

How can you build a future that will last for generations?

Create a family office to
nurture the family legacy.
Americas



The better the question.
The better the answer.
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Building a better
working world



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Introduction

Today, private family capital is larger than private equity and venture capital combined. The increasing concentration of wealth held by very wealthy families and rising globalization are fueling the growth of family offices. There are at least 10,000 single family offices around the world – most of which were set up in the last 15 years.

Family offices are complex organizations that require deep knowledge – not just of investment variables, but also a host of other factors. This guide is a detailed handbook for those planning to set up a family office and also for those looking to set benchmarks of leading practice within their existing family office.

This guide covers:

- ▶ What a family office is
- ▶ Why to set up a family office
- ▶ Services a family office should offer
- ▶ How to create a business plan and strategy
- ▶ Investment process
- ▶ Reporting and technology concerns
- ▶ Philanthropy
- ▶ Family office cost
- ▶ Important governance considerations
- ▶ Risk management





What is a family office?

The modern concept of the family office developed in the 19th century when the family of financier and art collector J. P. Morgan founded the House of Morgan to manage the family assets. While each family office is unique, in general, today's family office is a family-owned organization that manages private wealth and other family affairs.

Types of family offices

Over the years, various types of family offices have emerged. Which one you choose is dependent on the family structure, size and complexity of investments, and holdings.

Single family office (SFO)

- ▶ Distinct legal entity serving one family
- ▶ Family owns and controls the office
- ▶ Manages assets completely separated from family and family enterprise
- ▶ Provides dedicated services tailored to the needs of the family members
- ▶ Accommodates initial family growth, complexity
- ▶ Typically manages investments, tax reporting and planning, fiduciary trusts and estate management, and risk management for the family
- ▶ Many have legal and concierge functions
- ▶ Professionalizes private wealth and asset management

Multifamily office (MFO)

- ▶ Distinct legal entity serving multiple families that pool their wealth
- ▶ Mostly commercial, selling services to other families
- ▶ Addresses the high operating costs of a family office through economies of scale
- ▶ Often directed by the "lead" family that initiated the office
- ▶ All assets managed under one umbrella
- ▶ Often evolve from a successful SFO, prompted by other families pushing for access
- ▶ May manage the fiduciary, trusts and estate business of multiple families as well as their investments
- ▶ Some provide concierge services
- ▶ Caters to a range of family size, wealth and maturity levels

Embedded family office (EFO)

- ▶ Usually an informal structure within a business owned by an individual or family
- ▶ Family can allocate management to trusted and loyal employees of the family business (usually the CFO and staff)
- ▶ Linked to the family business
- ▶ Low level of separation between the family and its assets



01

Why set up a family office?

As concerns about wealth preservation and succession planning within family businesses continue to rise, families are increasingly evaluating the benefits of setting up a family office.

A family office supports the family vision and legacy, ownership transitions, leadership transitions and successful wealth transitions.

Benefits of a family office

Privacy and confidentiality

Privacy and the highest possible confidentiality are the most important parts of managing the family assets for many families. The family office is the sole entity that keeps all the information for all family members, covering the entire portfolio of assets, activities, tax and general personal information.

Governance and management structure

Governance and management structures transparently handle the complexities of family, ownership and investments, helping the family to avoid future conflicts.

Alignment of interests

Alignment of interests between the business, advisors and the family is important to avoid conflict. This can be difficult in a non-family office structure, where multiple advisors work with multiple family members.

Figure 01: Evolution of a family office



**Private trust companies help a family govern, manage and administer the trusts of the family.*

Potential higher returns

Centralizing and professionalizing asset management activities can result in higher returns or lower risk from investment decisions. Formalizing the investment process also enhances returns for all family members.

Separation of family enterprise and family assets

A separation, or at least distinction, between the family enterprise and the family's assets or other holdings provides privacy and focus, and decreases distraction. Some specific, strategically chosen people focus on the business and others focus on the family and nonbusiness assets.

Risk management

Operational consolidation of risk management and performance reporting enables advisors and principals to make decisions that are more directly aligned with the family's objectives.

Centralization of other services

Coordinated professional services, including philanthropy, tax and estate planning, family governance, communications and education, can better meet the family's mission and goals.

Focal point for the family

Aligning the family members is easier when there is a focal point managing, for example, the philanthropic activities or jointly held assets of the family.

Concerns of setting up a family office

Establishing a family office is a big undertaking, and there have been cases when family offices have not met the family's expectations. Some of the potential concerns are:

High cost

The cost of initial setup and ongoing maintenance is high, as is complying with investment and tax regulations and other compliance reporting. This means that the level of assets a family office needs to oversee must offset its fixed costs.

Since the services of a family office are costly, the amount of family wealth under management is generally at least US\$250m, depending on jurisdiction and location, though this varies widely. It's more effective to calculate the minimum wealth under management by considering return expectations and targets and the resulting costs of the family office. See Section 07 for more information.

Lack of market, legal and tax infrastructure

Family offices work better in geographies with sophisticated markets and legal and tax structures. In emerging markets, the lack of these structures has undermined the development of family offices.

Preference for privacy

Some families are hesitant to consolidate their wealth information through a centralized family office structure.

Lack of trust in external managers

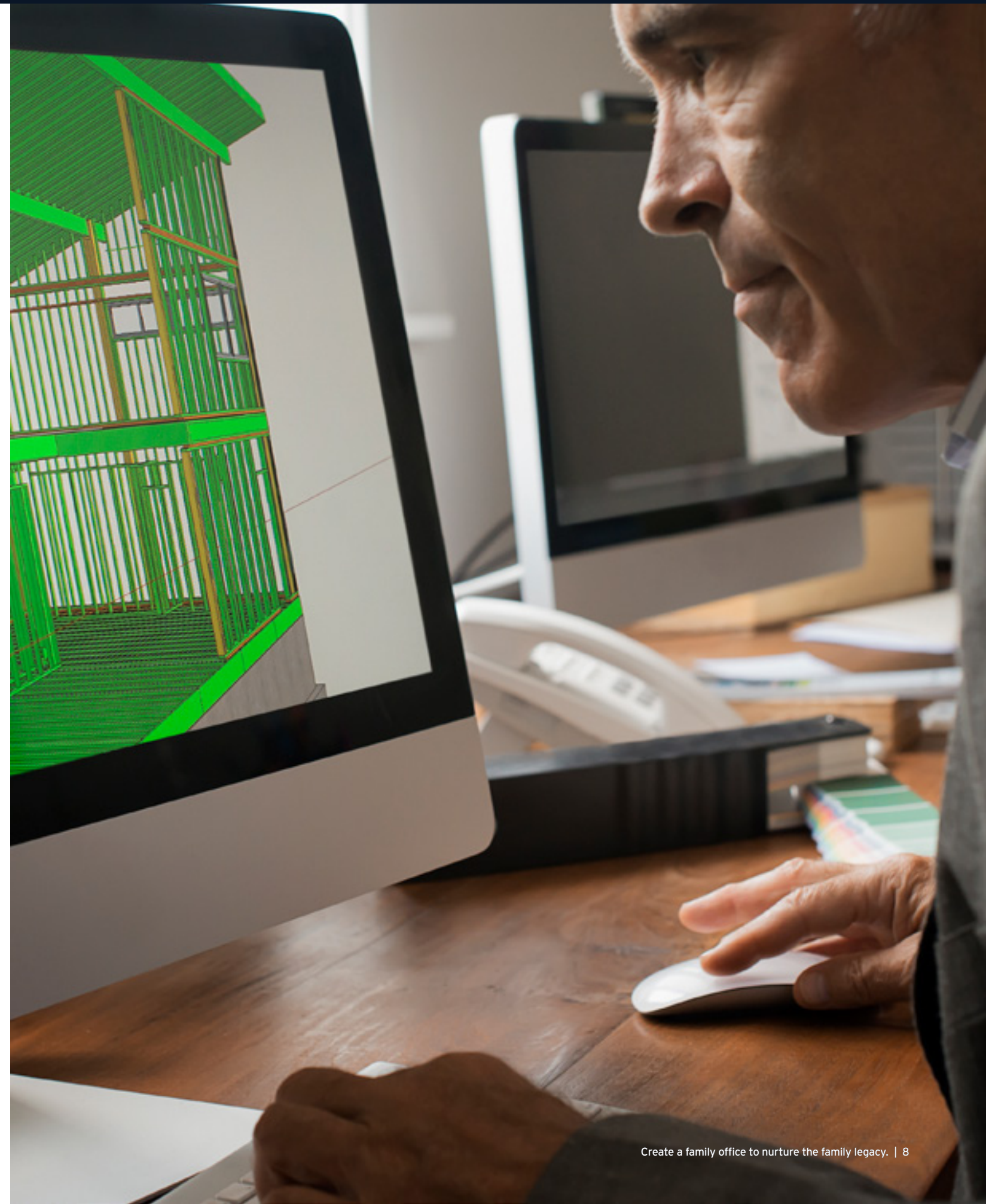
Success of a family office is contingent on the level of trust and comfort families have with external asset managers. However, trust typically stems from long-standing relationships, something that only comes over time.

Expectations for returns

Ultimately, long-lived family offices preserve and grow wealth. In recent years, securing market returns has been more difficult and has led to some tension.

Different generations' goals and objectives

During generational transitions, family office structures are tested as the next generation has different goals and objectives in managing the family's wealth.



02

What should your family office do?

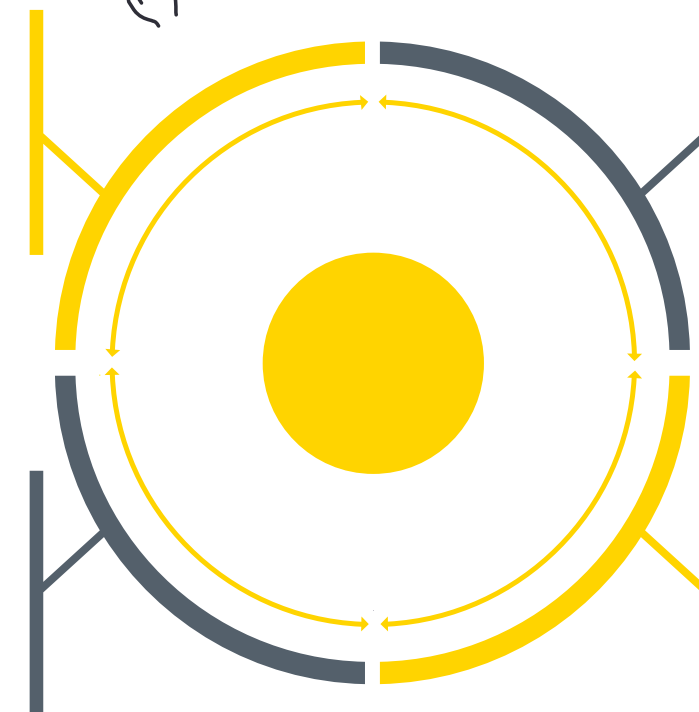
Each family is unique, so the services each family office provides should be uniquely designed to serve the family's needs.

A fully developed family office can provide any number of services, including financial planning, advising, governance and strategy. Before creating a family office business plan (see Section 03), the family must determine the expectations, priorities and scope for the family office.

Use these questions to help prioritize:

- ▶ What services should the family office offer?
- ▶ Who should be the beneficiaries of the family office?
- ▶ What is the family's strategy to secure and expand its wealth over generations?
- ▶ Is the family's priority passive asset management of liquid funds or will it include a portfolio of direct, private equity or venture capital investments?
- ▶ Where does philanthropy fit into the mix, if at all?
- ▶ Should the family office act as the asset manager or should it just be an advisor of specified services to family members?

Figure 02: Family office services



The lists that follow, while not comprehensive, detail a wide array of services that family offices can provide in financial planning, strategy, governance and advisory services. This can help inform decision-making as family office priorities are chosen.

