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# The Northwood PERSPECTIVE

## Chairman’s Message

Tom McCullough



In a recent, Q&A session with a group of university students, Warren Buffett was asked how he decides what he is going to write in his now-famous annual Berkshire Hathaway shareholders letter. He describes it this way, “I try to think of my shareholders as my partners. I try to think of the information I would want them to send me if they were running the place, and I was the shareholder. What would I want to know? This is what I tell them.”

In a similar way, we try to do the same in this column and in the newsletter in general each quarter. We describe as directly as we can the issues that we wrestle with in diligently managing the affairs of our client families. It is not easy and there are many challenges. But we try to share some of the discipline, common sense and experience we apply to the process of managing family wealth.

One of the things we have learned along the way is the value of facts and clear communication. It is amazing how clarifying it can be to apply actual, true, quantifiable facts to any decision process. Most people make decisions based on opinions, partial information and best guesses. Facts bring a rigour and discipline that lead to better outcomes and a higher level of confidence.

Another thing we have learned over the years is to be honest (with our client families and ourselves) about what we can and can't do, and what we can and can't control or predict. And then we try to focus our efforts on the things that matter and that we can control. When it comes to the unpredictable, we suggest conservative estimates. Positive surprises are rarely a problem, whereas negative surprises can play havoc with family plans.

But there are some things you can predict, and some you can even control. You can control how much you spend, and you can predict how much cash you will need to fund a certain lifestyle. A diversified portfolio is an important risk mitigation tool and is another factor the investor can control. And while investors can't control the returns their investments provide, they can exercise some control over the way they themselves respond. Tools such as a written wealth plan and an investment policy statement can provide much-needed self-discipline that can help save the portfolio from the effects of rash and unwise reactions.

We try to bring a sensible approach to the complex task of managing family wealth. Using fact-based decision making and focusing on the controllables are two good tools that families have in their toolbox.

When you think about it, it is not that complicated. To be sure, the world is complicated and getting more so, but a straightforward, sensible approach is often the best way to tackle it. To quote Warren Buffett again, “There seems to be some perverse human characteristic that likes to make easy things difficult.” Hear, hear!



## Introducing the Northwood Investment Insights

Dan Solomon, MBA, CFA




We are pleased to announce the first edition of the Northwood *Investment Insights*. As an integral component of our investment process, we frequently debate both the prevailing and developing investment themes that impact our clients. Last year, we began documenting what, in our view, are the most significant points of these themes, in combination with a striking chart that helps to complement the story.

We have decided to begin to share these thoughts periodically in our Northwood *Investment Insights* publication, and we will provide it on a more regular basis if there is interest. The purpose of the piece is to highlight the main investment themes that we believe private investors should be thinking about. It will be distributed along with our *Perspective* Newsletter and will also be available on our website.

Themes for this Quarter:

- The Challenges of Rising Markets
- US Economy Remains Resilient (but Risks Remain)
- Low Rates Continue to Plague Investors
- Canadian Housing Defies the Odds
- Stock Market Seems Oblivious to Geopolitical Risks

Please click [here](#) to view the Summer 2014 edition of the Northwood *Investment Insights*. 

### NEW FAMILY WEALTH MANAGEMENT PROGRAM



Introducing a new 3-day intensive Family Wealth Management program for family members and family office staff offered through the University of Toronto’s Rotman Executive Education department. The course will be held on October 23-26, 2014, and will be taught by Tom McCullough and other key faculty members and wealth management leaders. The program is already more than half full. For more information and to enroll please visit:

<http://tinyurl.com/od5kr7s>

## Effectively Managing Direct Private Equity Investments

Tom McCullough, MBA, CIM, CIWM, CFBA

Northwood's Tom McCullough recently chaired the 10th Canadian Private Family Office Invitational in Banff, Alberta, where he led a panel discussion on how families of wealth can effectively manage direct private equity investments. In addition to Tom, the panelists included family office leader, Stefan Erasmus (Werklund Family Office), and private equity fund manager/ direct investing specialist, Irfhan Rawji (Parkland Fuel Corporation).

The conversation focused on lessons learned, best practices and key factors for family investors to consider in making decisions related to these types of opportunities. We have included a summary of the key takeaways from the various discussion topics featured throughout the panel.

### The Diversification Dilemma

Most families of wealth have built their fortunes on entrepreneurial success focused in a particular industry, resulting in a highly concentrated portfolio. And so a common dilemma for these families is: should they look at direct private equity as a means of portfolio diversification, or as a way to enhance the return that they are already earning in their area of expertise? There seemed to be two conclusions from the panel. The first approach is that families should adhere to the "stick to what you know" rule.

