



2014 Private Wealth Outlook  
Championing growth  
Redefining the roles and responsibilities  
of the evolving family office

# Contents

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|  |   |
|--|---|
| Foreword   | 1 |
| Setting the stage                                | 2 |
| To the next generation...and beyond              | 3 |
| A more institutional approach to risk management | 4 |
| Increasing demands on the finance function       | 6 |
| Technology dreams – and nightmares               | 7 |
| Shaping the future of the family office          | 8 |
| Contacts   |   |

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# Foreword

## Dear colleagues:

"It was the best of times; it was the worst of time..." So begins Charles Dickens' *A Tale of Two Cities*. In many ways, this describes the environment that the financial services industry is facing as we start 2014. The economy is showing some signs of life, balance sheets are stabilizing, and investors' confidence is trending toward the positive. That said, the coming year likely will be one of continued challenges for industry executives to realign business models, adjust to increasing regulation, and attempt to innovate for growth.

The investment management industry certainly is seeking to balance opportunity and challenge. Many parts of the business have seen growth in assets under management and profitability. We also note a renewed investor tolerance for risk return, and firms are responding in a

number of ways, including the launch of new products and by exploring global expansion. At the same time, these new forays are confronting industry participants with a more complex array of risks and they will need to account for these growth-related risks as they stay on the right side of regulators who are enforcing rules with renewed vigor. Nevertheless, many investment managers are poised to take advantage of increased opportunities for growth in the coming year.

We are pleased to share with you this outlook for 2014, based on original research combined with the insights and first-hand experience of many of Deloitte's leading investment management practitioners. We hope you find this report insightful and informative as you consider your strategic decisions in the upcoming year.

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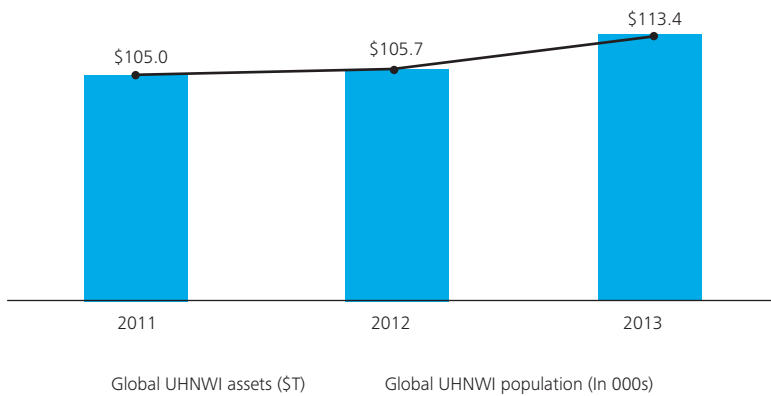
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# Setting the stage

In 2014 the private wealth industry is expected to be as competitive as ever. While worldwide wealth is growing (see Figure 1), there is an increasing number of institutions competing for the assets of the relatively few, very wealthy families.

**Figure 1. Global ultra high-net-worth individuals (UHNWI) assets (\$T) and population (000s)\***



\*UHNWI Includes Individuals with household assets of more than \$50 million

Source: "World Ultra Wealth Report 2012 and 2013," Wealth X and UBS

The private wealth industry does not have one universally accepted definition. Broadly, it refers to the multitude of entities and institutions that serve the financial needs of high-net-worth individuals and families. Key players in this marketplace include private banks, private client groups, trust departments, and the wealth management arms of banks and broker-dealers. Although the heritage of these

institutions varies widely, they have evolved to the point that their private wealth offerings, at a high level, look remarkably similar. Each organization offers a variety of advisory services as well as financial products to address the objectives of their clients. For this 2014 outlook, the focus is on a distinctive arm of the industry, the single-family office (FO), whose major defining characteristic is that all of its "clients" are members of the same family. There are many types of FOs; some offer full-service operations that include investment management, legal, accounting, and tax advice while others provide only administration and oversight – and many combinations in between. The distinct character of the customer base among wealth management firms means that while the primary function of the FO is to manage wealth, it tends to become very involved in the life of the family. This includes providing support in many nonfinancial areas, extending in some instances to intergenerational education and advice. Often, a single individual has created the wealth through a business and created the FO to manage that wealth. As the family evolves, the goals and dynamics of the FO can change quite dramatically in response. Balancing the diverse needs and desires of various family members, a challenge in any family, can be made significantly more challenging by the large amounts of wealth involved.