Financial planning

Investments

Investment management services are central to preserving family wealth. Family offices can:

- ▶ Evaluate the overall financial situation
- ▶ Determine investment objectives and philosophy
- ▶ Determine risk profiles and investment horizons
- ▶ Allocate assets (determine mix between public and private investments and allocations within those sectors)
- ▶ Support strategic banking and other investment advisor relationships
- ▶ Manage liquidity for the family
- ▶ Provide due diligence on investments and external investment managers

Philanthropy

Managing philanthropic efforts and community engagement is an increasingly important function of a family office:

- ▶ Establishing and managing appropriate structures (e.g., foundation, donor-advised fund, advocacy-focused entities or other structures)
- ▶ Planning, strategy and advice
- ▶ Developing environmental, social and governance programs for philanthropy and investment
- ▶ Assisting with establishment and administration of charitable giving, including vetting appropriate institutions
- ▶ Offering guidance for planning a charitable funding strategy
- ▶ Advising on technical and operational management of charitable activities, including compliance, reporting and regulatory matters
- ▶ Forming funding and grant-making entities (including foundations and trusts)
- ▶ Organizing charitable activities and related due diligence

Life and budget

Life management and budget services can include concierge services but are broader in scope:

- ▶ Managing budgets, paying bills and processing payroll
- ▶ Reviewing and analyzing wealth, short- and medium-term liquidity requirements, and long-term objectives
- ▶ Managing residential and holiday properties, private jets and yachts
- ▶ Managing household and other support staff, including personal security

Strategy

Business and financial advice

Family offices can provide advice on strategic financing and business opportunities, including:

- ▶ Debt syndication
- ▶ Promoter financing
- ▶ Bridge financing
- ▶ Structured financing
- ▶ Club deals
- ▶ Private equity
- ▶ Mergers and acquisitions
- ▶ Management buy-outs
- ▶ Business development

Estate and wealth transfer

Succession and legacy planning are among the most important functions of a family office:

- ▶ Performing wealth protection, transfer analysis and planning for all types of assets and income sources
- ▶ Monitoring and updating estate and inheritance plans to confirm they are coordinated and operated correctly
- ▶ Carrying out customized services for estate settlement and administration
- ▶ Offering professional guidance on family governance
- ▶ Giving professional guidance on wealth transfer to succeeding generations

Training and education

Family offices can play an important part in preparing the next generation of the family in wealth management, financial literacy, family legacy and values, and wider economic matters:

- ▶ Organizing family meetings
- ▶ Developing family education plans and verifying family education commitments are maintained and met
- ▶ Coordinating generational education with outside advisors and programs

Governance

Reporting and record-keeping

Maintaining records and confirming there is a strong reporting culture are often parts of a family office's services:

- ▶ Comprehensive consolidating and reporting of all family assets from multiple perspectives (e.g., investment performance, tax reporting, partnership reporting and fiduciary accounting)
- ▶ Consolidating performance reporting for investments
- ▶ Performing benchmark analyses
- ▶ Maintaining and evolving the reporting system
- ▶ Preparing and reporting taxes
- ▶ Administrative services
- ▶ Providing support on legal matters and/or references for support, and managing law firms
- ▶ Paying invoices and taxes and coordinating tax compliance
- ▶ Paying bills and reviewing expenses for authorization
- ▶ Opening and maintaining the appropriate bank accounts and cash management structures
- ▶ Reconciling bank statements
- ▶ Managing employees and benefits
- ▶ Providing public relations referrals and managing public relations firms
- ▶ Providing technology systems and cybersecurity referrals and managing vendors
- ▶ Managing compliance and controls

Succession planning

Securing a smooth succession and planning for future generations are some of the most important duties of a family office:

- ▶ Performing continuity planning to prepare in case of unanticipated disruptions in family leadership
- ▶ Evaluating senior executives both inside and outside the family
- ▶ Periodically evaluating board roles of family and non-family directors
- ▶ Structuring corporate social responsibility platforms and programs
- ▶ Developing formal knowledge-sharing and training programs
- ▶ Implementing intergenerational estate transfer plans
- ▶ Adopting a family governance system, such as a charter or constitution, specifically aiming to:
 1. Formalize the agreed structure and mission of the family, family investments and family business
 2. Define roles and responsibilities of family and non-family members
 3. Develop policies and procedures in line with family values and goals
 4. Determine processes to resolve critical business-related family disputes



Advisory

Tax and legal advice

Managing tax and legal matters has become an increasingly important function of family offices in recent years. A family office will typically employ a general counsel, a chartered or certified accountant or several accountants, and tax professionals who are responsible for:

- ▶ Constructing and regularly evolving a tax plan that best suits the family
- ▶ Constructing and regularly evolving a legal and regulatory compliance plan that best suits the family
- ▶ Designing investment and estate planning strategies that manage investment and non-investment income sources and their tax implications
- ▶ Confirming all parts of the family office and family comply with the legal and tax plans of the family

Compliance and regulations

Family offices need to verify strict compliance with regulations on investments, data privacy and general operations related to where the family office is located and where the family office invests or does business. The family office is often responsible for:

- ▶ Establishing a corporate governance mechanism
- ▶ Supporting compliance with an internal auditing service
- ▶ Engaging a human resources function to hire, evaluate and maintain staff
- ▶ Group performance monitoring and compliance
- ▶ Offering recommendations on independent and board advisory formation
- ▶ Strengthening the regulatory investment process to comply with federal, state and local laws

Risk management and insurance services

This is a critical service, especially during financial crises, natural disasters and other major disruptions. The family office role is:

- ▶ Analyzing, measuring and reporting on risk
- ▶ Assessing insurance requirements, policy acquisition and monitoring
- ▶ Evaluating existing policies and titling of assets
- ▶ Evaluating security options for clients and property
- ▶ Formulating disaster recovery options and plans
- ▶ Protecting assets, including financial data, which could involve offshore accounts
- ▶ Developing strategies to confirm hedging of concentrated investment positions
- ▶ Managing the physical security of the family
- ▶ Managing data security and confidentiality
- ▶ Overseeing cybersecurity of the physical office, households, family members and other assets (e.g., motor vehicles, planes, yachts)
- ▶ Reviewing social media and general public relations policy and developing a reputation management strategy
- ▶ Coordinating personal and asset security



In-house or outsource?

Even the largest family office will need to assess whether and what to outsource. Outsourcing can provide great benefits in cost efficiency and access to know-how. But some services should be kept in-house for confidentiality and family office independence. It's critical to strike the right balance between in-house and outsourced services. The family office goal should be providing the most effective services in the most efficient way while avoiding and mitigating operational risks.

Making the decision between in-house and outsourcing depends on the unique circumstances of the family and the family office.

Figure 04: Range of services – in-house vs. outsource



Figure 03: In-house or outsource? Every family is different



Factors to consider

1. Cost and budget

Escalating costs can be a challenge. Be sure to do a cost-benefit analysis, including elements like quality, privacy, economies of scale and potential cost savings.

2. Professional experience

The family's top priorities should be covered in-house to confirm independent professional advice. However, some professional experience is hard to build and maintain in-house if it's not used regularly.

3. Regulatory restrictions

All regulations that pertain to the legal structure and jurisdiction(s) need to be considered. While single family offices are significantly less regulated, multifamily offices often fall under specific regulatory regimes. Without professional management, you run the risk of serious cost and reputational fallout from negative publicity and legal action.

4. Technology and infrastructure

External technology providers can be effective, and outsourcing these services becomes a higher priority as financial operations become more complex.

5. Complexity

If the family's assets are substantial and complex, the family office will have to hire more staff or outsource more services. However, in-house staff must retain the ultimate overview and decision-making authority.

6. Data confidentiality

Services where confidentiality is a priority should be handled in-house. Non-critical systems and infrastructure can be outsourced. Each family is unique, so the services each family office provides should be uniquely designed to serve the family's needs.

03

Business plan, staffing and strategy

If a family decides that it needs a family office, what are the next steps? Just as when an entrepreneur starts a new venture, a family office needs a written business plan, solid long- and short-term strategic plans, and the right staff.

Business plan

To create a business plan, it's crucial to first understand the values, vision and mission of the family and the family office. Section 08 discusses this in depth. With this information, the business plan can be started.

The key components of a business plan should include:

Summary

- ▶ **Vision and mission:** Describe the vision and mission of the family office.
- ▶ **Why, what and who:** Explain why it is being created, what it will do (services) and whom it is designed to serve.
- ▶ **Evolution:** Describe how the family office is expected to evolve. For example, will it eventually serve unrelated families as a multifamily office or just serve the single family and its multiple generations?

Family business

- ▶ **Relation to family business:** Describe the business linked to the family office or whether the business has been sold. Family offices often start as an embedded family office in the business and become a separate entity when the family and its complexity and risks outgrow the business staff or cause conflicts between competing priorities of the business and the family.

Structure

- ▶ **Reporting:** Describe the reporting structure of the office (e.g., flat or hierarchical). This decision is usually an outgrowth of the vision and mission of the family.
- ▶ **Legal structure and ownership:** This discussion should include what type of entity will house the office and ownership by future generations.
- ▶ **Intended regulatory and tax impact:** It's important that the family understands the potential

consequences of the structure options. Tax and legal advisors are often used to help advise the family on structure and jurisdiction.

Jurisdiction

- ▶ **Country and local jurisdictions:** Describe the country and local jurisdictions in which the office and entities will be based. In some countries, local or regional government entities, like states, have vastly different tax, legal, regulatory and jurisdictional benefits.

Governance

- ▶ **Governance structure and systems:** Define which boards and committees will exist, how these will be selected, how they will change over time, how decisions will be made within them and whether they will include non-family participants. (See Section 08 for more guidance.)

Services

- ▶ **What and for whom:** Describe the services the office will deliver and for which family members or generations. In some cases, there is a list of base services available to all family members with additional services available on an à la carte basis. See Section 02.

Staffing

- ▶ **Staffing plan:** Include a staffing plan based on the services that will be performed and the number of family members to be served with an overlay of the organization or reporting structure. (There is a detailed discussion on staffing later in this section.)

Operations

- ▶ **Describe the operations of the family office:** Like staffing, operations are a function of the services and number of family to be served and the technology available to support them. The design should consider the key technology to be purchased and the cost benefits of building internal capability vs. outsourcing to third parties.

Financials

- ▶ **Funding:** Describe how the office will be funded (e.g., business activities, billing family members, charge on investments).
- ▶ **Budgeting:** Describe the pro forma budgeting for the office, including staff, facilities, technology and outsourced services.

Work plan

- ▶ **Include a detailed plan of how the office will be implemented:** Services could be rolled out in phases or perhaps outsourced initially and brought in-house later (see Figure 05 for a sample implementation plan).

Business and strategic planning for the short and long term

Business and strategic planning should be an ongoing exercise. Annual business plans are important for all family offices, but those that have continued for generations often create additional 5- to 10-year strategic plans and governance to consider the 100-year vision of the family.

Figure 06: Family office strategic planning components



In a crisis (such as the COVID-19 pandemic), it is more important than ever that families have a long-term outlook on the businesses and investments they own. The strategic plan should be looking at “stress testing” assumptions on asset growth and income against the projected number of future family members and their consumption.

Family constitution

The family constitution outlines the 100-year vision of the family. It is the foundation of the family governance system and the main document the family uses to outline its purpose, vision, mission and values. See Section 08 for a more comprehensive discussion of family governance.

- ▶ **Business or investment growth planning** that considers the balance between preserving wealth and creating wealth-generating assets (e.g., new business, real estate development plans, monetizing non-income-producing land, private equity investing).
- ▶ **Crisis response and continuity planning** to identify and prioritize risks to the family and the family office. Make a plan to manage people, process and technology during the crisis; test the risk response plan regularly; and prepare for business recovery after a disaster.
- ▶ **Direct philanthropy and community engagement planning** to look at the impact of donations as much as the amounts. The strategic plan for the family should determine the long-term impacts the family is trying to achieve in the communities it decides to support, such as how to have a greater impact by providing higher education or health care.

5- and 10-year strategic plans

These plans are designed to bridge the gap between the vision and mission outlined in the family governance documents (sometimes considered a 100-year plan) and the annual business plan.

Often, the process the family goes through to create the plan is just as important as the outcome. Planning for the next 10 years causes the family to think very differently than annual planning.

Families often find it helpful to bring in an outside advisor to lead and facilitate the process and help to bring new perspectives.