The years of experience operating in a specific industry will often forge a material sourcing advantage for the family, where it can then leverage its industry network and knowledge to source and evaluate prospective deals. By sourcing its own deals, this will allow the family to gain a critical first-look at the most attractive opportunities instead of being peddled already overlooked and less desirable investments by brokers or other intermediaries.

The second option is that families should consider "picking one other area" where they have (or can build) a competitive advantage and focus their private equity investing there.

The panelists agreed that families should not spread themselves thinly across a wide range of industries and strategies.

The challenge with any direct private equity investing strategy is the extensive resource commitment required for the due diligence, execution, and ongoing monitoring/ reporting of any direct private equity investments that the family has made or is considering. Unless the family has its own well staffed family office or has employed an advisor with experience in these activities, then it should be careful not to take on more than it can handle.

If a family wants to get broad diversification in private equity, they should consider a fund.

### The Importance of Process

The panel also agreed on the importance of process in direct investing. Many serial entrepreneurs have "never seen a deal they don't like" so they may be quick to add new investments without adequate due diligence and strategic intent. This can have serious implications given the concentrated and illiquid nature of direct private equity investments.

Thus, mechanisms should be put in place to safeguard the family from making any decisions that they might ultimately regret. This can be a tool as simple as the Investment Policy Statement (IPS) that can prevent over-allocation to riskier strategies and a rigorous investment evaluation process, possibly with an investment

committee to bring the important "second sober thought" to the decision process.

These management tools and policies will act as a natural way to keep family investors from making poorly thought out decisions and improve the probabilities of ultimate success.

### The Exit Plan

In establishing its investment process for direct private equity, the family should also consider including guidelines for an exit plan. Here the family should first determine what its intentions are with respect to its direct private investments. Does it view the asset class as a long-term income investment, or a temporary one with the potential for a high payoff? For instance, the family might prefer the cash annuity it earns from a successful investment instead of realizing its value in the short-term. Consequently, it may not want to be forced out of that investment by a matter of policy that pressures it to sell.

On the other hand, if the family is involved in the asset class chiefly for the possibility of enhanced investment returns, then having an exit plan in place would be crucial. It could be surmised that if the investment thesis is strong, then the exit will come naturally to the family. However, unforeseen complexities can cause even the best investment to be a challenge to exit without the appropriate strategy in place.

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### Is There a Case to be Made for the PE Fund?

If diversification is the purpose of an allocation to private equity, then the family should consider the indirect route in order to circumvent the resource disadvantage it would face in making direct investments in an industry it doesn't know. Here the case can be made for investing with a private equity firm that has the requisite expertise. Unfortunately, the current environment for private equity investing makes the already difficult task of finding and accessing the right manager even more challenging.

The availability of affordable credit has contributed to increased competition for portfolio investments. As a result, many prospective investments have gone to auction and sold for lofty valuations, which ultimately limits the potential for further value creation. This underlines the importance of investing behind a general partner that can source its own proprietary deals.

Furthermore, for private equity funds, performance data suggests that there is a wide dispersion of returns between the best managers and the rest of the pack, and it is also the best managers that have the most persistent performance.

The confluence of these factors amplifies the significance of conducting the rigorous due diligence necessary to find the right manager. And of course, because the best managers are in high demand it is now also commonplace for the funds offered by these managers to be oversubscribed.

An integrated advisor with existing relationships in private equity fund investing can be brought in to facilitate an indirect private equity investment. Involving a third party can help advance the due diligence process and also provide the benefits of the ability to leverage existing relationships to gain access to highly sought after funds.

Finally, if the situation merits, what might be the best strategy for a wealthy family seeking to diversify using private equity but lacking the specific industry experience to succeed, is to invest as a general partner alongside a seasoned private equity fund manager. However, the ability to locate such an opportunity will likely heavily depend on the size of the family's allocation to private equity and its industry relationships. 🌲

## The Importance of Clarifying Values in a Family Wealth Plan

Dr. James Grubman and Dr. Dennis Jaffe

*This is one of the many thought-provoking guest essays originally featured in Tom McCullough's new book, 'Family Wealth Management – 7 Imperatives for Successful Investing in the New World Order', available on Amazon (<http://amzn.com/0470824298>).*

Families successful in creating wealth rarely pause to step back and think about what the wealth means or can accomplish for them as a family, now and in the future. There is a golden opportunity to look inward at these questions when the family revises its wealth planning, whether proactively upgrading its wealth management services or in having to react under time pressure to a stressful change in generational leadership. Too often, families begin with technical questions about tax planning, portfolio management, estate planning, and the like. Yet, the best planning occurs when the family anchors itself in knowing the purpose and goals for their wealth.

These are questions less about managing a portfolio's value than about cultivating and preserving the family's values. These questions cannot be answered by one person alone, but require engagement

and dialogue within the family where members likely hold different values and experiences.