While competition remains intense for the business of ultra-high-net-worth families, the FO model remains a very attractive option to wealthy families. The advantages of the structure, including direct oversight, customization of services, and privacy, cannot be matched by any other entity. However, many large financial service institutions are devoting significant resources to serving ultra-high-net-worth families, making the space very competitive. This will drive FOs to carefully evaluate when and how to partner with these institutions and when to go it alone.

## *To the next generation...and beyond*

Succession planning is an ongoing concern for many FOs, businesses whose fate is often tied to the founders, many of whom belong to the baby boomer generation and are now reaching retirement age. Like any family-owned business, an FO requires a succession plan that addresses the longer-term continuity of the enterprise.

One key aspect of the plan is for the FO to clearly articulate its goals and how it will balance the various interests among family members and related entities. Having a clear vision of purpose is likely to ease the transition from the founder to the next generation and some FOs have even developed formal “mission statements” to serve this purpose. Considerations extend beyond financial, economic, and tax decisions, and include strategies to help family members understand the family’s values and long-term goals. Many founders of FOs have built their wealth from virtually nothing and often have a strong desire to see it perpetuated for many generations, both in the family and through charitable causes. Their children and grandchildren, having grown up in a completely different environment, may not share or even understand these goals. Sometimes, when goals cannot be aligned and a common mission defined, FOs “spin out” part of the family wealth to a new FO entity. This can occur for interpersonal issues, differing goals, or other reasons; but this decision must be undertaken with care.

### **What's new for 2014**

An interesting trend is the increase in socially responsible investing and charitable advocacy. Socially responsible investing can take many forms, from avoiding investing in companies whose businesses or policies the family does not condone, to investing proactively in causes the family might support. While this can be an attractive proposition, the FO needs to carefully balance the desire of the family to support a cause with the FO’s fiduciary responsibility to focus primarily on investment return. At the same time, the FO can be instrumental in encouraging family members to take a more involved and direct involvement with the charities they do support. Rather than simply donating funds, an FO might become more actively involved in the management of the charitable organization, providing input to the direction of the charity.

Another key trend is the increasing globalization of both families and their wealth. This is occurring on several fronts as more wealth is being created abroad, which in turn is leading to more FOs abroad. Newer emerging markets in parts of Asia and Latin America are key drivers of this trend. A portion of this foreign wealth is being “on-shored” to the United States as families are attracted to its relative stability and security. Also, like many financial institutions, families centered in the USA continue to look abroad for better investment returns and diversification. The growing globalization of wealth is also driving international tax complexity, affecting both income tax and estate planning. There is a global trend toward tax transparency, further increasing the tax compliance requirements of the FO. An example of such tax compliance regulations is the Foreign Account Tax Compliance Act (FATCA) and its counterparts enacted by foreign governments.

While wealthy families are not moving completely away from traditional investment products, in 2014 more of them are likely to show an increased interest in investing directly into operating companies. This evolving investment approach continues to blur the line between FOs, private equity firms, and venture capital firms. Interestingly, some FOs have hired experienced private equity professionals to help manage their alternative investments, which can result in FOs competing with investment managers on some deals and partnering with them on others. It has also contributed to a very competitive market on private equity deals and finding attractive return-on-investments may be a challenge in 2014. In the end, it may not be the deals an FO enters into, but the ones they avoid overpaying for that separate them from the pack. When directly investing, FOs are not always going it alone, but at times are pooling capital with other FOs in order to participate in larger deals, an arrangement sometimes facilitated by industry vendors.

### **The bottom line**

As more founders of FOs near retirement age, intergenerational issues, always a priority, are becoming even more important. Signs of a stirring economy are encouraging the less risk-averse families to explore new investment approaches. However, there seems to be a lot of money chasing a few good deals and the risks can compound quickly. FOs will likely continue to tread cautiously and carefully evaluate their investment options to see if the risk-reward ratio makes sense.

## A more institutional approach to risk management

With the responsibility to prudently manage the family's wealth, governance has always had a preeminent position at FOs. As client interest grows in new product types and geographies, client reporting demands increase. Therefore, FOs are taking a more structured and formal approach to risk, compliance, and reporting and are looking to regulated financial service institutions as a model.

Many FOs are enhancing how roles and responsibilities are defined, documented, and monitored to address some of the key risks they may face (see Figure 2).