Major elements of a 5- or 10-year strategic plan

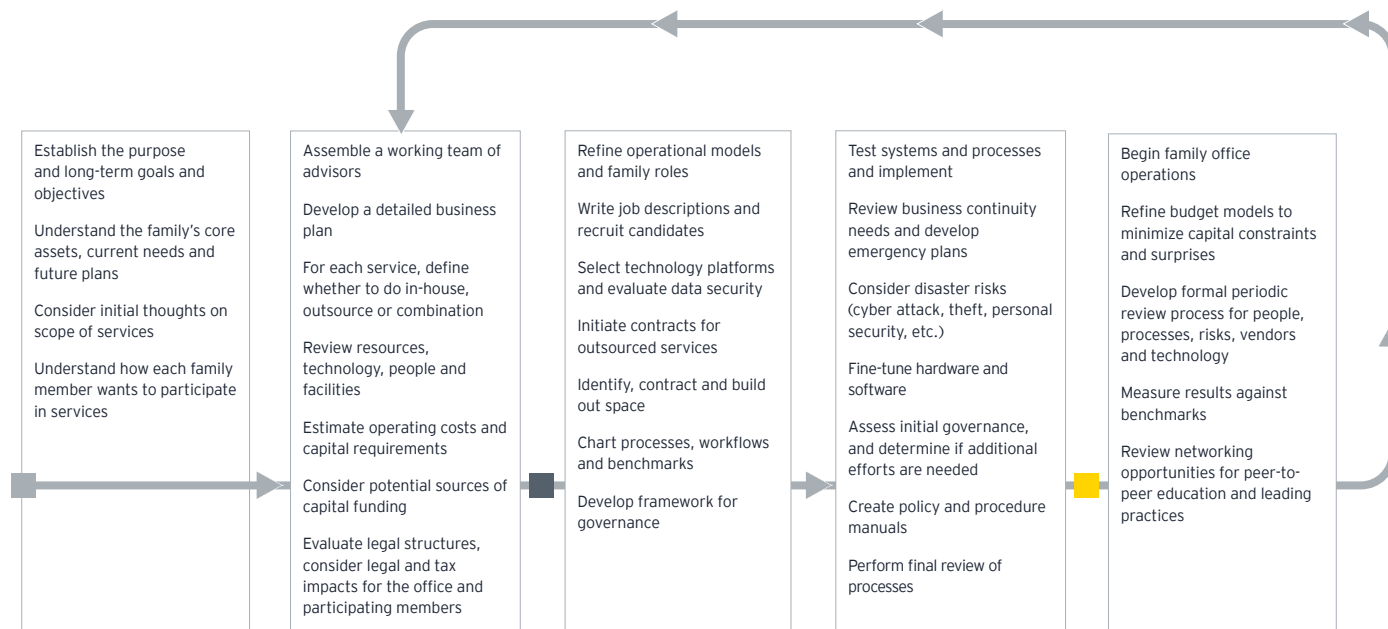
Long-term strategic plans should include:

- ▶ **Succession planning** for the family office leadership and plans to support succession in family leadership. Preparing for leadership transitions takes many years, regardless of role. Families may want to develop programs that include training, mentorship and business internship programs to give them the experience to lead the family.

Figure 05: Family office strategic planning



Iterative analysis and modeling



Major elements of an annual business plan

An annual business plan should include:

- ▶ **Reflection.** Evaluate how the family and the office performed against the prior year plan, including:
 - ▶ Strengths, weaknesses, risks and opportunities of the family and the family office
 - ▶ Major changes that have occurred since the last planning exercise
 - ▶ Success or major gaps in the family moving toward its long-term vision specified in the family governance
- ▶ **Feedback.** Ask family members what they think of the office, its staff and the support it provides. This information can be gathered through an annual survey. Quite often, the older generation is pleased with the office while younger generations are less happy. Work to understand different opinions and align expectations as part of the planning process.
- ▶ **Risks.** Complete a risk assessment of the family and family office every year or every other year to determine current risks and how they may be mitigated. This is an opportunity to consider:
 - ▶ Succession planning
 - ▶ Risks from staff or operations
 - ▶ Economic, legal or tax events
 - ▶ How business risks might impact the family or family risks might impact the business

- ▶ **Family office operations.** Evaluate the current family office operations. Priorities often change, and some services may be better delivered by an outside provider. This is a good time to evaluate each outside advisor or service provider and to determine whether the office needs additional staff or needs to plan for other changes, such as upcoming retirements.
- ▶ **Technology.** As a growing concern among family offices, technology requires a lot of time and resources. Compare current offerings with the rapidly changing marketplace, including how tools work together to meet the family's needs. Cybersecurity must be a part of this evaluation, including how it could impact the family's finances and its potential effect on the family's privacy and physical safety. (See Section 09 for more information on cybersecurity.)
- ▶ **Family initiatives.** Consider any new initiatives the family desires and how the office will support them. Are there new businesses, real estate development activity, philanthropic initiatives or a major family anniversary to plan for? Is the office equipped to take on these tasks? If not, planning ahead allows for reallocation of resources, time, people, money or bringing in outside resources to meet the need.
- ▶ **Budget.** Together, the components discussed in this section help determine the budget for the coming year, including how it will be funded. When the family sees and agrees with the plan and future initiatives, it will be much more likely to agree to the required funding.

Recruiting, developing and incentivizing family office staff

Staffing is crucial for the success of a family office. It's a big challenge to identify, attract and retain the best talent. Family offices usually don't have a human resources department to manage talent. Recruiting becomes the responsibility of the family and trusted advisors – neither of which are specifically trained to make staffing decisions. A further complication is the distinction between family members working for the family office and non-family professionals.

This section focuses on recruiting and retaining non-family professionals.

Recruiting

Family offices usually need some outside guidance on the recruiting process, formulating incentive packages and maintaining strong relationships with new employees. However, families have big advantages in recruiting because they have more flexibility to offer attractive compensation and incentive packages to senior executives. The working environment and culture of a family office can also appeal to the right candidate looking for a change from corporate culture.

Leading practices for family office recruiting

- ▶ **Understand the family and family office culture.** Are you a flat organization? Does the family like direct feedback? Is the family conflict averse? Understanding these elements (and others) allows job candidates to be compared and evaluated for fit with the culture and potential for success in the culture.
- ▶ **Write a clear job description.** This can be flexible but must capture the key elements and essence of the role. Family office executives are often involved in multiple projects, so job descriptions are often too broad and try to capture too much. Focus on the key elements of a successful candidate and consider both tangible and intangible requirements.
- ▶ **Form an interview committee and candidate scoring matrix.** Hiring for roles such as CEO and chief investment officer (CIO) should not be the responsibility of one person. Share the process with others. Developing a scoring matrix to rate the candidate against the criteria outlined in the job description will support the committee in making decisions.

- ▶ **Perform background, credit and reference checks.** A recommendation from a trusted advisor or family member is valuable, but extensive checks should still be made. The process should be rigorous and should include formal background, credit and reference checks.

Retaining talent

Retaining people once they have been recruited depends on compensation and feedback.

Engagement and retention efforts should include:

Compensation

- ▶ **Career conversations.** These should be performance-based and consistent and incorporate an element of long-term compensation.
- ▶ **Incentives.** Incentives can include co-investment opportunities, transaction bonuses and even partnerships. Incentive plans often reflect the standards in the industry that created the family's wealth, so packages vary by industry.
- ▶ **Benchmarks for compensation.** Different countries and jurisdictions have different salary ranges. The salary range will also be based on duties and how complex the family is. It may be wise to bring in advisors who can complete salary and compensation studies for the family office.

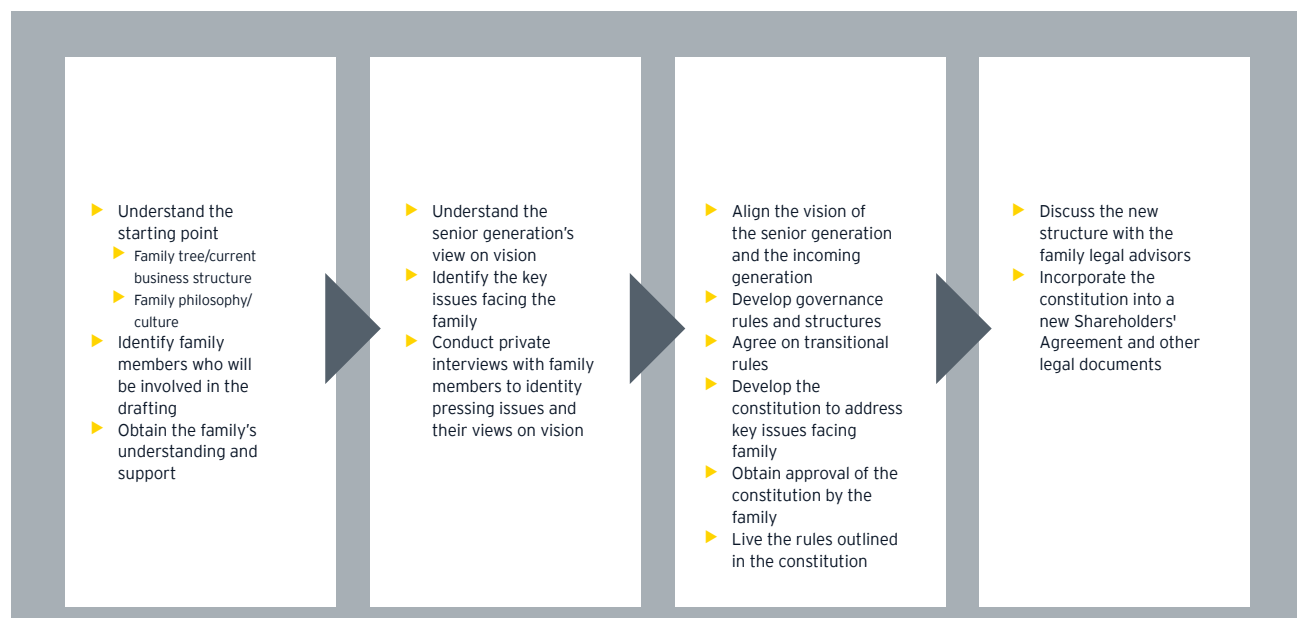
Feedback

- ▶ **Delivery.** When executives move from a highly structured corporate environment to a family office, they may feel uncertain about their performance and the family's satisfaction with their role due to a lack of meaningful feedback.

While the family may not be used to a need for feedback, it should try to give a fair and thorough assessment of performance where possible. CEOs at family offices can often feel isolated, largely because of a lack of feedback rather than concern about compensation.

- ▶ **Receptiveness.** It's important for the family and the family office executives to maintain a sense of partnership, but they should do so without affecting the impartiality of the executive. Family office executives must be open to giving and receiving feedback so honesty and openness can flourish. The ability to give and receive honest, open feedback is dependent on the long-term commitment to the family, cultivated by appropriate incentive planning – and the unquantifiable element of personal chemistry.

Figure 07: Building a family constitution





04

The investment process

How do family offices invest their principals' money? Since there are no fixed investment regulations that apply to family offices, they tend to follow their own individual investment policies. Family offices can often diversify their assets very broadly, much more than institutional investors, depending on the amount of assets under management and freedom from investment regulations. Many family offices take an open approach to their investment policy and try to avoid conventional investment paths.

Many put money into alternative investments, such as art, forests, ranches and farmland. This flexible approach enables family offices to spread risks while reflecting the personal preferences and passions of family members. However, investment freedom tends to be reduced in proportion to the level of services family offices receive through third parties and the number of families served by the family office.

Understanding family influences

The behavioral, financial and legal factors involved in structuring the investment process of a family office are complex and fascinating, and largely dependent on issues around family legacy:

- ▶ In what economic sector has the family made its money?
- ▶ To what extent is the family still actively involved in the business?
- ▶ To what extent do family members participate in the family office?
- ▶ What is the background of the chief investment officer (CIO) of the family office?
- ▶ What is the composition of the family?

Each of these factors tends to produce a strong behavioral bias for how a family's wealth is invested and how it is producing a diversified portfolio for the long term. These factors often influence the family office's investment profile and investable universe. The composition of the family also drives investment strategy. A family office set up by a first-generation entrepreneur will have different goals than a family office serving a fourth-generation family.

Three phases of the investment process

Broadly, there are three phases to the investment process for a family office.