There are two main reasons why a family must ensure that its wealth management is integrated with its values. The first is that families of wealth must learn how to *work together in the sharing of assets*. Most successful families originally come from modest financial circumstances, arising from working- or middle-class lives to make the journey to wealth. Their values, skills, and culture stem from the much less affluent world from which they emerged. Financial resources were typically scarce, with most decisions based on the needs of individuals or nuclear families.



In new circumstances where resources are abundant and blended across generations or family branches, the family as a whole must learn new decision-making skills and strategies. This requires a process for open sharing of differences that can lead to resolution of problems, rather than bitterness or estrangement. The adult children must be included in this dialogue, as they have their own

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perspectives on wealth, what wealth can do, and the direction of their futures. Working together on sharing assets amicably and effectively means the family must know its culture and its values. Otherwise, risk to the family grows over time from excessive conflict or unresolved differences.

The second reason is that affluent families must learn how to *raise the next generation responsibly with wealth*. Wise parenting and grandparenting with wealth requires adapting the family’s middle-class orientation to add new strategies where solid values are taught and demonstrated. These are crucial for raising responsible, strong, and purposeful children and grandchildren.

Research has demonstrated that families must do the following:

- Communicate effectively about money and wealth, rather than stay silent or leave things to chance.
- Actively prepare the next generation with skills and knowledge for living with affluence.
- Develop clear agreements, policies, and procedures for working together to pass on assets and control across generations.

Most successful families, for example, hold regular family meetings where information can be discussed and pending issues figured out collaboratively. Family leaders relate the story of how the wealth was built, including the risks that were taken and how those risks

were managed. In turn, they learn from their children who have become adults with their own families.

The elder generation listens to the next generation’s life goals and plans, with a willingness to discuss how the family wealth can make a difference in the lives of everyone. The family also develops consistent, transparent policies so decisions about financial support, gifting, or the family business remain equitable over time. Effective, clear communication within the family; effective preparation of heirs as good stewards of wealth; and effective processes for governing the family justly are the core processes. Taking the time to develop these processes ensures the successful transfer of wealth, whether through inheritance, lifetime transfers, or both.

Few families who come to wealth have been prepared for these tasks. They often don’t know these new strategies are even necessary. Truly successful wealth management is best when grounded in the family’s very nature—its story, its culture, its values. Those families who make the effort to know themselves can develop a wealth plan that is thoughtful, integrated, fair, and deeply satisfying. By investing in this process seriously, they plan well and develop responsible communication and decision making.

Values-based wealth planning then leads to the most wonderful payoff: family members who can manage the power of wealth and use it effectively for themselves and for society

## Ontario Budget Update

Barrett Lyons, CPA, CA, CFP



The 2014 Ontario budget was tabled on May 1st and struck down by the opposition on May 2nd. Having won the election with a majority, the Liberals have indicated they will move quickly to retable the same budget in July. Highlights of the provincial budget provisions that impact high-net worth taxpayers include the following:

- **Personal Tax Rate Increase** - For the 2014 tax year, a new tax bracket will be defined from \$150,000 to \$220,000, and the ‘super tax’ bracket has been lowered from \$514,090 to \$220,000, casting a substantially larger net on high income tax payers than before. A comparison of the old vs. new rates and brackets is noted below:

Old Brackets	Old Rates	New Brackets	New Rates
First \$40,120	5.05%	First \$40,120	5.05%
\$40,121 to \$80,242	9.15%	\$40,121 to \$80,242	9.15%
\$80,243 to \$514,090	11.16%	\$80,243 to \$150,000	11.16%
Above \$514,090	13.16%	\$150,001 to \$220,000	12.16%
		Above \$220,000	13.16%

- **Ontario Retirement Income Security** – The provincial government proposed to introduce a mandatory Ontario retirement pension plan similar to the federally run CPP program, to assist in providing retirement income to seniors. The ‘Ontario Retirement Pension Plan’ is proposed to be introduced in 2017, and consultations will be taking place in the interim. In addition, Ontario will introduce a framework to parallel the federally legislated changes to introduce pooled registered pension plans for employers.
- **Small Business Deduction** – Changes are proposed to correspond to the new federal rules to grind down the small business deduction for Canadian controlled private corporations with taxable capital above \$10M. The deduction is eliminated at \$15M of taxable capital.

Source: <http://www.fin.gov.on.ca/en/budget/ontariobudgets/2014/>

## Summer Reading List

Here, once again, is our Annual Summer Reading List, a popular feature in the Northwood *Perspective*. This spring, we chaired both the East and West Canadian Private Family Office Summits in Niagara-on-the-Lake, Ontario and Banff, Alberta. We ask each of the speakers to share their favorite book ideas and then we publish the lists in the Northwood *Perspective*, just in time for summer. Enjoy!



