

ALSO IN THIS ISSUE:

- An Entrepreneurial Family Culture and the Preservation of Wealth.....3
- Remembering the Value of Active Management.....4



The Northwood PERSPECTIVE

Chairman's Message

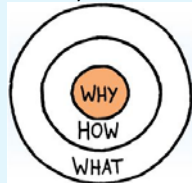
Tom McCullough

Starting With Why

In his best-selling book *'Start with Why'*, author Simon Sinek studied the leaders and companies who've had the greatest influence in the world. He discovered that they all think, act, and communicate in the same way - and it's often the exact opposite of what everyone else does.



Every organization on the planet knows WHAT they do and can itemize the products and services they offer. Some organizations know HOW they do it (i.e. the things that make them special or set them apart from their competition). But, Sinek says, very few people and organizations can clearly articulate WHY they do what they do. WHY is a purpose, a cause or a belief. It provides a clear answer to why we get out of bed in the morning, why our company even exists and why that should matter to anyone else.



Using his Golden Circle diagram, Sinek argues that people naturally communicate from the outside-in. They usually go from the clearest thing to the fuzziest thing. They tell people WHAT they do, HOW they're different or special and then they expect them to choose their product, follow their ideas or vote for them.

The problem is that WHAT and HOW do not inspire action, or even satisfaction. Facts and figures make rational sense, but people don't make decisions purely based on facts and figures. Starting with WHAT is what commodities do. Starting with WHY is what leaders do. Leaders inspire. They work from the inside of the circle out. Think about these great leaders and brands:

- Sam Walton (Walmart) wanted to make quality goods affordable and available to average people.
- Herb Kellerman (SouthWest Airlines) wanted to take the stodginess out of air travel, and bring it to the common people.
- Bill Gates (Microsoft) had a vision of accessible information for all.
- Steve Jobs (Apple) wanted to think differently and challenge the status quo

This really resonates with me. Maybe because we started Northwood with a vision too. It was never only about WHAT we do (i.e. integrated wealth management, goals-based investing, family governance and education, tax and estate planning). And not just about HOW we do it differently (i.e. objective, holistic, client-centered, proactive, fact-based, integrated).

Rather, it started with WHY we do what we do. When we conceived Northwood in 2002, it had everything to do with *helping families*. We wanted to help them to identify and meet their goals, to make good decisions, to reduce stress and worry, and to bring a sense of order and control in a topsy-turvy world. We wanted to provide them with the gift of objectivity and never having to wonder if their advisor had a hidden agenda. We wanted to reduce the worry of important things falling through the cracks and help families with the many financial balls they have to juggle. And we wanted to help them have the kind of conversations about family and money that would build their wealth and strengthen their relationships. We wanted to improve their lives.

We work hard to do this every day.

Observations from Silicon Valley

Scott Hayman, CPA, CA, CFP, TEP



With all of the technological change that has occurred over the last number of years, it is sometimes hard to comprehend what might be next. As a child, I watched *The Jetsons*, a cartoon about a family from the future that flew in personal planes and had video phones among other things in their homes. I remember distinctly at the time thinking that having this type of technology would never happen in my lifetime. Now I skype with my daughter on my cell phone!!

I recently returned from a week-long trip to California. The reason for the trip was the semi-annual meeting of the Wigmore Association (www.wigmoreassociation.com). Regular readers of this newsletter will remember that Wigmore is a global association of eight leading family offices from four continents around the world. The group is composed of the Chief Investment Officers from each family office and meets to exchange views on the outlook for the global economy and markets, share insights on investment strategies, review investment managers, and discuss best practices for serving wealthy families. Past meetings have been held in London, New York, Melbourne, Toronto, Frankfurt, Rio de Janeiro, Montana and Singapore.



This most recent trip took us (-- Northwood vice-president Eric Weir and myself) to San Francisco and Silicon Valley. The focus of the trip was to get a sense of what is happening in the venture and private equity space of the technology sector.