Phase 1: Identify goals and risk tolerances

Setting investment goals

For most investment funds, whether sovereign wealth funds, endowments or family offices, the first step of the investment process is to establish clear investment objectives and risk profiles.

In some cases, the discussion of the investment process is led by the CIO of the family office. In others, it can be a more collective discussion with family members and cover establishing charities or other philanthropic initiatives.

Some leading practices include:

- ▶ Examining prior investment styles
- ▶ Giving questionnaires to identify the family's tolerance to risk
- ▶ Performing scenario testing that illustrates sensitivities to risk and portfolio drawdowns

This is also a good time to make the distinction between liquid assets (such as tradable securities) and illiquid assets (such as direct investments, private equity and real estate). The latter are difficult to value and often require some funding support. Many CIOs also tend to view illiquid assets differently than liquid asset portfolios when it comes to returns and investment horizon.

The importance of cash flow

There is often a greater and more irregular call on the investment portfolio in a family office than other organizations. Family members may request funds for business-related activities, private equity stakes, philanthropic and impact investments, or ongoing expenses.

Being able to model the impact of cash flows on an overall investment portfolio is important. The focus on yield and cash flow tends to be higher for family offices. Families should consider their overall liquidity needs carefully during the portfolio creation process and should update the liquidity needs model regularly to reflect the changes in family needs over time.

Phase 2: Establish the portfolio structure

Once the specific investment goals and the risk profile of the family office have been established, the next step is to map these goals and risk profiles to a recommended asset allocation. In some cases, historical asset return data is used to give a sense of what future returns might look like, but as stock market history has shown, the past is not a great guide to the future.

Defining an investment policy statement

Once an asset allocation recommendation has been reviewed, understood and accepted, the family should formalize its investment plan in an investment policy statement. An investment policy statement is a road map for all parties involved in the client relationship, including investment advisors, investment managers and trustees. It also provides a course of action to be followed in times of market dislocation, when emotional reactions may result in imprudent courses of action.

Enabling tax efficiency

Selecting the most efficient combination of assets for the family requires an adjustment to portfolio optimization that takes into consideration the ultimate after-tax return the family would expect to receive. For each asset class, the expected return should be deconstructed to reflect the income yield vs. return from capital appreciation.

Based on the level of turnover typical for each asset class, monitor unrealized gains to quantify potential short-term and long-term tax liabilities. Providing asset allocation analysis on an after-tax basis presents a realistic view of the return the family can expect from its portfolio investments, as well as an optimal mix of investments tailored to a family's specific tax situation.

Phase 3: Implement and govern

Once an investment policy statement has been created, the family office can begin thinking through how to deploy and manage capital. The type of investment strategy a family office pursues is a function of sourcing capabilities, desired control, liquidity needs, investing experience and family office infrastructure.

Family office investment strategies

Family office investment strategies generally fall into two broad categories:

1. Third-party managed
2. Direct
 - a. Public
 - b. Private



Figure 08: Illustrative family office investment strategy



Often, a family office will use a mix of these strategies to diversify investment exposure and improve risk-adjusted returns.

Third-party managed investing

Family offices use asset management funds to invest their capital in third-party managed investing. Families can make high-level decisions around how to allocate their capital between industry sectors and asset classes at the fund-selection level. However, below the fund-selection level, families have limited influence over investment decisions. Asset managers may focus on public or private entities and on traditional or alternative asset classes.

Direct investing

In direct investing, the family office makes the decision to invest capital into a specific asset or security. This type of investing requires the family office to do its own research and due diligence, and it must follow asset-level performance and manage its portfolio of assets on a day-to-day basis on its own.

Public direct investing

Public direct investing is centered on liquid debt, equity securities, exchange-traded funds and derivatives that trade over a public exchange. These investments are made through the use of public information and are subject to regulatory requirements that both protect and constrain the investor. Unless very large positions are accumulated, public direct investing allows for very limited influence over the underlying asset's management and strategic decisions.

Private direct investing

Private direct investing focuses on taking a more active role in the deal process and underlying investment. The family office will often be more involved in business decisions and strategy for the entity or asset. The investment can be structured as debt, equity or as a specific asset purchase (e.g., real estate). Information can include both public and nonpublic items. Regulatory requirements are much looser, giving the investor greater access to information but more limited protection.

Implementing the investment portfolio and governance

Implementation of a portfolio and quality governance are crucial. How a portfolio is implemented must be consistent with the objectives and structure previously determined. The formal investment policy statement defined in Phase 2 is an important part of maintaining an appropriate governance structure.

The family's goals, objectives and asset allocation should be reviewed regularly. It is a good practice to rerun asset allocation diagnostics on portfolios at least once a year to make sure that they perform as planned.

Governance and transparency are very important, and regular meetings and calls with principals, the family office staff and external advisors will help to clarify broad macro views, turning points in strategy and issues relating to implementation.

Investment governance roles and responsibilities

The roles and responsibilities in investment governance should be clearly defined:

- ▶ **Family.** The family members who are primarily responsible (individually or through a family council) for setting investment goals and defining investment strategy. Depending on the level of participation within the family office, family members may also play a role in managing the investment life cycle.
- ▶ **Investment committee.** A team of trusted advisors that is primarily responsible for governing and overseeing the execution of a defined investment strategy. Membership may include family members, family office leadership and independent advisors.
- ▶ **Investment team.** A team of family office employees that is primarily responsible for managing the investment life cycle, with a focus on idea generation, investment due diligence, execution, and day-to-day monitoring of performance and risk analytics.

Managing the investment life cycle

The rapid growth of family offices is a relatively new trend, and because of the diverse origins of many family fortunes and the different backgrounds of CIOs, it is difficult to pinpoint a uniform family office investment process. However, regardless of the processes utilized, the people, process and technology of the family office must enable end-to-end management of the investment life cycle (see Figure 11).

Figure 09: Family office investment strategy benefits and considerations



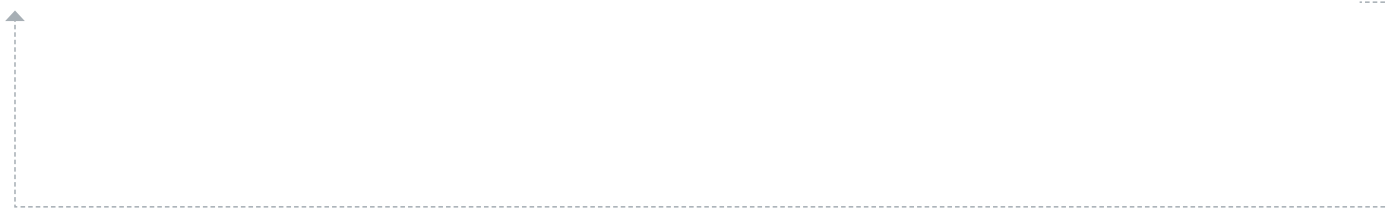
Strategy	Benefits	Considerations	Examples
	<ul style="list-style-type: none"> ▶ Lowest infrastructure requirements ▶ Investment access is good, but customization is limited ▶ Third-party knowledge can be valuable 	<ul style="list-style-type: none"> ▶ Management fees ▶ Limited control over how capital is allocated at fund level ▶ Transparency can be limited ▶ Potential conflicts of interest ▶ Redemption features can impact liquidity 	Fund investing: <ul style="list-style-type: none"> ▶ Mutual funds ▶ Private equity ▶ Infrastructure funds ▶ Hedge funds ▶ Fund of funds
	<ul style="list-style-type: none"> ▶ Liquid asset class ▶ Avoids management fees ▶ Highly customizable portfolios ▶ Large investment universe ▶ Ability to use family office experience in investment selection 	<ul style="list-style-type: none"> ▶ Limited to public market opportunities ▶ Information must be public ▶ Generally, has limited influence over underlying entity or asset ▶ Subject to public market volatility around valuation ▶ Moderate infrastructure requirements to manage portfolio 	Traditional investing: <ul style="list-style-type: none"> ▶ Money markets ▶ Fixed income ▶ Equities ▶ Commodities ▶ Options
	<ul style="list-style-type: none"> ▶ Avoids management fees ▶ Highest potential for "alpha" ▶ Structuring flexibility ▶ Ability to use family office experience in investment selection ▶ Highly customizable portfolios ▶ Increased access to information, including nonpublic ▶ Ability to influence decision-making around underlying asset 	<ul style="list-style-type: none"> ▶ Investment sourcing can be challenging ▶ Illiquid asset class ▶ Investment process, including due diligence and documentation, can be burdensome ▶ High infrastructure requirements 	Alternative investing: <ul style="list-style-type: none"> ▶ Private equity ▶ Venture capital ▶ Mezzanine debt ▶ Real estate ▶ Infrastructure projects ▶ Natural resources ▶ Royalty streams

Figure 10: Investment governance roles and responsibilities



Role	Family	Investment committee	Investment team
Setting investment goals and defining investment strategy	●		
Overseeing the execution of a defined investment strategy	●	●	
Managing the investment life cycle			●
Idea generation			●
Investment due diligence	●	●	●
Execution		●	●
Day-to-day monitoring of performance and risk analytics	●	●	●

Figure 11: Managing the investment life cycle



Idea generation

The family office should determine how investment opportunities will be sourced and vetted against the family office's investment strategy. There are two options:

1. **Bottom-up:** An in-house portfolio management team sources opportunities, leveraging in-house research systems mapped against portfolio guidelines and restrictions.
2. **Top-down:** The family office leverages external relationships and networks to identify interesting opportunities that need to be filtered against portfolio guidelines and restrictions.

Due diligence

The family office should determine the information investment decision-makers need to make buy, sell and hold decisions.

This may include:

- ▶ Subscribing to market research for in-house analysis or outsourcing due diligence to an external third party
- ▶ Using a due diligence documentation presentation format, such as an investment thesis memorandum (a consistent format will accelerate decision-maker review)
- ▶ Building an iterative feedback loop into the process to garner additional information and refine the due diligence process

Authorization

Authorization parameters should be established and communicated across the investment management team. Authorization can be concentrated solely with family members, with an investment committee or with a combination of both. In addition, the CIO may be granted a discretionary mandate for certain asset classes or investment types.

Execution

The family office should determine how the execution of the investment strategy will be enabled by people, processes and technology. An in-house team could be given responsibility for trading an active portfolio, or investment execution can be outsourced to external investment managers via separately managed accounts or fund structures.

Monitoring

Investment decision-makers need to review buy, sell and hold decisions. The family office should determine how reporting and review will occur:

- ▶ Will reporting extend beyond traditional returns-based reporting and encompass other elements, such as risk analytics (e.g., attribution, contribution, exposure)?
- ▶ Is real-time reporting necessary to support strategic decision-making?
- ▶ Should investment decisions be backtested against the original thesis or theses?

Strategy alignment

Mechanisms should be established to verify the investment portfolio aligns with the family's goals and objectives for now, next and beyond:

- ▶ Will short-term deviations from the defined asset allocation be rebalanced to align with investment strategy?
- ▶ Will investment strategy be reviewed on a periodic basis to align with the changing needs of the family (i.e., planning for the next generation)?



Private direct investing

Recently, a strong trend has emerged of family offices pursuing direct investments in the private market. The primary drivers of this trend have been:

- ▶ A search for better investment control
- ▶ Attractive risk-adjusted returns that have limited public market correlation
- ▶ Lower price volatility

Private direct investing requires the implementation of a formal investment committee process to identify, vet and execute new opportunities as well as manage ongoing portfolio needs.

Some family offices have chosen to team up with other family offices to pursue this strategy as a club. This offers attractive synergies in infrastructure, deal sourcing and idea sharing but also creates governance issues with investment selection and ongoing management.

For small to midsized family offices, the club approach may also enhance their overall competitiveness in the marketplace by increasing the capital available to pursue new opportunities – an important criterion in winning a competitive deal. Similarly, family offices may decide to pursue individual deals on a co-investment or stand-alone basis.