Overall, the cost of compliance and client reporting is continuing to increase, and it does not look like it will lessen any time soon. FOs occupy an interesting space in the wealth management industry. They manage tremendous wealth and deploy significant capital into the financial markets but their needs are not always considered when new rules are being contemplated by Congress or regulatory bodies. As a result, they must be highly vigilant about regulatory changes that might adversely impact them. They may well, as they did when the Dodd-Frank proposal was issued, continue to partner with other FOs to advocate for their perspective when regulations are

Figure 2. Examples of how FOs address risks they may face

### Common risks facing family offices



#### Financial

- Improper trade authorization
- Deviation from investment policy



#### Technology

- Cybersecurity
- Data confidentiality/privacy
- Business continuity



#### Employment

- Payroll fraud
- Internal data theft

### Controls and risk mitigators



#### Authorization/limits/access

- Dual signatures for transactions
- Stringent assignment of access



#### Bookkeeping/reconciliations

- Strong internal audit function
- Robust exception-processing procedures



#### IT controls

- Stringent remove-access policy
- Comprehensive data encryption
- Enforcement of password policies



#### Segregation of duties

- Up-to-date segregation policies with periodic spot checks

Source: Deloitte Center for Financial Services

being developed. A case in point is the need for FOs to continually evaluate whether or not the family-office exemption from registering as an investment adviser still applies. With a continued push for tighter financial regulation and services that cross asset management, insurance, and banking, FOs will need to keep a very close eye for any pending or proposed regulations. Spotting potential trouble areas early will likely give them the best opportunity to make a case when they believe that FOs should fall outside of proposed regulations.

#### **What's new for 2014**

As a broader set of investments is utilized by more FOs and the investments become more geographically dispersed, diligence and monitoring of the investments has become more challenging. Families often have competing interests and desires regarding how to invest, spend, and donate the family wealth. Advances in technology can make monitoring easier, but can also place stress on FO resources and underlying infrastructure. To battle this trend, many FOs have adopted some of the leading policies, procedures, and controls of regulated wealth managers. In a sense, they are shifting toward a more institutional approach to running their businesses. Also, although FOs are not regulated by the SEC, many are paying very close attention to SEC priorities that might

impact them. For example, David Blass, chief counsel of the SEC's division of trading and markets gave a speech to the American Bar Association in April 2013 in which he discussed various activities of private funds that might require registration as a broker-dealer. He noted that the SEC staff will be giving increased attention to this issue. One example of potential brokerage activity is when private funds pay transaction-based compensation on deals in which they are involved. As FOs participate in more direct investments, the issue of whether or not private funds need to register as a broker-dealer is likely to be closely watched by FOs.

#### **The bottom line**

In general, FOs understand that they cannot mitigate every risk at once, and that a systematic approach to risk management can be very effective. This process usually involves several steps, including evaluating internal and external risk factors, prioritizing the highest risks, and remediating the highest priorities first. This emphasis on risk management involves significant investment, but most FOs believe that the investment is necessary to serve the needs of the family and protect both the family's wealth and reputation.

## *Increasing demands on the finance function*

The role of the chief financial officer (CFO) can vary widely at FOs based on the priorities of the family and the individual in the role. Some CFOs are more investment-oriented while others are more tax-centric, and still others may be more operationally focused. However, no matter what their focus, all of them bear significant responsibility in seeing that the wealth of the family is managed prudently and that family goals are being met.

If the role of the FO is to help ensure that family assets pass along to future generations or charitable organizations, then the investment and tax strategies must be tied back to the planned use of the assets. If they are not connected, then the risk exists that the assets will be insufficient to fund what was planned. While this fact may seem obvious to many, it should not be assumed that all family members understand it. There is an ever-present need to confirm that individual family members understand the correlation between the assets they have, the projected growth of those assets, and the impact spending habits have on the growth. This effort takes coordination between the investment, operations, and client service teams with finance playing a key role by generating information such as financial statements, cash flow, and spending reports.

### **What's new for 2014**

The importance of due diligence regarding FO investments seems to grow every year. This area is becoming more and more complex as investments are more international and more diverse. Due diligence now goes far beyond the standard analysis of financial statements and capital structure, with an increasing emphasis on knowing the

parties on the other end of the transaction. As noted above, FOs are partially addressing this issue by hiring experienced talent from wealth management firms.

As services continue to be unbundled and costs become transparent, the most appropriate way to share these costs across various entities and generations is an area of debate. Although the clients of an FO may all belong to the same family, their assets are held in a variety of investment structures and legal entities. The family members represent a variety of age groups and their requirements and priorities can vary widely. This can result in some family members using far more services at the FO than others. This divergence in services makes deciding how fees should be charged to various members and entities a difficult decision. While no fee model is perfect, FOs will likely continue to move away from transaction fees, exploring models such as flat fees, retainer fees, and fees based on net worth, rather than assets under management.

