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The Northwood PERSPECTIVE

Chairman's Message

Tom McCullough

Welcome to our Fall 2012 newsletter. As usual, the last three months have been busy at Northwood as we serve our existing families and add new ones.

As some of you may know, we are part of an international association of family offices called the Wigmore Association (named for the street in London, UK where we had our first meeting). There are now six firms in the association - from the UK, Germany, US (2), Canada, and Australia. The group is composed of the Chief Investment Officers of each of the family offices. We meet twice a year to share investment manager research, global investment perspectives and best practices for serving wealthy families.

It was Canada's turn to host the association and we had an excellent meeting in mid-September in Toronto. Each hosting country typically invites a few relevant, high-profile speakers to join us for private meetings. Northwood was pleased to host David Denison, the recently-retired president of Canada Pension Plan Investment Board, the Hon. Michael Wilson, Chairman of Barclays Canada and former finance minister and US ambassador, Roger Martin, Dean of the University of Toronto's Rotman School of Management, and Dr. Helima Croft, a middle east specialist and geopolitical and commodities analyst with Barclays in New York.

In addition, we met with a select group of investment managers covering topics such as infrastructure, private equity, real estate, farmland, credit funds, and global resources. We also had substantive discussion on the state of Europe, the US election, developments in China, Brazil, the Middle East and other developing markets and the global economy. Each member shared their own firm's investment outlook, asset mix and portfolio construction.

While there is a range of investment views among the members, everyone was focused on a number of key themes including the following: the importance of government debt reduction and political stability; finding replacements for the ultra-low returns offered by government bonds without adding too much risk; looking for ways to best position portfolios for either outcome in the bi-modal world we live in (probable recovery, but possible disaster); making the shift to a world no longer dominated by only the developed-world economies; and evaluating a wide range of alternatives investments and ways to lower investment costs for clients.

Each member finds substantial benefit from the idea exchange among the members as well as the guest speakers, and we find that it helps to continually improve our investment process and results for clients. The next meeting will be held in Frankfurt, Germany in March 2013.




Control what you can control and conservatively estimate the rest

Eric Weir, CFA, CFP



Investors face a world full of unknowns which can play havoc with our plans and aspirations. Investment returns are unknown, future trends in inflation are uncertain, correlation among asset classes is a moving target, and the level of market volatility is, well, volatile.

Interestingly enough, the investment industry spends most of its time focused on forecasting the above economic factors, despite substantial evidence that it is almost impossible to do so accurately or consistently.

"Investors are hopeless at forecasting, yet it may be at the heart of their investment process." James Montier, Grantham Mayer Otterloo

Obviously some investments can be forecasted more accurately. A five year bond portfolio is more predictable than a basket of equities, and dividends are more predictable than the associated capital gains. It doesn't mean that investors should not have expectations for their investments. It's just that markets are notably fickle in terms of when and how the returns will be delivered. And if the timing of the returns doesn't match up with the timing of the family's spending needs, there may be a problem.

One of the risk management tools families can use is to find the elements of a wealth plan that are actually *controllable* and manage them well. This is particularly important in the low investment return environment in which we currently find ourselves.

What things can be predicted or controlled?

Taxes – Every dollar saved in taxes goes into the pocket of the investor. In that way it is a 'certain' additional return with no added risk. There are a number of ways to save taxes depending on the family's jurisdiction and tax regime, including income splitting, trust and other tax structuring, deferral of taxable gains, and tax-effective investment products.

Investment costs – Similar to taxes, every dollar saved in costs also goes into the pocket of the investor. It pays to minimize these investment costs wherever it makes sense. Costs can include investment management fees, trading, custodial and advisory costs and transaction fees.

In a low return environment, exercising control of these two factors in particular – taxes and costs – can have a significant impact on the net investment return available to the family.

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Personal expense control – While not always easy, some components of family expenses can in fact be controlled. Some expenses are completely optional and other expenses can be cut back. In some cases, assets (like homes or other personal use assets) that require ongoing spending can be sold.

Personal budgeting - At the very least, future family expenses can be predicted. Having a reasonable idea of what those expenses are likely to be and how much investment return will be required to fund them is one of the most important factors in planning and portfolio management. It allows the investor to target a return (and the attendant risk) that is reasonable and appropriate to meet their needs, and can prevent investors from 'reaching for extra' return at the worst possible time.