The private direct investing process

The private direct investment process can be broken into three broad phases:

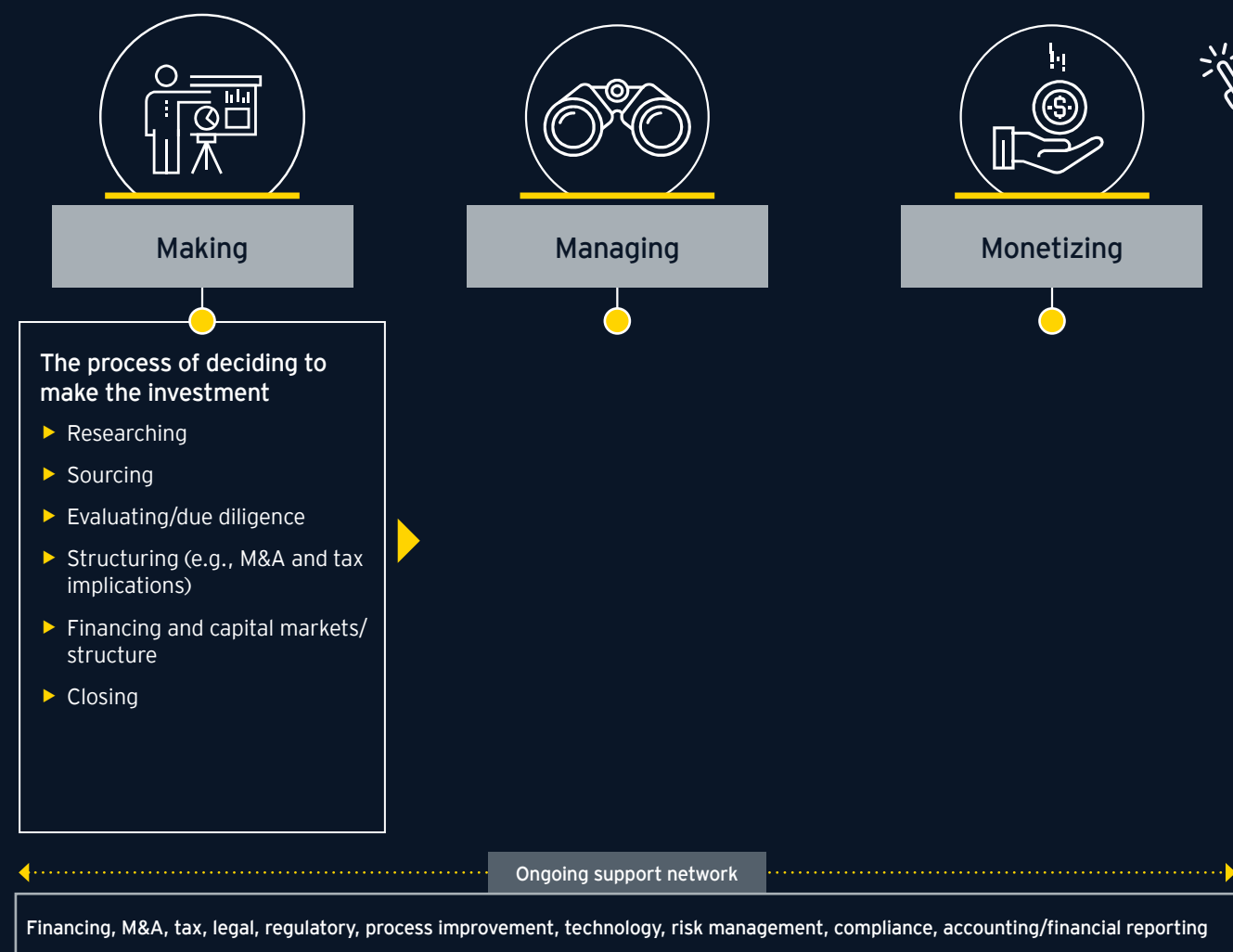
1. Making
2. Managing
3. Monetizing

Setting up a formal investment committee process around the implementation of these phases and setting up the necessary infrastructure for dealing with direct investments are critical. Family offices need to make sure that they have the right resources available and policies and procedures in place to confirm that the risks and opportunities around each investment are understood and managed.

While family offices often possess the foundation needed to create a successful direct investment strategy, investment gaps can exist at each phase of the process. Family offices, like traditional asset managers, often rely on outside professionals to assist with specific services that are not carried out in-house (e.g., M&A advisory,

capital markets advisory, legal advisory, tax advisory, accounting). This is particularly true as a family office platform initially begins pursuing the private direct investing strategy. Over time, however, as it gains experience and builds out its infrastructure, many of these professional services can be brought in-house.

Figure 12: Private direct investing process



05

Reporting and technology

Family offices face a significant challenge to verify the secure management of the diverse assets, complex ownership structures, and varied business and personal interests of their client families. To operate successfully requires many kinds of information: financial data to support decision-making, portfolio data to confirm the effective oversight of assets, and continuous monitoring of processes to spot and mitigate risk.

In today's digital world, producing relevant information means that data must be gathered and synthesized from a web of sophisticated – and specialized – service providers and partners. Technology plays a central role in supporting this process.

Core business needs

Before choosing or creating technology solutions, it is important that a family office identifies its core business needs. The technology to meet these needs can range from a single off-the-shelf product to a sophisticated ecosystem of integrated solutions. Components of this ecosystem can also be outsourced or provided by external service providers, freeing up the family office resources to focus on growing the wealth.

Many family offices begin with systems adopted from an operating company, such as a corporate general ledger, and adapt these to manage the family office activity. Ultimately, as services to the family expand and the family's portfolio of interests grows, a family office may require as many as six types of accounting to properly account for and report its family's assets.

Figure 13: Up to six types of accounting for family offices

It's more complex than journal entries.

Controlling a family office can require up to six types of accounting.

1. Marketable securities

Next-day aggregation of third-party manager data across multiple custodians

2. Illiquid investments

Tracking capital calls with cash inflows and outflows and other reference data from periodic third-party manager statements

3. Partnership

Allocation of income and investments and accounting attributes through multiple tiers of beneficial owners

4. Financial

Advanced double-entry accounting required to consolidate multiple investment or operating entities, including bill pay and treasury management

5. Tax

Adjusting journal entries required to track basis modifications related to IRC 704(c) allocations, depreciation and other book/tax differences

6. Trust

Segregation of principal and income cash, modifications related to calculation of assets and liabilities, court reportings

CIO focus: portfolio management and accounting

The CIO, whether internal or outsourced, is concerned with systems and reporting around the investment portfolio, including forecasting future performance. Family offices invest in diverse asset classes and frequently employ a mix of active and passive investing styles. Some family offices employ an asset allocation model and invest their wealth with carefully selected fund managers. Others make their investments in-house, in asset classes ranging from real estate to private equity to hedged multi-asset class securities portfolios.

Portfolio management and accounting systems are key to managing these processes and must be tailored not only by asset class but also by the information needs of the portfolio decision-makers. The information needs of the CIO and portfolio manager are tied to the investment style they have adopted. Reporting needs can range from specific data on risk and performance of particular funds to research support for planned investments and comprehensive risk analytics to plan the construction of the overall portfolio.

CFO focus: cash flow and auditable records

The CFO is mainly concerned with effectively managing cash flow and maintaining accurate and auditable records. Often, portfolio management platforms are insufficient as stand-alone solutions and must be paired with additional technology tools – such as a general ledger – to address further office complications related to asset ownership structures (e.g., in many cases, assets are owned via trusts, partnerships and other corporate structures and require partnership accounting).

The family's focus: consolidated reporting and nonfinancial systems

The family's focus is often consolidated reporting, which bridges all other functional perspectives. Automated consolidated reporting has been proven to be the most valuable tool of all for a family office and is a leading practice.

Families are also heavy consumers of nonfinancial data of various types and increasing sophistication. The management of such unstructured data may require systems and knowledge distinct from the portfolio and financial data ecosystems.

Figure 14: CIO and CFO goals and objectives for system output



Other nonfinancial systems

In addition to financial systems, family offices also require the support of workflow- and communication-specific tools in order to effectively manage information and the scope of their responsibilities.

Central to workflow and communications systems are customer relationship management (CRM) tools. These are vital for a family office to manage critical information in one central location. Information retained in a CRM database may include family contact information; documentation of family discussions regarding services or major family events; the structure of the family; and third-party contacts, such as legal counsel, accountants and insurance contacts.

CRM-type tools are also likely to be employed in other functional areas of the office. The investment function, for example, will want to document its due diligence and research processes in manager selection. Trust administrators will use CRM-type functionality to track decision-making on distributions and investments, reporting to beneficial owners, and the reasoning behind key decisions.

Other necessary family office functionality related to workflow and communications, but often requiring integration or additional modules, includes:

- ▶ **Shared calendars.** A centrally posted calendar is accessible by all family members to schedule important dates, such as family council meetings, investment committee meetings, the annual family retreat or individual family members' use of shared family assets.

Figure 15: Technology stack reporting perspective



- ▶ **Message boards.** Privacy is a key tenant for many ultra-high-net-worth families – regular social media is far too public. Private message boards enable distant cousins to communicate and share pictures and videos behind the family office firewall.
- ▶ **Secure portal.** With the rise of phishing attacks on compromised email accounts, family members need a way to communicate with the family office to receive reports, submit requests and access important documents; the portal often provides single sign-on access to other accessible features.
- ▶ **Request and approval workflow.** Visual step-by-step status updates for family member requests, from initial submission through research, approval and completion.
- ▶ **Digital signatures.** Embedded within an existing tool, family members can enter a private key to encrypt a set of information to digitally sign documents, such as board minutes, budget approvals or legal documents, which is useful when a document requires signatures from multiple family members who are not geographically close.
- ▶ **Dashboards.** Interactive graphic representation of data, customized to multiple perspectives, accessible via phone or tablet; family office personnel push curated data sets to a pre-configured layout that can be dynamically sliced and diced by the end user.

Human capital and technology

When choosing technology for a family office, it is imperative to have the right people in place to manage and operate the software. These people, who may be in dual operational roles, should understand performance analysis and accounting principles. They should be detail oriented and have the ability to leverage technology for integration. Increasingly, experience with business intelligence and other analytical toolsets is an essential skill set.

Depending on the breadth and technical complexity of the office's technology ecosystem, some family offices may hire a chief technology officer, who would be responsible for support, updates, communication and software training.

The implementation of technology in a new or existing family office may require additional resources beyond the current office personnel. While systems often are touted for their ability to automate mundane or repetitive tasks, there is an operational toll on the office to run and maintain the systems. External consultants can fill the personnel gap by providing advice and support for integration, implementation and the preparation and verification of input data. They can also provide clarity, based on broad family office experience, into leading practices with respect to the diverse reporting needs of the family office stakeholders.

Implementing technology

Once the core needs have been identified and the appropriate solutions chosen, it is vital to implement them efficiently and as cost-effectively as possible. Successful implementations often include the following activities:

- ▶ Create a comprehensive project plan, detailing the responsibilities of each vendor and office staff
- ▶ Assign an internal resource with delegated authority to project manage the implementation
- ▶ Agree on the data import processes with each vendor, including the ordering of implemented entities, length of implementation history and relevant nonfinancial attributes
- ▶ Create data and functionality test scripts for each platform, prioritizing end-user report packages
- ▶ Hire an external consultant for data output testing to verify alignment with stakeholder reporting requirements
- ▶ Hold frequent meetings (at least weekly) with each vendor on progress toward project plan milestones



Digital transformation in the family office

Family office technology presents a broad array of challenges for organizations seeking to keep pace in a rapidly changing digital world. Based on conversations with family office leaders and experience over the last several years, we believe many family offices are not yet ready to tackle a virtual working world. And yet this is an increasingly important task in light of the technological and other types of disruptions in recent years.

Many offices are still emerging from the era of spreadsheets stored on desktops. Only a small percentage have deployed more sophisticated systems focused on automating workflow processes, providing remote approvals or integrating disparate functions.

