# Risk and the Role of a Family Office:
## What Entrepreneurs and Senior Executives Need to Know

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Creating wealth is considerably different than sustaining that wealth, particularly if you are an entrepreneur or corporate executive. The path to this particular type of sustainability can be a perilous one but a Family Office can smooth that path and ensure that it remains clear for those who will inherit the wealth.

Entrepreneurs (and some very senior corporate executives) face a unique set of circumstances that can put their families and their personal wealth at more risk than they might have imagined. In most cases, these individuals are highly exposed to one company. The company they own is also the company they work for. Unwittingly perhaps, the entrepreneur has all of his wealth invested in the company, and only the company. Such a concentration of wealth has never bothered the entrepreneur (indeed, it is how he made his fortune). But with succession planning and retirement not far off, he suddenly realises that his financial well-being may be at risk because all of his wealth is tied up in his one and only investment, the company. Enter the family office, a team of professionals that can help mitigate the risks and prepare the entrepreneur to manage the shift from creating wealth to sustaining it.

The Role of a Family Office?

A family office is an entity established or engaged by a single family or a group of families to manage all of their financial affairs. The focus of the family office is on managing, building and sustaining wealth for current and future generations. It also plays a major role in risk management, by building a diversified portfolio instead of one built on a single holding, and ensuring that this portfolio is properly managed and likely to be able to provide the funds to meet all the family's goals and objectives. While many value a family office for its ability to deliver a range of straightforward and complex financial services many of these same people recognise that its main value is its ability to manage risk.

### Four Key Risks

Apart from the risks inherent in their businesses, entrepreneurs and CEOs face four broad categories of risk:

1. Concentration risk
2. Management risk
3. Balance sheet risk
4. Succession risk

### 1. Concentration Risk

Concentration of investment can be a great way to grow wealth, but diversification is the more prudent path to preserving wealth. The trick is in knowing how and when to convert that single, concentrated asset into a more diversified pool of assets, to mitigate the risk of something bad happening to that one asset. Most entrepreneurs and CEOs discount the riskiness of their own business because they know it so well. But regardless of the type of business, having 'all of your eggs on one basket' leaves you exposed to a substantial loss if something were to go wrong.

The owners of a Canadian pet food manufacturer probably assumed the pet food industry was a highly stable, low-risk business. That was until contaminants were found in their product, leading to a recall of over 50 million units and a plunging share price. Similarly, many investment bankers who had amassed substantial deferred compensation in the form of shares of their parent bank realised, in the market meltdown of 2008, how vulnerable their wealth and future lifestyle plans were to the price of one stock, which dropped almost 50% in six months.

It is important for entrepreneurs and senior executives to have a diversification plan in place, especially since it is not easy to move quickly when difficulties arise. Transitions can be dangerous inflection points. Private businesses are generally illiquid, and significant public shareholders usually have regulatory constraints on their ability to buy and sell shares of their company. So the combination of bad timing and a large concentrated asset can be devastating. And of course the 'mother of all transitions' comes when the business is sold or the deferred compensation vests (usually on retirement). These events need to be well planned for, both from timing and tax perspectives, to mitigate the potential impact of unforeseen negative events and help to ensure the highest possible value of the asset. In our experience, scant attention is paid to these risks.

### 2. Management Risk

When a business owner sells a business or a CEO retires, and their wealth shifts from a concentrated, relatively illiquid operating company to more diversified set of financial assets, they are often unprepared for the different skills and resources required to manage this new form of wealth. Think about it this way. It would be unimaginable for a CEO or business owner to run an effective

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operating business totally on his or her own. Most CEOs have a team of executives with diverse skill sets – sales, marketing, manufacturing, and accounting – with whom they regularly sit around the boardroom table to strategise and to manage the company.

But somehow that logic doesn't seem to play a role in the management of substantial financial wealth. Most wealth holders have no specific strategy for their financial assets, and the new set of required senior 'executives' – tax, legal, investment, planning, philanthropic – rarely sit around the table together to manage the financial wealth in an integrated, strategic manner. In addition, there is often no active 'CEO' or 'COO' of the financial wealth. The fact is that most business owners and CEOs will admit that management of their personal wealth is not their core strength.

Three factors can exacerbate this management risk. First, behavioral psychology tells us that entrepreneurs and corporate CEOs (particularly men) have an independent streak that helped create their success. At the same time, however, they are subject to feeling overly confident that they can manage anything ("If I could manage my business successfully, why shouldn't I be able to manage the financial wealth?") But financial wealth is a different animal than an operating business, and it requires a different set of skills. It also requires at least the same level of attention that the business did. It can be learned, but it takes diligence, effort and time to do well and to stay current with new developments.

Second, the financial press tells investors that managing financial wealth is easy and you should, in fact, expect to be able to regularly outperform indexes or be able to select the best investment managers on a consistent basis. Unfortunately, the reality is quite different, as any investor who has been through a few cycles will know.

The third and perhaps most important issue is the way the financial services industry is structured. Most firms are organised and offer services around their own areas of expertise or interest, whether it is investments, insurance or tax planning. On the other hand, the needs of the wealth holder are usually integrated and interconnected. In fact, most financial issues can't be neatly folded into one particular discipline or another. It leaves the wealth holder responsible for connecting all the dots to ensure that an objective, unbiased assessment is made and that all the potential consequences are taken into account. The lack of an integrated approach to the management of financial wealth can result in a collection of 'investment islands,' with no connection to one another or to the goals for the family or their wealth. It can also lead to costly dropped balls and missed opportunities.

## 3. Balance Sheet Risk

Most entrepreneurs and corporate executives are very comfortable around a corporate balance sheet. They know that there must be enough current assets to meet current liabilities, they recognise the need to balance liquidity, cash distributions and reinvestment of capital into the business, and they understand how an excess of liabilities can weigh on the health of an enterprise and limit its future options.