### **The bottom line**

As the lives of wealthy families become more international, their investment choices broader and generational needs more diverse, the role of the CFO in FOs is evolving to meet new demands for transparency and reporting. Key aspects of the role include determining that due diligence will keep pace with investment options, and that reporting and disclosure of performance and fees meet the needs of the family.



## *Technology dreams – and nightmares*

Technology adoption at FOs continues to grow with an emphasis on investment performance and tax reporting. However, while great advances have been made in recent years, there is still a strong desire for robust functionality to provide even more timely and accurate reporting. Concurrent with the increased adoption, technology risk has also risen and many FOs are investing substantial time to make sure that they carefully manage their technology risks.

Evolving financial products and investment structures are making client and tax reporting more challenging than ever. The desire to keep reporting timely and accurate is driving a trend for more automated workflows. Historically, reporting has included several manual steps, which can add to expense, slow the overall process, and lead to data entry errors. FOs are looking to automatically push data from record-keeping systems to reporting systems that move from initial data entry all the way through to the client's final tax return. While this may sound straightforward, when combining the diversity of investments with the various entities holding the investments, it can place a heavy burden on an FO's infrastructure. To be done correctly, an upfront effort must be made to validate the data structure and data validation process. Another trend is the effort to digitize paper records, particularly those pertaining to cost-basis reporting. Having these records in electronic form will make them searchable and accessible, which should make future income- and estate-tax reporting a more efficient task.

### **What's new for 2014**

The adoption of mobile applications, particularly tablet-based, is likely to rise due to the widespread popularity of these devices. The most common use of tablets is expected to be monitoring investments and performance reporting. These tools can be used to facilitate virtual client meetings as well as to enhance in-person meetings. Presenting a family member's quarterly review on an interactive screen, rather than presenting a review on paper, can be a much more engaging way to interact.

While technology brings many advantages to FOs, it also brings challenges and chief among them are business

continuity and cybersecurity. FOs are aware they have a fiduciary responsibility to their family-member clients, and this includes being able to operate even in the face of a natural disaster, a widespread blackout, or a terrorist attack. The Internet and cloud-based systems that allow employees to work from almost anywhere have been a boon to business continuity and help mitigate the need for extensive backup sites. However, the greater reliance on technology can bring a greater exposure to cyber-attacks. There appears to be a wide range of cyber-preparedness among FOs. Some FOs have internal institutional-level plans and infrastructure while others rely more heavily on service providers. There is not a single "right" answer to solving this challenge; each FO should assess its systems as well as the systems of its key vendors to determine the greatest vulnerabilities. Attacks can come in many guises, from distributed denial-of-service attacks to phishing and social engineering. One form of risk that is gaining more attention is the threat of the FO's employees who have access to internal systems and data. It seems that the most prudent approach in this case is to follow the advice of the Russian proverb "doveryai, no proveryai," translated "trust but verify," which was popularized by President Ronald Reagan. While a robust cybersecurity program can absorb significant resources, in the long run, it may be a relatively inexpensive investment relative to the economic, reputational, and personal safety issues that a breach can cause.

### **The bottom line**

Technology remains in an evolutionary state at most FOs. Many are becoming more and more reliant on technology, which has helped tremendously in areas such as tax and client reporting. However, some FOs continue to face the challenge of supporting many independent systems. In some sense, as FOs catch up with larger institutions in technological capabilities, they are facing larger technological challenges. To respond to these challenges, FOs should consider adopting institutional-level programs around business continuity planning and, in particular, cybersecurity.

# Shaping the future of the family office

The private wealth space is poised for a very active year in 2014, with key issues in nearly every aspect of the business (see Figure 3).

Many ultra-high-net-worth families are broadening their investment portfolios in search of the right mix of risk and return for their portfolios. They are entering new geographies and participating in more direct investments. These investments, when combined with additional tax and client reporting demands, are placing a due diligence and operational burden and reporting on FOs. In response,

some FOs are continuing to look to regulated wealth managers as a model and evolving to a more institutional structure that includes a renewed focus on procedures and controls. To implement these efforts, many FOs are seeking experienced wealth management talent and continuing to invest in technology. The increasing use of technology calls for robust business continuity planning and preparation for cyber-attacks. Despite the competitive and cost pressures, the FO remains a structure with distinct advantages that is likely to remain very popular for wealthy families for the foreseeable future.

**Figure 3: Six trends in the private wealth industry in 2014**



Source: Deloitte Center for Financial Services

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