Family office executives need to be honest with themselves about how their organization stacks up against five common weaknesses:

- ▶ **Lack of bench strength.** Most family office staff members are stretched thin. Personnel generally do not have the free time to focus on strategic initiatives. As a result, few offices have an adequate internal bench to tackle a major technology project, even if they try to compensate by hiring an outside consultant.
- ▶ **Systems unfit for purpose.** Family offices often find themselves working with systems that do not support their daily tasks. Systems may have been adopted from the family's operating company or were purchased without understanding the platform's true functionality. In other cases, the activities of the office have radically changed (e.g., transition from a concierge-focused office to an investment-focused office), but the systems were never updated to align to the new mission. These systems often fail to generate the data needed to support clear, timely decision-making – except with extreme manual intervention.
- ▶ **Ad hoc is the new normal.** Sometimes long-running and time-intensive tasks are not mission critical and/or are being performed to satisfy a long-forgotten request by a family member or executive. A family member may have asked the office to track, for example, specific purchases during a calendar year. Since then, the office staff has continued to track those transactions in case they are asked again. Or worse, a staff member may have inherited a task – or the procedures to complete a task – from a predecessor and have no knowledge of the purpose driving the activity.
- ▶ **Underutilized systems.** Because family offices tend to grow over time, systems are often implemented by the wrong people (e.g., junior-level staff who lack strategic perspective, functional subject-matter resources without technology experience or third-party IT support). As a result, systems are often implemented incorrectly or don't utilize the full range of available features. What looks like a need for a new system could simply be a need to reimplement the current systems.
- ▶ **Satisfied with status quo.** If family offices delay deploying new technologies or performing system upgrades, they may eventually find themselves too far behind the curve to catch up with the coming digital revolution. What should have been a gradual or incremental adjustment is suddenly an enterprise-wide disruption. And delaying the purchase of new software until there's more going on in the office negates the current capacity and shifts the implementation to a time when catch-up may be impossible.

Four steps to begin a digital transformation

As family offices have shifted toward a remote working environment, their reliance on the internet has grown exponentially, exposing both vulnerabilities and opportunities. Family offices should consider the following when thinking about technology needs:

Formalize remote infrastructure. Family offices often reserve their virtual infrastructure for key executives. During the COVID-19 pandemic, all personnel began working remotely on unsecured mobile and home devices. Spinning up a virtual private network – that also extends to family members – is the first step to confirming that a secure environment doesn't stop at the office's doors. Then, family offices should develop an incident response plan that includes reputation risks.

Consider cloud-based applications. The family office technology market has been rapidly moving toward the cloud. With software-as-a-service license models becoming the norm, portfolio management, document management and general ledger systems are no longer being developed for on-premises installations. This presents several opportunities. Cloud-based applications offer protection in business continuity situations and anonymity against potential cyber events. Cloud hosting also provides cost savings and protection against the risk of losing equipment to fire or other natural disasters.

Focus on cybersecurity. Business disruptions subject all family offices, even those with sophisticated systems, to greater cybersecurity threats. Threat actors take advantage of these situations. Executives can begin protecting against these threats by monitoring the social media footprint of office personnel and the family, taking an inventory of private data (extended to key vendors) and adding additional layers of control over high-dollar and high-risk processes like non-routine cash requests or capital calls. (See Section 09 for more on cybersecurity.)

Leverage the capabilities of others. Even though advanced digital technology may appear to be beyond a family office's immediate grasp, a family office can begin to take incremental steps by leveraging the capabilities of third parties. Partnering with a vendor who has already made the investment of time and capital lowers the cost of entry for the family office.

If they haven't already, family leaders, trustees and family office executives should begin asking questions to find out what the office is doing to keep pace with digital disruption. Ultimately, every family office will need to prepare for a digital future. By acting now, family offices will be able to meet the digital revolution head on.



06

Philanthropy – more money, more options

When families and family offices consider philanthropy, the first thing that usually comes to mind is charitable giving for public good, using a donor-advised fund or a family foundation. Today there are many other options for families looking to give back and make a difference.

These include:

- ▶ **Traditional philanthropy.** Single or shorter-term financial contributions to individual social causes and organizations.
- ▶ **Nontraditional or “taxable” philanthropy.** There is an increasing willingness to use structures that don’t have tax benefits to achieve families’ philanthropic goals. Often, by foregoing tax benefits, the structures also are freed from the associated operational constraints.
- ▶ **Impact investing.** Families are considering philanthropic goals when investing in companies, organizations and funds with the intention of making a positive contribution to society alongside a financial return (e.g., using environmental, social and governance criteria when selecting an investment).
- ▶ **Venture philanthropy.** The mirror image of impact investing, venture philanthropy uses investing techniques, such as metrics-based analyses, to measure the effectiveness of philanthropic projects (the projects’ “return”) and fund (or defund) accordingly.

Making philanthropy a reality

Before embarking on philanthropic efforts, it’s important to understand what the family wants to achieve, the options available and the constraints that different options may place on them. Essentially, family offices need to:

1. Define the job
2. Choose the right tool to fit that job
3. Use that tool effectively

1. Defining the job: what does the family want to do with its wealth?

It starts with doing some deep thinking about what the family priorities are for its wealth. In years past, the main goal was usually to preserve and grow wealth for the next generations. That is not the sole goal, or even the primary goal, for families anymore.

Ultra-high-net-worth families often want to use their wealth to have a stronger and more focused impact on society beyond writing a check to a charitable organization. They may be passionate about a particular cause and want to use their wealth to really make a difference in that realm. Or perhaps the family wants to be involved in a more hands-on way, taking “moon-shot” bets on future-focused technologies with the potential to change the world.

These efforts are most effective and lasting when they are closely tied to the values, vision and mission of the family and the family office and are spelled out in the governance and strategy documents.

Once the goals are understood, create a timeline and milestones, including any long-term aspirational goals. Give thought to philanthropic goals and structure from the short term to the very long term. The structure the family needs to achieve its goals today may be very different from what it needs 20 years from now.

2. Selecting the proper tool

Once the family has decided on its goals, the next question is how best to achieve them. They may require influencing legislation or political decisions, investing in a private company, or hiring and engaging staff to solve a particular problem. The right infrastructure choice will depend strongly on the jurisdiction and direction, but some common options include:

- ▶ Donor-advised funds
- ▶ Private foundations
- ▶ Public charities

Each option comes with its own benefits and detractions, including potential long-term issues and unintended consequences. The family and family office should be fully aware of the implications of each structure and the doors it may be closing (or opening) with its selection. For example, as tax efficiency increases, operational flexibility and control tend to decrease (Figure 16).

Before making a decision, it's best to evaluate each of the following elements:

- ▶ Governance and liability
- ▶ Taxation
- ▶ Disclosure
- ▶ Permissible activities
- ▶ Regulatory oversight
- ▶ Ability of the family and/or family office to control the use of funds

Figure 16: Entity choice process



While it's not necessary to do everything right away, it's important to verify that the structure is expandable and able to accommodate future desires.

3. Wielding your tools well: challenges and considerations

There are many challenges to navigate when considering philanthropic efforts and impact investing. Practically speaking, the regulatory landscape can be complicated, but it is heavily dependent on jurisdiction.

There are also important considerations around legacy, generations and staffing.

Generational transition

While it may seem rather grim to contemplate, everyone dies – even billionaires. To leave a lasting legacy, philanthropic structuring needs to account for what happens after family members die (particularly unexpectedly). Families and family offices need to confirm that the mission the family has undertaken continues to be fulfilled past a family member's death and that there is a smooth transition from one generation to another.

It's particularly important to understand how any philanthropic efforts fit into the ultimate estate plan. If not done well, the death of a family member can cause a lot of leakage and damage.

Important considerations:

- ▶ Who controls the entities?
- ▶ How will estate tax issues be addressed?
- ▶ How quickly should the funds be spent?
- ▶ Is there a for-profit company in the mix that needs to be addressed?

Annual contingency planning is a leading practice to confirm that the family members' most recent wishes are being respected.

Staffing: keep it in the family?

Considering the complicated considerations described above, it is critical to employ people with the right skill sets for philanthropic efforts.

It also may be tempting to place younger-generation family members in charge of family foundations and other philanthropic efforts as a way to help train them for succession. While this is an attractive notion on the surface, if the family member is not passionate and

skilled, it may not work as the family intends.

The family should treat philanthropic efforts as seriously as it does governance and succession. While it's tempting to use family office staff as philanthropy generalists, leading practice is to hire an experienced professional or outsource to a company well-versed in this space.

Consider the following when making staffing decisions:

- ▶ What is the impact that the family wants to achieve?
- ▶ What are the skills and abilities necessary for that success?
- ▶ How will reporting take place?
- ▶ If a family member is going to be involved in these activities, are they passionate about the cause?
- ▶ Do they have the skills needed for the role? If not, is there someone who can mentor them?

07

How much does a family office cost?

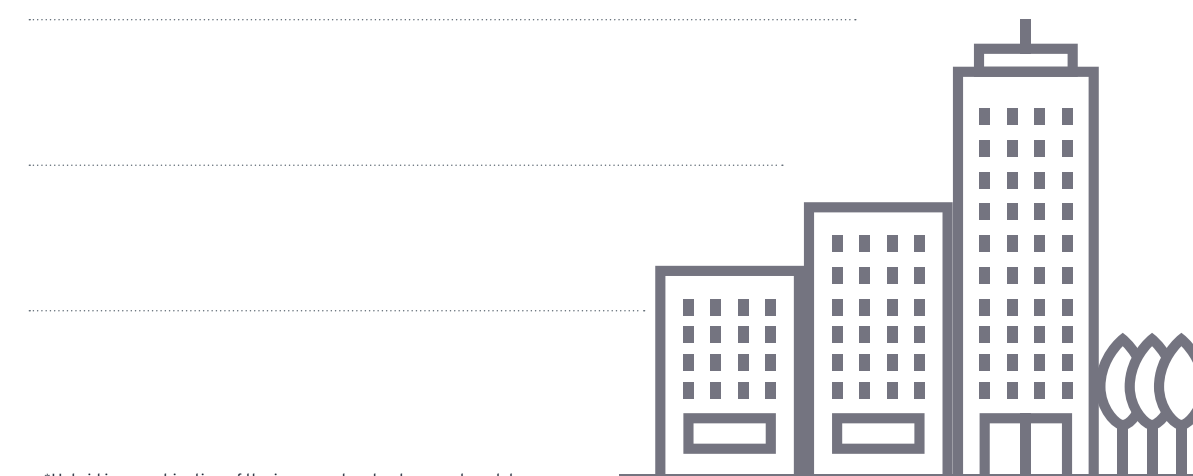
A family office is unique to the family that sets it up – there really is no average family office and thus no average cost of a family office.

Anecdotally, a stand-alone, full-service single family office will cost a minimum of US\$500,000 to US\$3m annually, and in many cases, it will be much more. So, for such an office to be viable, the family should be worth US\$1b or more.

A family office can be set up with less, but the services will be limited to administration, control of assets, consolidation, risk management and oversight of outsourced providers. Setup costs also include recruiters, compensation professionals, relocation costs, legal setup costs and the search for infrastructure, such as office space and technology solutions.

Fully integrated

Figure 17: Recommended family office type based on assets and costs



*Hybrid is a combination of the insourced and outsourced model.

Staff costs

A review of publicly available research indicates that a significant portion of total office costs is staff compensation and benefits. Anecdotally, staff compensation tends to be approximately 75% of the total cost of running a family office. This is attributable to two points: first, that family office personnel tend to be senior, long-tenured employees, and second, that family offices are willing to pay a premium to acquire and maintain superior talent.

Figure 18: Staff chart

Overall costs

Family offices typically have operating costs between 30 and 125 basis points of assets under management (AUM), not including investment management fees, and depending upon the amount of AUM.

Compensation and benefits generally account for about two-thirds of the operating costs of running family offices, with the other one-third spent on rent, office operations and administration.

Investment management fees will range between 25 and 100 basis points of AUM. Offices with the lowest total operating costs focus on administrative tasks, such as record-keeping, personal expenses and investment monitoring.



08

How to institute a strong governance structure



Governance tends to be one of the most overlooked strategic priorities in a family office. It can be a challenge to address the family needs, investment needs and business needs in a single framework. This section offers a road map for family office governance and introduces the concept of parallel governance, which leads to long-term sustainability and success.

What is governance?

There are entire books, seminars and programs dedicated exclusively to family governance. Governance is an ongoing, active process and not a destination. It takes time and effort to put a governance system in place, and it takes active management to operate it and adjust it as necessary to continue to meet the goals and needs of the family and office.