The same risks and constraints apply to a family balance sheet as to a corporate balance sheet. Short-term assets with minimal variability (such as cash) must be available to fund current liabilities (such as this month's private school bill). Longer-term assets (such as equity or real estate) will be required to meet long-term liabilities (such as bequests).

Too great a focus on investment returns (vs. the entire family balance sheet) can put financial wealth at significant risk. The quest for the highest possible return without appropriate regard for specific objectives, risk of loss, or the appropriate matching of assets and liabilities, can push the wealth holder further out on the risk curve than they realise or than they need to be. It can also lead (aided and abetted by the investment industry) to a loose collection of investments that serve no specific purpose on the balance sheet. In fact, most of the investments in wealth holders' portfolios have been sold to them by one of the purveyors rather than bought by them to meet a specific need or to play a particular role on their family balance sheet.

By way of a case study, in late 2008, a 50-year-old partner in an entrepreneurial business came to our firm with a serious problem. A year earlier he had a net worth of $20 million, including a large primary residence and vacation home (both with mortgages). His earnings substantially outweighed his $750,000 annual spending, and he was enjoying (and indeed counting on) the strong stock market returns of the previous several years. When equity markets crashed in the fall of 2008, his portfolio (of 80% stocks) lost half of its value. In the soft economy, his variable compensation fell substantially and even his employment became tenuous. With a post-crash net worth of $13 million (a large portion of it still in non-income producing personal-use real estate) and substantial debt servicing and family education commitments, his balance sheet was substantially impaired and in need of immediate attention.

## 4. Succession Risk

It's no surprise that the word 'success' features prominently in the word succession. It is vitally important that the business is prepared to continue its success once the current leader moves on, particularly, when the wealth of a family is underpinned by just one asset. A well-planned succession has a significant impact on the continuing cash flow of the founder, if he or she plans to retain a stake in the business, or on the price the buyer is willing to pay for the business. Well-thought out succession is also relevant to senior corporate leaders who often continue to own shares in the company, and that form a meaningful component of their wealth.

While preparing a business for effective succession is a critical component of a family wealth plan, there two other types of succession must also be considered. The first is family succession – essentially preparing next generations to know how to live with the wealth they will inherit. The impact of that wealth can be overwhelming and even ruinous to next generations who have not been educated in the stewardship, responsibilities and management of wealth, and the access and privileges it can buy. Communication between parents and children can be challenging at best, and a sensitive topic like money can make it even more difficult, unless it is handled well.

Respected wealth psychologists Dr. James Grubman and Dr. Dennis Jaffe have an interesting take on the relationships between the first-generation wealth creators and the next generation. In their excellent paper entitled 'Immigrants and Natives to Wealth' , they liken becoming wealthy to a move from one country and culture to a new and very different country. The 'immigrants' to wealth have left their proverbial 'home country' (i.e. a more modest socio-economic status) and through a business or corporate success have moved into the new 'land of wealth.' Not surprisingly, they don't always feel completely comfortable in the new land and still carry with them many of the values of the old culture. Contrast this with their children, who are typically 'natives' in this new land of wealth, having been born and grown up in it with little or no knowledge of the old country or its values. You can imagine (or may have experienced) this culture clash, either from the perspective of an immigrant or a native.

The second additional succession component is the succession of the wealth itself. Families that want their wealth to last through their own lives and to be available for future generations have a special task to sustain and grow that wealth so that it can continue to fund the needs of the family for the future. This can be a tall order, since investment returns tend to grow in a linear fashion and family size grows exponentially. A common problem several generations out (without the proper planning) is that the wealth will prove to be insufficient for meeting the needs of the increasing number of family members. This same idea can also apply to family legacy. Legacy is an equally important component of family wealth, and consists of the core values, philanthropic heritage and human capital the family wants to create and sustain. It must also be preserved, nurtured and developed.

## The Family Office as a Risk Mitigator

The family office was initially conceived to mitigate the above-mentioned risks and help build sustainability into family wealth.

There are three main roles the family office plays in this risk mitigation. Diversification of the core concentrated asset is often a prudent way to protect the risk of loss should the unthinkable happen. This diversification must be undertaken in a thoughtful manner, and be well managed at each turn. At the same time, it must be flexible and leave family options aws open as possible.

A family office's job is, almost by definition, integration. The issues wealthy families face don't fit neatly into one particular practice area, but rather they "sprawl messily across the disciplines", to quote Roger Martin, dean of the Rotman School of Management. The family office, with its deep knowledge of the family and its goals, as well as its staff's experience in a wide variety of professions of origin, plays an important role in providing the family with objective comparison, perspective and integrated advice and recommendations.

Discipline is the third factor a family office can bring to bear on managing wealth. Just as doctors typically engage other physicians to treat them and their family members, family offices can play an important role with wealth-owning families. The family office can bring independence and objectivity, a less emotional perspective and a fair and fact-based decision making process that can significantly improve the workings of a family and the management of its wealth.

Many entrepreneurs and senior executives have not thought much about the risks discussed above. It is important to take the time to step back to identify the family's objectives, and then to determine what steps are needed to meet the goals. That may be the most important legacy an entrepreneur or senior executive can leave his family.

## Engaging a Family Office

As a lawyer colleague said to me a few years ago, "My personal financial affairs never make it to the top of my in-basket." Like many people, she was so focused on her work and her business that she never quite got around to doing the planning necessary to make sure her family's financial affairs were not put at risk. The family office is one way for wealthy entrepreneurs and corporate executives to be sure they get the help they need to mitigate the substantial (and not always obvious) risks facing the family, particularly as they make the critical transition from a period of building family wealth to one of sustaining it.

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