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2ND EDITION OF ROTMAN WEALTH MANAGEMENT PROGRAM FOR FAMILIES



On the heels of the very successful inaugural Family Wealth Management course in 2014, the University of Toronto's Rotman School of Management is pleased to offer the program for a second time. The 3-day intensive Family Wealth Management program for family members and family office staff will be held in Toronto on October 22-25, 2015, and will be taught by Tom McCullough and other key faculty members and wealth management leaders. For more information and to enroll please visit: <http://tinyurl.com/od5kr7s>

We had a number of speakers ranging from a nano-technology fund to venture and private equity firms, and we also visited or had visits from nine companies in San Francisco and Silicon Valley including, Salesforce, Le Tote, Uber, RelatelQ, Addepar, HyTrust, Zanbato, Cisco and Twist Bioscience.

Below are a number of observations from our meetings. We are by no means experts in technology investing but now have a little more perspective on investing in the sector, and pass on the following insights:

1. San Francisco and the Silicon Valley is an unbelievably fertile ground for innovation and the development of ideas. You can run into anyone and have a conversation with them that may lead to a new idea or financing or connection for the future. We heard numerous stories of being in a coffee shop and someone sits down beside you and you get talking and it turns out to be Tim Cook from Apple.
2. The rate of technological change over the next five years is likely to be exponential. From nano-technology and the work being done in DNA research, to the technology companies that are trying to 'disrupt' traditional businesses, technology will inevitably lead to substantial change in our lives. Some of that change has already started. For example, Uber is disrupting the traditional taxi market with their model and have an opportunity to do the same kind of thing with the logistics industry. There are now more Uber drivers in New York City than there are traditional cab drivers.
3. Private companies are staying private longer than they were 10 years ago, which is leading to higher valuations in the private markets. The recent \$40B valuation of Uber is the most dramatic example of this phenomenon. Previously, companies would go public at much earlier stages, and public market investors could participate in the growth.
4. Capital appears to be plentiful for the sector. While there are a large number of companies that require capital, there are ample sources of funds, especially for the good companies. And since good companies have no issue in raising capital, they are selecting investors based on the other value they will add to the company. This makes it increasingly important to invest with top tier funds as they offer more to an investee than just capital. Historically, the returns in the venture capital space have been dominated by the top venture funds, and this is expected to continue.
5. There is a continuing shift of resources to San Francisco. There are many small technology companies that have decided to base



themselves in San Francisco versus Silicon Valley. From the ones we spoke to, this is due to the employees wanting a more urban centre to live in. It has produced other challenges, however, not the least of which is housing. Housing has become very expensive in San Francisco, pushing rents above those in New York City as the most expensive market in the country.

6. In this competitive environment, some acquisitions are being done simply to 'buy' software engineers, and a term has even been coined for these transactions – 'acquihires'. Some smaller (8-15 person) companies are being purchased, and the buyers may not really be concerned with the technology that they have developed but more that they have good engineers.
7. Large technology companies struggle with growth and must often take on different investment strategies not just for growth, but simply to sustain their revenues. At the two largest companies that we saw—Cisco and Salesforce—we met with the head of their internal merger and acquisition departments. These departments are integral to their success. That is not to say that they will not grow without acquisitions, but they are a very big part of that growth.
8. The market seems to be a little different than the technology bubble of 1999-2000. As companies are staying private longer, they are taking more time to commercialize their products and develop revenue streams from them. Saying that, some of the recent valuations still seem to be excessive and hard to understand. For example, one of the companies we met had \$2 million in sales and was sold for \$400 million dollars—200 times sales—which makes little sense based on traditional valuation metrics.
9. Security is a growing industry. One of the companies we saw was a cyber security company which does work for the CIA and the NSA. Surprisingly, most hackers enter systems using attachments on emails that unsuspecting employees open, which then unleash viruses and malware into the system. In some cases, the malware allows them to take administrative control of the system which can obviously lead to big problems. While technology is available to prevent direct access to systems, the very fact that they can still get in using email is a difficult issue to combat. As fast as fixes are created, new ways of getting in are being developed. Employee training and diligence is extremely important. The simple advice is, "when in doubt, don't open attachments!!" Good advice, even for our own home computers. 🌲

An Entrepreneurial Family Culture and the Preservation of Wealth

Professor Heinrich Liechtenstein

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

The importance of family culture is becoming increasingly clear over time as playing a key role in preserving family wealth across generations. In particular, the value of an entrepreneurial culture in a family of wealth is one of the defining characteristics of those families, with and without a principal operating business, that keep and grow their wealth across economic cycles and through periods of adversity from within or surrounding the family.