"More money has been lost reaching for yield than at the point of a gun."
- Raymond DeVoe, Jr.

Personal decisions - When you think about it, there are actually quite a few other things you can control. You can decide how much longer you will work (and receive income), which can be very significant for large income earners. You can decide when you sell (or don't sell) the family business. You can decide to take money off the table in good times to cover the inevitable bad periods. And you can decide how much future flexibility you want to gain by reducing debt.

Investment strategies - There are also investment decisions you can control that will affect the outcome in your portfolio. You can decide to

buy investments at a discount to their true value to provide you with a certain margin of safety when markets decline. You can decide to reinvest your dividends or allow your interest to compound (i.e. not withdrawing the funds). And you can rebalance your portfolio by buying more of an asset class when it declines. In addition, if you have the financial capacity and ability to withstand volatility, you can buy less-liquid or higher-risk assets that normally have to pay investors a premium to own them.

Investor behavior - 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.

As for the things you can't control, like investments returns, the wise risk management route is to use conservative estimates in your planning models. Positive surprises are rarely a problem, whereas negative surprises can play havoc with family plans.

The investment industry spends a lot of time trying to forecast things that really can't be predicted. For investors looking for a more sensible and predictable financial life, it is wiser to focus on the elements you *can* predict or control, and use conservative estimates for the ones you can't. 🌲

A German perspective on the European Crisis, the ECB, Merkel, and "The Greeks"

Rick Pitcairn, Dr. Fritz Becker and Martin Friedrich – Wigmore Association



The Wigmore Association is a global collaboration of the chief investment officers of six family offices from across North America, Europe, and Australia. In addition to Northwood, other founding members include HQ Trust (Germany), The Myer Family Company (Australia), Pitcairn Family Office (US), Progeny 3 (US), and Sand Aire (UK). The group is focused on the growth and preservation of family capital. It meets semi-annually to exchange views on the outlook for the economy and the market, and to share research and insight on investment strategies and managers. A recent interview with two members, Pitcairn and HQ Trust provides an excellent example of the interaction among group members. The following article was originally printed in Pitcairn's Q2 2012 investor newsletter.

Considering the importance of the European situation, Rick Pitcairn (CIO of Pitcairn) reached out to Dr. Fritz Becker and Martin Friedrich, colleagues from the Wigmore Association, to get their insider perspective. Fritz Becker and Martin Friedrich are both respected investment professionals and economic thinkers at HQ Trust, a Germany-based family office. Becker serves as CEO and Managing Partner of HQ Trust and Friedrich is the firm's Head of Research and Co-CIO.

Rick Pitcairn: What is your overall view of the situation in Europe and how committed is Germany to the monetary union that the Euro represents?

Dr. Fritz Becker and Martin Friedrich: It depends on who you mean by Germany. The government (and politicians more generally), the business elite, or the average "Hans" Six-Pack (you would probably call him Joe) each have a different perspective.

The common people of Germany are disenchanted with the Euro project. Many wish they could have the Deutschmark back. There is widespread resentment towards bailouts because Germans think they would be better off if Germany didn't support "The Greeks" and would rather cut them off from the supply of liquidity. They do not regard such a step as problematic because nobody has told them (yet) how it will affect their lives.

The government is torn between the obvious necessity to engage with its Eurozone partners and lend support to the Euro project and Chancellor Angela Merkel's burning wish to be re-elected in 2013. That is why Merkel has tried to appear tough against the profligate Southern Europeans, a position intended to please and reinforce the views held by Germany's Hans Six-Pack. Merkel's strategy is not working well. In a recent poll commissioned by Bild Zeitung, a popular German paper, only 33% of those asked said that Merkel is making the right choices, while 48% oppose her actions. This relatively recent deterioration of the political atmosphere puts enormous pressure on the coalition.

The business elite, on the other side, understand very well that Germany's position as a leading export nation is at risk if the situation doesn't get resolved. They are putting increasing pressure on the government to take action. This pressure, which Merkel must feel is exacerbated by the recent worsening of German economic data, may be a prerequisite for a solution. This is a relatively recent event, an important "shoe to drop." Already the media is giving a lot of attention to the recent losses at GM's German subsidiary, with the US management clearly contemplating major job cuts. And that is only the beginning.