The importance of governance

A sweeping generational wealth transition is predicted over the next few years, so it's important for families and family offices to start working on governance now. Clear governance helps set clear boundaries, coordinate financial demands, develop nonfinancial capital, and set priority and ownership of oversight for the family and its investments.

To manage this change and avoid disruption, it is important to have a solid, working governance system in place. Based on work with multigenerational families and family offices, the best structure for long-term success is a system of parallel governance focused on owner governance and business and/or investment governance.

Six steps to better governance

Implementing a new governance structure is a long-term process and can be a daunting. Here the process is broken down into six steps to offer a road map for the governance journey.

Step 1: Understand governance

Governance is put in place for three main reasons:

1. To manage expectations
2. To define common purpose, values and vision
3. To agree on conflict resolution and have a process for it

Lack of governance may inadvertently create conflict

Navigating conflict is the elephant in the room when planning for governance. Often, a family believes it is managing expectations and has created common values when actually the tasks of the family and the family office are creating conflict.

Conflicting goals and objectives

As the family grows and the complexity of its assets and wealth grows, the systems to govern both must also grow or the goals and objectives of each different family group can begin to conflict (Figure 19).

Purpose: a family office should manage more than assets

The family should set a purpose and vision for the family office through the family constitution and governance documents. A family purpose is the glue that binds the family together, building on family history and stories to engage future generations, whether in the family business or in other family activities, such as philanthropy, the family office and investment management.

Purpose builds a foundation for family unity and plays a key role in managing expectations and setting out the principles that guide family members in how they interact with each other, both inside and outside of the family enterprise. When families examine their purpose and values, they decide what is relevant to them and create a road map that can guide their decision-making.

Often a family believes the family office should just manage assets (i.e., be an investment office). If a family office doesn't have a connection or understanding of the goals and objectives of the family – whether financial, human, social or intellectual – it can lead to conflict due to a lack of transparency and understanding.

Step 2: Inventory the size and complexity of family and family office

As the family begins to outline the services of the family office, think about the complexity of the family and the structure that will be managed. The governance system for a first-generation small family will be much

different than the system for a large multigenerational family. First-generation families that prepare now will have a much better chance of becoming a successful multigenerational family in the future.

The type and complexity of the family office you want to create is important to understand when thinking about governance.

Four factors will impact the types of governance chosen:

1. Number of families served
2. Types of asset classes managed
3. Number of professionals in the office, including key executives
4. Tax and legal structure

Often, family offices are built without a clear road map, which can lead to complexity and conflict over the longer term. Family offices tend to have a basic understanding of their legal structure, but it's equally important to think about other structural components when setting up a family office:

- ▶ What services are provided and to whom they are provided

- ▶ Roles and responsibilities of professionals in the family office and who those professionals are, including the top executives or department heads
- ▶ Who has oversight for the review of the assets owned by the family, including thinking about innovation, disruption and market events that could affect the family balance sheet
- ▶ Who has oversight for review of performance of assets against benchmarks

Figure 20: Simple investment tax structure 

Figure 19: Growth of family and tension of active and inactive family members 



Figure 21: Complex investment tax structure 

Clearly understanding the organizational structure allows employees and the family to consider improvements and adjustments to governance that can be made to support long-term success.

Step 3: Identify any existing governance structures

Understanding the current governance system of the family, whether formal or informal, is important before beginning a change. An informal governance system often exists, even if no formal system has been put in place. Informal systems lack clarity in expectations, shared vision and conflict resolution.

When trying to implement change, the informal system often overrides the formal system and can undermine the change efforts. That means the informal system needs to be explicitly understood and addressed for any changes in governance to be successful.

Document where the family is on the governance journey

As noted in Step 2, there can be blurred lines between areas of governance, important roles and responsibilities.

For governance to be successful, it's important to untangle these issues. Start by understanding and mapping where you are now:

- 1. What we do: corporate and/or business governance.** This includes oversight of investments, business and investment companies; formal boards and advisory boards; and selection of executive management.
- 2. Who we are: family governance.** This includes oversight of the family's shared vision and values; who is part of the family; and formal structures, such as a family council or family assembly.
- 3. What we own: wealth.** This can be thought of as the family office, the private trust company and/or trustees who can control the wealth.

Step 4: Decide on governance system: top-down or parallel

Governance systems can take many forms, based on various models and schools of thought. Most governance frameworks take a hierarchical, top-down approach.

Top-down governance

Family council or family assembly

The top-down approach (see Figure 22) starts with a family council that is tasked with family identity and cohesion. The top-down approach appears to give the family (regardless of qualification or interest) control of advising and setting the direction of the business and investments.

Shareholders council

The family council is followed by a subset of the family tasked with confirming that the business and investments are aligned with family values. The shareholders council works to oversee the board of directors or investment committee, which oversees the investments and businesses of the family.

Committees

The shareholders council generally acts as a system of committees to address important issues that affect the family, the business or investments. Committees are often made up of family members, many of whom are not active in the investments, family office or businesses that are responsible for day-to-day operation.

Once again, the committees and influence of the family are important, and there can be confusion about who is responsible for the actual execution and oversight of the mandates set out by a committee.

Parallel governance systems

Parallel governance is set up so that owner governance and business/investment governance work side by side (see Figure 23), with a clear understanding of operating models and responsibilities. This model helps to support long-term success and avoid disruption.

Owner governance

In a parallel governance system, owner governance helps develop the family and owners to provide "patient capital" to the businesses and investments the family owns.

Figure 22: Top-down governance system

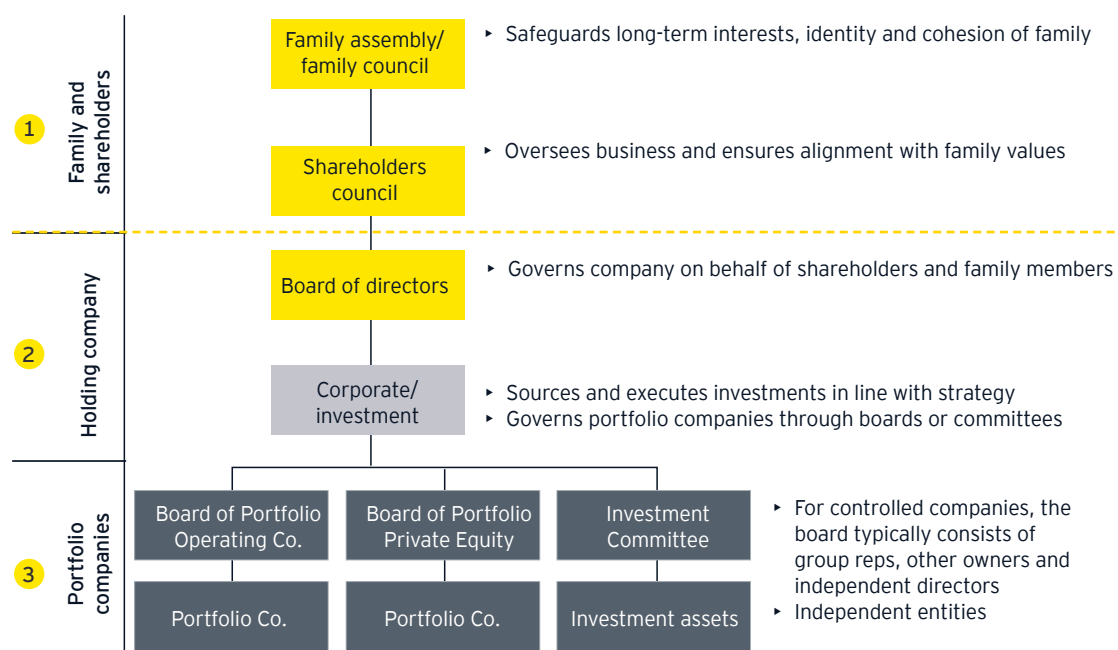


Figure 23: Parallel governance systems



An owners group and an owners board support the family through human capital and emotional development, preparing them for good stewardship, supporting the family mission and offering guidance by focusing on six key development principles:

1. **Owner cohesiveness:** How does the family stay together? What are common values?
2. **Owner governance process:** How does ownership transition from generation to generation?
3. **Owner mentoring:** What does it mean to be a good owner? What are the important roles and responsibilities of an owner?
4. **Business understanding and boundaries:** How is the family educated on the business and investments and the boundaries for participating in or managing these assets?
5. **Business-related philanthropy:** How does the family develop philanthropy that ties into the communities that are important to the family?
6. **Trust and estate:** What are the wealth-transfer plans, including rights as a beneficiary and responsibilities of a trustee?

Most families or family offices are focused on only one or two of these key development principles (with trust and estates often being a disproportionate focus). This leaves gaps in the family development for long-term success.

Business governance

In a parallel governance system, business governance develops the business and investment systems to provide operational confidence to the family about the business. This operational confidence allows the family to supply patient capital to the businesses and investments.

A business or investment board and executive team provide:

- ▶ Current results and future strategy reports
- ▶ Oversight and development data
- ▶ Operating results and operating data

They do this by focusing on six key development principles:

1. **Value creation and know-how:** How does the family continue to create value and develop intellectual capital?
2. **Business governance process:** How does operation, oversight and management of the business and investment assets transition from one team to the next and from generation to generation?
3. **Corporate development capacity:** In a disruptive, ever-changing world, how do the family and the business develop the capacity to generate new ideas and avoid becoming obsolete?
4. **Risk measurement:** Do the business and the family understand the risks (financial, reputational, political) of the business and investments they own in parallel with the profile of the family?
5. **Business/owner boundaries:** What are the boundaries between the family and business, and how do family members participate on boards, as trustees and in management?
6. **Transition preparation:** What are the plans for board transitions, ownership transitions and management transitions, including clear guidelines, qualifications and timelines?

Developing a parallel governance system is a process that can take years and needs to be actively managed and monitored, but it delivers substantial benefits to families and family offices.

For a family office, the goal is to be at the center of instituting parallel governance, supporting and managing the family through the process while also supporting the maintenance and development of the system over the long term.

Primary benefits of parallel governance

1. Developing a capable future owner base – education, experience, care and affinity
 2. Preserving values, tradition and history through generations
 3. Professionalizing generational transfer
 4. Overseeing generational transition and succession processes
 5. Stewarding over operating business, investments and family capital
 6. Agreeing upon future governance models and related board of directors guidelines for the operating business
 7. Strengthening the patient capital base
 8. Owner(s) participating in the operating business, investments and family holding company
 9. Managing relations between the owners, trustees, and operating/investment board and executive
 10. Recognizing and resolving conflict
-



Step 5: Analyzing how to get from here to there

Once you understand the current structure based on Steps 1-4 and determine the future structure, it's time to perform a gap analysis of four pillars: owner governance, owners board, investment governance and business governance.

Each pillar can be broken into smaller subcategories and assessed based on information from the previous steps. As an example, under owner governance, the owners board, owners group and each of the six strategic priorities could be assessed. Once the current state is determined, focus on the developing items. These are the areas that will need the most attention and effort.

Identify a change management team

It is important to develop a team to manage any changes in governance. Create an inventory of current strategic advisors, both internal and external, and the skill sets those advisors have in different domains. Then, work to fill any gaps with internal or external advisors. For example, do those who would support owners governance have owners governance experience? Are there other advisors or groups that should be vetted and added to the process to support the family going forward?

Step 6: Appoint a team and develop processes

There are three key components to a successful governance change:

1. **A qualified team** to develop and manage the governance process. Using the team gap analysis from Step 5, fill in the team with inside and outside advisors.
2. **Family sponsorship** is crucial. The family's control parties (those in control and responsible for governance and oversight) need to be part of the process for change.
3. **An internal project management office (PMO)** to manage and drive the change. The PMO should report to the control parties to remove roadblocks and enable change.

A long-term process

Understand that governance is a process that is designed and developed over time. Design and testing will take 12 to 24 months, and it can take 3 to 5 years to fully implement.

As part of the design and development phase, prioritize tasks and map out how to achieve the priorities. The tasks should come from the gap analysis developed by the team and advisors.

Once developed, prioritize tasks by ease of implementation and impact on the organization. This will help unearth "quick wins" – things that are easy to implement and have a high impact on the organization to gain momentum for change.