In a number of academic studies completed over the past few years, family culture, values, and other 'soft' factors were rated by families as equally important as—and in some cases even more important than—the hard variables such as asset allocation and investment advisor selection in preserving family financial prosperity.

Two Key Insights

Research completed on two separate occasions has reinforced two basis insights. First, as demonstrated by analysis completed for a private roundtable in the United Kingdom for a group of substantially wealthy international families, family culture was an area of exceptionally high importance. When asked to rank-order the critical elements of family legacy, the relative importance of formal governance documents and structures, leadership, and culture were selected consistently as the top three issues. Of these, culture came out a surprising first choice among the families present. Second, in an earlier and more comprehensive analytical study, it was the entrepreneurial nature of family culture that was the most highly appreciated—and determined to be the most important factor preserving family wealth over time.

In the business world, it is becoming increasingly well known that 'culture overcomes strategy'; identifying the nature and need for change within a corporate culture must be an essential part of any business strategy or organizational study. The same has now been found to be true in the area of family business, family continuity, and family wealth management.

What is most interesting about these insights is that they are, as yet, not fully supported by any detailed understanding of what makes up a family culture and how those elements can best be managed to create change in the culture which can lead to the desired outcome of a strong, cohering, positive, and entrepreneurial family culture.

Practical Advice on Individual Experience and Family Culture

As the research develops and understanding deepens over time of what culture is, there are already a number of proven practices that can be put in place today to shape the experience and attitudes of a new generation. These experiences may, if shared broadly across a whole family or targeted generational group, affect the broader family culture as well.

These ideas include:

- Internships within the businesses and family offices of other, like-minded families.
- External work experience for a significant period of time, say three to five years, with real performance feedback.
- Running a small company.
- Participating in an MBO (actually an MBI—management buy-in) of one of the family companies.
- Taking up a role in social entrepreneurship in another country, creating three types of experience: foreign environment, social focus, and entrepreneurship.
- Spending some time as an executive assistant to a successful start-up entrepreneur (described by one family member as “working with one of the beasts”).
- Working in an emerging country.

In all cases, those experiences should be accompanied with real feedback, pay linked to performance, a reporting relationship to someone other than a family member and, if possible, the establishment of a relationship with a family or family business mentor who can help carry forward the lessons learned during the experience.

By creating these kinds of opportunities, and shaping the experience of the future leaders of the family, current leadership teams can influence both individual capability and family culture for the better, and improve the odds of keeping both family and family wealth intact and thriving into the next generation.

Professor Heinrich Liechtenstein is an associate professor of finance at the IESE Business School in Barcelona, Spain, and a director of his family's nonprofit Liechtenstein Academy. His work addresses many relevant areas for legacy families and their governance, business, and investing activities. 🌲



Remembering the Value of Active Management

Dan Solomon, MBA, CFA, CFP



As it turns out, 2014 proved to be a very challenging year for active equity fund managers. The S&P 500 reached all time highs, yet close to 90% of US active managers trailed the index. The Vanguard 500, a leading passive index fund, was in the top quartile of all large cap US managers. This outcome, which has happened only five times in the past 20 years, always raises the question of whether active management is worth the money and if low-cost ETFs are the answer. This article looks at some of the reasons why active management can make sense over the long term, particularly for conservative investors.