RP: Many US analysts believe the European Union will survive the crisis only if a better political union is formed to support the monetary union. They think that the major impediment to the formation of that political union is the reticence of German people to support what they feel are structural inefficiencies in peripheral Europe. Do you agree with this view? If not, why not?

FB/MF: We think that view is broadly correct, but somewhat one-sided. Among the candidates lining up for help, some are highly cooperative and have already made significant progress by putting in place the conditions for recovery. Ireland and Portugal are in that bucket. Look at their bond yields if you need any proof. On the other side, Greece has constantly tried to evade tough decisions, ducked out of reforms, and generally been a bad partner, informing those trying to help last minute if something has gone wrong. That has poisoned the atmosphere at the negotiating table. Greece has held on, and probably will, mainly because they pose a credible threat that their exit will trigger widespread contagion and a run on banks elsewhere in Europe, something which EU politicians fear even more than they hate to extend further help to Greece.

Helping Spain and Italy is a whole different ballgame. Without real structural reforms, the solvency of the entire EU-System will be at risk even if Germany opens its checkbook. These countries are simply too big to be saved from the outside. Spain alone might work, but not Italy, and France's public finances are also in bad shape. Here, the German view of the situation is help Italy and Spain (for example with bond purchases) too early and stop the reform momentum because politicians will have no incentive to push through unpopular decisions. Help Italy and Spain too late and the damage to the real economy will be even bigger. You also run the risk of radical political parties ascending to power, creating a bigger problem.

Yes, the Germans have misguided perceptions of who is to blame, but there is also a resistance to real or perceived loss of sovereignty on behalf of Southern Europeans that holds us back from making faster progress.

Start with your family's goals....But what are they?

Scott Hayman, CA, CFP, TEP

So how do you determine what the goals of your family are? Many families have trouble articulating or narrowing down their goals. They may not know what they want and certainly feel unprepared to set a specific number to the goal. The first step in goal setting is reminding yourself of what is most important to you, this can be drawn out by asking yourself and your family questions such as the following:

- What defines you as a family?
- What are your biggest concerns?
- What are the best things you have done for yourself and your family in the last 12 months? How would like to be able to answer that question one year from now?
- What are your wishes for your children?
- What have you not done in your life yet that you would still like to accomplish?
- How do you want to be remembered?
- If money were no object, what would you do for the rest of your life?

RP: Do the German people support the leadership of Mario Draghi at the ECB?

FB/MF: It's unclear how much it matters, because Germany doesn't have a majority in the governing council. Draghi does face opposition from the senior ranks of the Bundesbank (Germany's version of the Federal Reserve). The Bundesbank is very wedded to somewhat old theories and has consistently blocked progress. Hans Six-Pack doesn't understand the ECB, but he has an almost genetic fear of inflation ingrained into his psyche. If asked, he will probably side with the Bundesbank. There is a saying in Germany, "Not all Germans believe in God, but they all believe in the Bundesbank."

RP: With the crisis as a backdrop, what do you feel are the prospects for the Merkel government? What are the major issues on which she finds support and on which she is politically attacked within Germany?

FB/MF: We believe that so far the German public has sided with the government on many issues. The longer the crisis drags on, the more doubts arise in people's minds. Maybe the famous "last shoe" will be a further drop in the German business climate, combined with a rise in unemployment (not yet observed). If there is a sharp deterioration in the economy into an election year, it will not bode well for re-election – sound familiar?

RP: What is your assessment of the chance that during the next 6 to 12 months the current European crisis leads us into a major financial dislocation à la 2008 that stresses global financial markets and causes widespread panic?

FB/MF: It is one of several scenarios and it cannot be ruled out. However, there are several important differences to 2008 that should be pointed out. Most financial market participants were not prepared for Lehman filing for Chapter 11. Today, corporations, politicians, and investors are much better prepared for a crisis with balance sheets and portfolios flush with cash and short risk. After what we lived through in 2008 and early 2009, the appetite on the side of the authorities for a major debacle must be very low. So the question is only when, not if, the ECB will step in and print money to calm down markets.