10 benefits of an active business/ investment board

1. Aligning skills and agenda to improve today's results and tomorrow's business/investments
 2. Encouraging self-discipline and accountability in management – robust and reliable reporting
 3. Providing a sounding board to aid in evaluating CEO/CIO and management team's ideas
 4. Offering honest, objective opinions on performance, strategy, compensation and other business matters
 5. Assisting in strategic planning and monitoring implementation/results
 6. Offering insights into key people and succession management
 7. Asking challenging, penetrating questions
 8. Giving confidential and empathetic counsel and mentorship
 9. Aiding creative thinking and decision-making
 10. Enhancing cooperative relations with constituents, including employees, advisors and the community at large
-



09

Family office risk management

Protecting family wealth across generations is an increasingly complex task. Family offices face many kinds of risk, from family succession challenges, to market disruptions, to the constantly expanding catalog of privacy and cyber threats.

Risk management initiatives are historically too narrowly focused. Family office personnel are pulled into siloed initiatives for specific processes, but these reviews fail to anticipate the real risks the family faces. There is also a growing body of literature that identifies individual risks in detail and offers advice to manage them, but it's often lacking advice on how to effectively balance risk and the business of the family.

To escape this pattern, family offices must view risk holistically and adapt an enterprise risk management approach tailored to their own risk appetite, resources and ability to execute coordinated initiatives.

What is effective risk management?

Good risk management practices include many components:

- ▶ Risk-oriented mindset that permeates the culture
- ▶ Clear communication
- ▶ Continuously monitored and improving controls
- ▶ Ability to predict issues
- ▶ Effective planning

Above all, risk management requires understanding, as a starting point, the concerns and risk appetite of the family. Protecting the legacy of the family is the purpose of the family office and should inform each stage of the process of establishing, managing and continuously enhancing a successful risk management program.

Managing risk requires a continuous process and consistent focus. Risks evolve over time and evolve quickly in today's world.

Figure 24 shows a summary of an annual or biannual risk management process, beginning with establishing a consensus on risk appetite and following the steps that allow that consensus to become a living, constantly evolving set of standards and key performance indicators.

Figure 24: Risk management processes



Step 1: Define risk and risk appetite from the family's viewpoint

Common risk concerns for families tend to be investment risk, family reputation, and family data and privacy – but not all families rank these equally or view them in precisely the same way.

A properly designed risk program begins with first understanding what the high-level risks are, according to the family. It must also clearly establish the family's tolerance for each risk – in other words, their risk appetite.

Often, there's a trade-off that must be understood by the office and the principals. Protecting privacy and reputation, for example, often means limiting or monitoring personal activities. The family office is responsible for clearly delineating the trade-offs and verifying they are communicated and heard by executives, staff and principals.

Figure 25: Functional framework for assessing family office risk

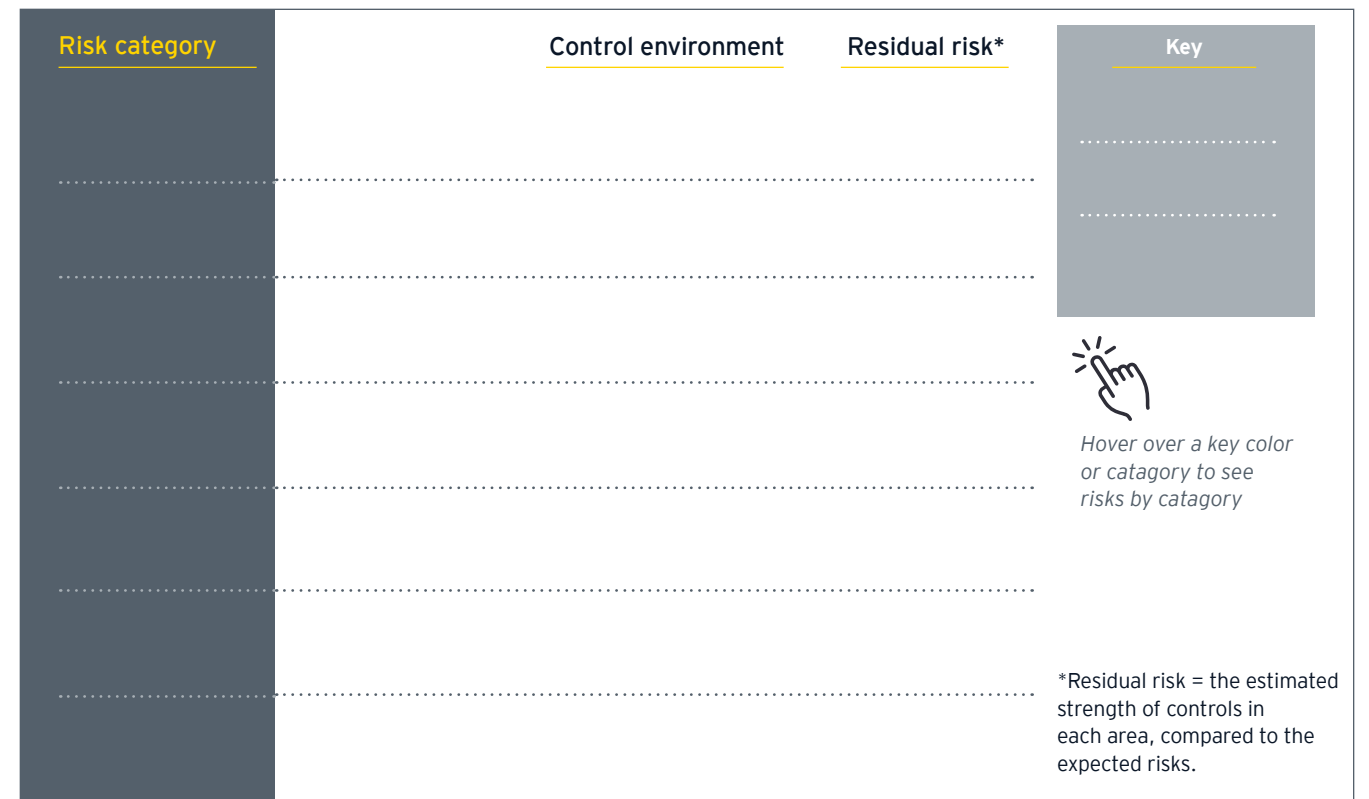
Translating ideas to concrete, measurable risks

To create a detailed risk control and monitoring process, the family office must translate its high-level concerns into specific risks subject to quantitative and qualitative measures. This process should be grounded in a rigorous methodology and tailored to the unique activities of the family office.

Risk identification should span each of the functional areas for which the office is responsible. Figure 25 shows a broad functional framework for understanding the risk environment of a family office. Family office management must use its understanding of the office's purpose, the strategic business plan and the family's risk concerns to identify the specific risks that may threaten its ability to achieve that purpose. Each area will also have its own subcomponents to consider.



Figure 26: Example of inherent and residual risk



Step 2: Prioritize risks

After identifying risks, the family office should also identify information that will help prioritize the risks and design controls or response measures. This should include:

- ▶ The potential impact(s) of the risk
- ▶ The likelihood of the risk
- ▶ The current controls in place to help mitigate and/or monitor the risk

Offices can use this information to model, quantitatively and qualitatively, the areas where their risk is highest.

Calculating inherent risk and residual risk

Inherent risk, calculated from the estimates of risk likelihood and impact in each area, is used as the starting point for true prioritization. The inherent risk is compared to the estimated strength of the controls that the office has in place to manage and monitor that risk.

Each area will have specialized controls designed to limit or monitor risk for that type of activity. Gauging the strength of controls usually involves assigning scores at both a detailed and strategic level about the presence, completeness and efficacy of the organization's control processes.

The following questions can assist in this effort:

- ▶ Has a control been developed to measure a specific risk?
- ▶ Are controls in this area complete?
- ▶ Is there a way to test the effectiveness of each?
- ▶ Are they ever reviewed by third parties?

The estimated strength of controls in each area compared to the expected risks results in a residual risk – the amount of risk remaining after all controls have been considered. A high residual risk (shown in red in Figure 26) may be the result either of engaging in very high-risk activity – in accordance with the office's risk appetite – or the absence or relative underdevelopment of appropriate risk controls in that area. Determining that base cause will allow the office to prioritize that area for further development.

Figure 26 shows an example of a risk model in which the family office has determined its inherent risk in each functional area, calculated from the estimates of risk likelihood and impact in each area. In this case, the base risk before establishing control activities is highest in risk, finance and technology.

In this risk map, the finance functional driver scored a high inherent risk because the family office supports a

multigenerational high-net-worth family across multiple jurisdictions and entities. However, by documenting financial policies and procedures, implementing a robust payment approval process with dual-factor authentication, and implementing an annual review of material cash transactions, the family office was able to create a strong control environment, resulting in a greatly reduced residual risk score.

The people functional driver scored a low inherent risk because the family office had experienced minimal turnover throughout the organization over the past five years, had diverse, qualified leadership and strong organizational culture. However, because succession planning had not been considered for key office leadership, the control environment was deemed to only be moderate, resulting in a slight increase of the residual risk score.

Step 3: Determine who is responsible for implementing controls

Risk controls come in many varieties, from policies and procedures, to external reviews and audits, to strategic planning exercises.

Who is responsible for performing these activities? The short answer is that it depends on the nature of the risk being managed. Figure 27 shows one framework for understanding how the nature of the risk determines the nature of the control necessary to manage it.

Figure 27 is based on understanding not only the risk itself but the response that the family office must be prepared to make in order to control it. Only by following a diagnostic process can structured recommendations be made to report the risk objectively, improve the control environment and ultimately mitigate the most important risks.

Process controls

Fraud risks will predictably arise in regular business processes, such as bill payment or wiring funds for investment activities – these require clear accounting controls and processes to confirm that they are correctly executed.

Planning controls

Risks such as key-man succession or managing the participation of new family members in the enterprise are no less predictable but require far more judgment to manage. These devolve to leading practice plans of many sorts, such as a business continuity plan for disruptive events, a succession plan for family and corporate trustees, or an information security management plan to confirm the privacy of the family and its affairs.

Risk transfer

Truly unpredictable risks, such as the COVID-19 pandemic or an unexpected weather event that destroys a valuable property, can only be managed by financing to transfer the financial risk to insurers.



Figure 27: Risk management and response matrix

Protecting against cyber risk

Cybersecurity risks are a hot topic among family offices, and for good reason. Information security breaches are widespread, with wide-ranging effects that can include theft, loss of reputation, loss of privacy, stolen identities and even physical risks (stolen information may be used to plan a robbery or kidnapping).

Some family offices have lagged behind in current cybersecurity practices. Historically, cybersecurity in family offices has focused on finances (e.g., making sure money is not transferred mistakenly or fraudulently). But as information has moved to the cloud and social media, the walls have expanded – opening many more opportunities for attack.

Cyber risks should be included in risk planning, which can mean changing the way the office looks at cybersecurity to recognize that breaches and social media threats will happen, and the job of the family office is to respond effectively and minimize the damage.

Offices should work closely with principals, families and employees to build cyber risk into the overall risk framework:

- ▶ Identify the scenarios that would impact family offices most, their risk tolerances and their pain points.
- ▶ Analyze the most likely scenarios and rate the risk level for each.
- ▶ Customize a good controls framework, such as the National Institute of Standards and Technology Cybersecurity Framework, to the organization to measure and mitigate risk to an acceptable level.
- ▶ Explore, create and – most importantly – test business continuity and incident response plans regularly.
- ▶ Continually educate all principals, family members and their households on the importance of adhering to these controls and the risks they face if they don't.

About EY Family Enterprise

As trusted advisors to ambitious business-owning families, including more than 80% of the world's top 500 family enterprises, EY teams have the experience and know-how to help the entire family enterprise – families, their family business and their family office – pursue growth opportunities while preserving values and building the family legacy.

Drawing from more than 100 years of experience supporting the world's most entrepreneurial families, EY Family Enterprise professionals are experienced in pinpointing and helping to optimize the drivers that impact family businesses' growth and longevity, preserve wealth and culture, and solidify multigenerational legacies.

Please contact your area EY Family Enterprise Leader to learn how EY can help your family, your family business and your family office grow and manage your wealth for generations. Visit ey.com/familyenterprise for more information.

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