In today's shortsighted world, where the financial media is mostly concentrated on soundbites and touting the expert of the day, it can be hard to focus on the long term. But it is in the long term where real wealth is built and real goals get accomplished. So, when conducting annual manager reviews, it should not be a 'what have you done for me lately' conversation. It is important to concentrate on a manager's ability to deliver strong risk-adjusted performance over long periods of time. Capital preservation is the cornerstone of most client goals and investment philosophies and so, in our view, the best way for a manager to add value is to deliver long term returns at or above market indices with below-average risk. With this investment mindset, it's easier to separate ourselves from the daily headlines and remind ourselves of the benefits of an active management approach designed to mitigate risk. Here are some real world examples:

Patience Pays Off for Value Investing

The value style of investing can provide an enhanced level of capital protection to client portfolios, especially in down markets. In our experience, these managers typically earn their keep during periods of turmoil. And because most crises are unforeseen, we believe that this style of investing should hold a prominent place in a conservative investor's portfolio.

This type of manager looks for stocks that trade at a discount to their 'intrinsic value'. To them, this discount is 'a margin of safety', and they will not hold any investment without this built-in layer of protection. The trade-off for this 'downside protection' feature can be lagging performance in strong markets. This occurs because as markets run higher, value managers tend to struggle to find opportunities because, in their opinion, valuations become too stretched. This can in turn cause many of them to increase the quality of their portfolio holdings and hold significant cash balances, as was the case for active US value managers in 2014. This was not productive for performance last year because the S&P 500's total return of 13.7% (in US currency) was well in excess of the yield you could earn on cash. (It is interesting to note that the more representative Russell 2000 Index rose only 4.9% last year.)

While value managers may face performance-related criticism in the short term, we believe the style is a prime example of how taking a long view to investing can pay off. For instance, prior to the onset of the 2008-09 financial crisis, many value managers were also facing valuation-related challenges and increased the quality of their portfolio holdings and boosted cash as a result. Their conservatism was ultimately appreciated by investors when their portfolios were insulated from the historic drawdown that followed. Many of these managers also outperformed when the markets began to recover as they were able to deploy available cash into stocks at attractive valuations.

Unlike value or other active managers, passive index funds are always fully invested and hold a portfolio that will track the market, more or less. Passive investments are a valuable and legitimate component of a portfolio but they don't have the same flexibility of active managers to moderate risk when deemed necessary.

The Benefits of Active Management at Home in Canada

Investors in Canadian equities can also benefit from active management. In addition to financial stocks, the Canadian TSX index is dominated by two sectors that are inherently cyclical – energy and materials. Overexposure to these sectors through investing in indexes or index-like funds, adds a level of volatility which may not make sense for many portfolios. Selecting investment managers who concentrate on minimizing risk as well as participating in growth, may tilt the portfolio to be underweighted in the more volatile resource sectors or hold more stable and high quality names within them. This approach can result in underperformance in the short term in the event of a broad scale rally in resource stocks. But, over the long run, this strategy can add an element of stability, such as in 2014, when Canada's energy sector suffered from the precipitous drop in oil.


The Advantage of Choosing to Own Quality

Focusing on quality companies can also be a good approach for conservative investors, no matter the managers' respective styles. Quality companies tend to be profitable, well established and less leveraged, and they have sufficient cash flows available to meet their obligations (i.e. interest and dividend payments, capital expenditures, etc.). While the growth prospects for these companies may seem less than other 'flavours of the day' in the investment universe, they are often financially well-positioned to deal with periods of heightened volatility and have produced good long term returns. Conservative investors can be comfortable when the performance of these companies lags when the general markets surge. The value comes in the relative outperformance when the

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investing environment is less favorable. A 'winning by not losing' approach has been a very successful strategy for conservative investors over the long term.

As discussed in the previous examples, active management has its merits for the conservative investor who is focused on protecting capital on the downside by minimizing risk in the quest for returns

over the long run. It is acceptable and should even be expected that value-oriented active managers will fare relatively less well in strong markets and relatively better in weak markets. Running a few steps behind the fastest runner may not feel like fun, but finishing strong, without major mishap, feels really good and is often more than enough! 



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