### Private Wealth Issues

- The New Financial Advisor: Strategies for Successful Family Wealth Management, *G. Scott Budge*
- The Stewardship of Wealth: Successful Private Wealth Management for Investors and Their Advisors, *Gregory Curtis*
- Willing Wisdom: 7 Questions Successful Families Ask, *Tom Deans*
- Strangers in Paradise: How Families Adapt to Wealth Across Generations, *James Grubman, Ph.D.*
- Family: The Compact Among Generations, *James E. Hughes Jr.*
- So You Want to Be a Philanthropist: How to Choose, Set Up and Manage a Successful Family Foundation, *Julia A Kittross*
- On the Shoulders of Atlas: A Story About Transitioning A Family-Owned Business, *Multiple Authors*
- Family Wealth Trilogy:
  - Family Wealth Management: Seven Imperatives for Successful Investing in the New World Order, *Mark Haynes Daniell and Tom McCullough*
  - Family Legacy and Leadership: Preserving True Family Wealth in Challenging Times, *Mark Haynes Daniell and Sara Hamilton*
  - Strategy for the Wealthy Family: Seven Principles to Assure Riches to Riches Across Generations, *Mark Haynes Daniell*

### Self-Development

- Leadership and Self-Deception: Getting out of the Box, *Arbinger Institute*
- The Anatomy of Peace: Resolving the Heart of Conflict, *Arbinger Institute*
- Parenting with Love and Logic, *Foster Cline and Jim Fay*
- The Secrets of Happy Families: Improve Your Mornings, Tell Your Family History, Fight Smarter, Go Out and Play, and Much More, *Bruce Feiler*
- Humble Inquiry: The Gentle Art of Asking Instead of Telling, *Edgar H Schein*
- Bridges Not Walls: A Book About Interpersonal Communication, *John Stewart*

### Biography/History

- Crazy Town: The Rob Ford Story, *Robyn Doolittle*
- Tragedy in the Commons: Former Members of Parliament Speak Out About Canada's Failing Democracy, *Alison Loat and Michael MacMillan*
- Grant, *Jean Edward Smith*

### Psychology

- Influence: Science and Practice, *Robert B. Cialdini*
- Deep Survival: Who Lives, Who Dies, and Why, *Laurence Gonzales*
- Thinking, Fast and Slow, *Daniel Kahneman*
- Understanding Media: The Extensions of Man, *Marshall McLuhan and Lewis H. Lapman*
- Mistakes Were Made (But Not by Me): Why We Justify Foolish Beliefs, Bad Decisions, and Hurtful Acts, *Carol Tavris and Elliot Aronson*

### Business/Economics/Investments

- Cradle to Cradle: Remaking the Way We Make Things, *Michael Braungart and William McDonough*
- The Intelligent Investor: The Definitive Book on Value Investing. A Book of Practical Counsel (Revised Edition), *Benjamin Graham, Jason Zweig and Warren E. Buffett*
- Blue Ocean Strategy: How to Create Uncontested Market Space and Make Competition Irrelevant, *W. Chan Kim and Renee Mauborgne*
- Flash Boys: A Wall Street Revolt, *Michael Lewis*
- Reminiscences of a Stock Operator, *Edwin Lefèvre and Roger Lowenstein*
- Focus: The Future of Your Company Depends on It, *Al Ries*
- Economics of Good and Evil: The Quest for Economic Meaning from Gilgamesh to Wall Street, *Tomas Sedlacek*
- The Outsiders: Eight Unconventional CEOs and Their Radically Rational Blueprint for Success, *William N. Thorndike*

### Fiction

- Once We Were Brothers, *Ronald H Balson*
- Ready Player One, *Ernest Cline*
- Little Sister, *Vince Fernandez* (soon-to-be-published)
- Bossypants, *Tina Fey*
- Still Alice, *Lisa Genova*
- The Forever War, *Joe Haldeman*
- The Dovekeepers, *Alice Hoffman*
- The Storyteller, *Jodi Picoult*
- The 39 Clues Collection, *Rick Riordan*
- Major Pettigrew's Last Stand, *Helen Simonson*
- Cutting for Stone, *Abraham Verghese* 🌲🌲



For more information, please call Tom McCullough or Scott Hayman at

Main: (416) 502-1245

[www.northwoodfamilyoffice.com](http://www.northwoodfamilyoffice.com)

Email: [tmccullough@northwoodfamilyoffice.com](mailto:tmccullough@northwoodfamilyoffice.com)

[shayman@northwoodfamilyoffice.com](mailto:shayman@northwoodfamilyoffice.com)

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