmore Association will meet in Brazil in September. 

## Canadian Federal Budget Highlights

Barrett Lyons, CA, CFP

On March 21<sup>st</sup>, Canadian Finance Minister Jim Flaherty tabled the federal budget for 2013. As advertised, the budget closes some complex “loopholes” to help generate revenue to support the achievement of a budget surplus by fiscal 2015-2016. Highlights on some of the budget provisions that may impact high-net worth taxpayers are noted below:

- **Leveraged life insurance arrangements** – The budget proposes to deny specific tax benefits associated with leveraged insured annuities and 10/8 arrangements where, in the absence of these benefits, the investments would not have been made.
- **Character conversion transactions** – Through the use of derivatives, the character of income on certain transactions can be converted from income to capital gains (taxed at 50% of the normal marginal rate) in a portfolio that would normally otherwise produce income taxed at the ordinary rate. The budget proposes to reclassify the character-conversion attributes of the transaction and allocate a portion of the gain to distinct income and capital components, eliminating the benefit of the conversion transactions.
- **Artificial dispositions** – On specified transactions, known as synthetic dispositions, a taxpayer economically disposes a property by entering in to an agreement whereby they eliminate the risk of future gain/loss on a property and acquire another property in exchange (the value of

which approximates the value of the original property) to mitigate the tax consequences of disposing the first (or maintaining continued tax benefits). The budget has put rules in place to create a deemed disposition on these types of transactions so the tax consequences are realized on the original property.

- **Lifetime capital gains exemption** – The exemption has been increased by \$50,000 to \$800,000.
- **Non-eligible dividends** – The effective federal tax rate on non-eligible dividends (i.e. dividends paid out of corporate earnings not taxed at the general rate) was increased to eliminate the fractional advantage of earning income at the corporate level vs. personally. At the highest marginal level, the effective federal rate increased from 19.58% to 21.22%.
- **Safety deposit box fees** – The deduction for keeping documents/property in safekeeping has been eliminated.
- **Personal tax rates** – No changes to the existing rates.

Source: <http://www.budget.gc.ca> 

## The Value Of Value Investing

Eric Weir, CFA, CFP



One of the most thoughtful, time-honored, and successful investment approaches is referred to as value investing. While there are many definitions, most practitioners will agree that value investors focus on buying securities that are priced substantially below their intrinsic value. Intrinsic value is determined by deep fundamental analysis on the company and the evaluation of key ratios such as price to-book value and price-to-earnings.

This gap between perceived and real value is a function of the emotions of investors and the related volatility of the stock market. As Benjamin Graham, one of the fathers of value investing, suggested, “Most of the time common stocks are subject to irrational and excessive price fluctuations in both directions, as the consequence of the ingrained tendency of most people to speculate or gamble.”

Over time, value investors believe the market will ultimately recognize the true value of the company and the stock price will rise (or fall) to meet the intrinsic value. The lower the price the investor pays for the stock (relative to the intrinsic value), the higher the “margin of safety” the investor receives, and the more “room for error” the investor has in case his estimate of the real value is incorrect.

Value investing requires substantial patience since investors have no idea what will drive the market to recognize the actual value of a security or when that will happen. As Warren Buffett, one of the modern-day practitioners of value investing, says, “We don’t get paid for activity, just for being right. As to how long we’ll wait, we’ll wait indefinitely.”

There is substantial evidence to suggest that value investing is an effective long-term strategy, but there are clear periods when it underperforms a

growth or momentum strategy. Investors need to have the flexibility (and ability) to shift styles at the appropriate time, or the staying power to wait out the dry spells until value investing starts to outperform again.

Warren Buffett has built up one of the largest fortunes in the world through shrewd equity investment over an extended time frame. Through disciplined investing, he drove the value of Berkshire Hathaway to such an extent that he created a personal fortune valued at over US\$40 billion. Buffett’s investments reflected a consistent philosophy that includes the following principles:

- Pursue a disciplined approach to investment decision making
- Avoid losses in the portfolio
- Make fewer, better investments
- Invest in companies an investor understands
- Look for strong cash flow and a strong management team
- Hold for the long term
- Understand, and benefit from, the psychology of markets

There is a practicality to what Buffett has done consistently and successfully over a long time. It relates to anticipating how human beings react to the concept of risk. Most people instinctively seek to protect assets against further downside when the investment environment causes assets to fall.

The real challenge in family wealth management is that it is hard to be a buyer when markets are falling, and a seller when markets are rising. However, as Buffet has suggested, an investor should buy when the sky seems to be falling, and sell when the sky is clear. His advice to investors is clear and succinct: “Be greedy when others are fearful and fearful when others are greedy.” 