It can also be helpful to have the broader family involved at this stage of the discussion (even if the whole group might not yet be involved in the investment and financial details). Goals can vary dramatically between different generations and family groupings and it useful to understand the range of issues.

One particular family had a dilemma common to many multi-generational financial families. The 60 year old parent (himself an inheritor of substantial multi-generational funds) was spending at a rapid clip on an expensive lifestyle and hobbies. His adult children were concerned that there would be no money left for them and their families. Not surprisingly, it also led to debates on the preference for income or growth in the investment portfolio.

It is particularly important for the patriarch or matriarch to allow the other members of the family to express their views so they will feel involved and engaged in the whole process. It is also beneficial to allow some time for reflection or 'soak time' after an important future-oriented conversation like this.

Here are some examples of family goals that might come out of a family discussion:

High Level

- Maintain family unity
- Continue our legacy of philanthropic activity
- Encourage an entrepreneurial spirit in the family
- Develop a sense of personal responsibility and independence among family members
- Keep things simple
- Be remembered in the community as a hard-working, fair-minded and generous family
- Secure the future health, education and financial welfare of all members of the family

More Specific

- Ensure that the cottage stays in the family for as long as possible
- Give the bulk of our charitable gifts during our lifetime (vs. after we die) so we will be able to see the results of our philanthropy
- Ensure that our children have strong financial literacy skills and are prepared to receive their inheritance when the time comes
- Climb Mount Kilimanjaro with the whole family

Financial

- Maintain our current standard of living (annual lifestyle spending of \$1 million) throughout our lifetime
- Donate \$1 million per year from the company to charitable causes
- Retain \$20 million in liquidity over the next several years to fund the purchase of a business acquisition
- Fund all education expenses for as many future generations of family members as possible
- Leave \$10 million to each of our four children on our death

A family office or good holistic advisor can be very helpful in drawing out the family goals and articulating them. Once determined, it is important to write them down. Seeing them in black and white on a list can help you assess whether they are something you really want to achieve or simply a passing idea.

Family goals can also change over time. They often shift with changes in family circumstances, family leadership and personal preferences, as well as changes in the external environment. Despite that, it is helpful to start with a snapshot of the family's goals as you see them today, at least as a starting point for discussion. 🌲

IRS offers amnesty to non-resident US taxpayers

Barrett Lyons, CA, CFP



Since our Q&A with Carol Fitzsimmons on US citizens living abroad in our Summer 2012 newsletter (*Issues Facing US Citizens Resident in Canada*), the IRS announced a new streamlined filing compliance process for non-resident, non-filing US taxpayers. The new process is applicable for "low risk" US taxpayers living abroad who have not filed income tax returns or Foreign Bank and Financial Accounts (FBAR) reporting who are seeking to become compliant.

Practically speaking, the process has been designed for the average, law-abiding US citizens abroad that recently became aware of their obligations due to the FATCA rules (and media attention) and would have filed their US tax reporting if they had known of the requirement. This new process allows these individuals to become compliant without being subject to significant penalties and interest, which they otherwise would be. This program offers no help to those with significant unreported tax liabilities.

Submission Process

Submissions will include overdue filings and answers to a standardized questionnaire. Based on the information included in the returns filed and questionnaire responses, the IRS will assign a compliance risk determination.

Low risk submissions will be processed as part of the new streamlined procedure and expedited. High risk submissions will not be eligible for the streamlined process and may be subject to a full audit. Factors that will be considered for evaluating the compliance risk will include the following:

- Complexity of returns
- Amount of tax due (only returns with less than \$1,500 annually are eligible for the new streamlined process)
- Evidence of sophisticated tax planning
- Income and asset level of taxpayer (higher levels will increase risk)
- History of noncompliance

Taxpayers that are administered through the streamlined process will be required to remit taxes due plus interest but will not be subject to penalties or follow-up actions.

This program will run alongside the Offshore Voluntary Disclosure Program (OVDP). Taxpayers will be able to choose either program but are not eligible for both. The OVDP will continue to be the only option for some leniency for taxpayers with significant unreported income tax liabilities or unreported foreign accounts. 🌲



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

Main: (416) 502-1245

www.northwoodfamilyoffice.com

Email: tmccullough@northwoodfamilyoffice.com

shayman@northwoodfamilyoffice.com

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