## Five Reasons You Should Give Your Son or Daughter Funds to Invest in a TFSA

Barrett Lyons, CA, CFP



For most affluent families, there *will* be wealth available to leave to the next generation. So the questions these parents ask are not “will they receive any inheritance?”, but “what is the right amount?” and “will they be prepared to manage it?” (See “How much should you leave your kids” on page 1.) In that case, at some point the next generation needs to develop financial skills and build experience in the management of wealth, both for their own funds and possibly to sustain family wealth for future generations.

Like anything else in life, this education will largely come from experience developed over time. But without any direction and encouragement, this experience might not come until they reach their 40s which could be too late. Commonly, the inheriting generation will spend their cash flow from employment and trust distributions through their 20s and 30s as they establish their family, home, and career – and have some fun!

In some cases, parents have used the tax-free savings account (‘TFSA’) or a similar savings account vehicle as a real opportunity to help children start the exercise of financial skills development at an earlier age. Parents gift a sum of money to their child for the purposes of investing in their TFSA account, and it is the responsibility of the child to then manage those investments. This wasn’t the government’s intended goal for the accounts, but the features of the program fit this learning objective surprisingly well because, first, it is a relatively small amount of money but it can accumulate to a handsome sum over time, and second, because TFSAs start at age 18 when children can start to be mature enough to make educated decisions and start to take responsibility for their own future. The following is a list of five reasons wealthy families should consider using a TFSA to help their children develop the necessary financial education, experience and skills:

**1. Building a knowledge foundation** – Unless they have a specific interest in investing, most 18 year olds do not know the difference between a stock and a bond. Starting at this age can help build a foundation of financial literacy so they can understand investing basics including:

- Stocks and bonds and their roles in a portfolio
- Other investment products including ETFs and mutual funds
- Various types of accounts (TFSA, RRSP, unregistered)
- The value of re-investment and compounding

If the child has an active interest or advanced knowledge in investing they can perhaps build their knowledge in more technical and varied areas of the capital markets.

**2. Developing investing experience** – There is no substitute for the value of actual experience. Enabling children to be involved and familiarize themselves with the role of investments in managing wealth will help provide that crucial hands-on familiarity. This can include learning how to evaluate and make informed decisions on purchasing securities, watching the “ebb and flow” of the market, how to deal with the inevitable “stars” and “dogs” in their portfolio, and making sell decisions. These activities will help

them understand the processes and challenges that investment managers face. Over time, they can develop an understanding of various investment management styles and the roles that each may play in a portfolio. Their experience may lead them to build a portfolio and style of investing of their own, or help them learn that they would rather have someone else manage it for them, but at the same time be an educated investor that can evaluate the manager.

**3. Working with an advisor** – Chances are the next generation will work with various advisors, possibly including a family office, investment manager, lawyer or accountant as part of managing the wealth they will inherit. Hiring, firing, understanding fees, and evaluating and extracting value from advisors are all part of the tasks and skills associated with managing wealth that the next generation will need. The earlier they learn these skills the better it will serve them and the family. We recommend to our clients that we meet separately with their children so the children can experience dealing with an advisor on their own and build their own relationship with us. Not only can we aid in education and the decision making process, but we are an independent voice separate and apart from their parents so they are sometimes more inclined to take advice from us versus “another lesson from mom or dad”.

**4. Planning and prioritization** – When families give funds to children to invest, an expectation is set that the funds are for their long term benefit. We encourage parents to then try to establish a dialogue with their children about what the ultimate purpose of the money might be. Making the heirs part of the decision process will aid in their participation in and ownership of financial decision-making. If they are given the freedom to decide what the funds are for (e.g. down payment on a home, wedding etc.), they can prioritize and plan for other lifestyle expenses. Engaging the family members in saving and investing at an early age will help them understand its importance to their own long term financial viability and success and that of the family.

**5. Timing** – Starting the wealth management education process with your children earlier will only make them more prepared for when they take on the responsibility of managing their own wealth and even the family’s wealth later. By the time you are ready to have specific conversations with them about wealth transition, they will have the required knowledge, instead of starting from scratch in their 40s when the patterns of their lives are already set. Moreover, in the event that something unfortunate happens to you or your spouse unexpectedly, there is a greater chance of your heirs “swimming rather than sinking”.

Above all else, it will help you sleep better now and in your later years, knowing that your children are on the path to managing their own lives effectively and developing the skills to help manage the family’s wealth for generations to come. 



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