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Setting up a Family Office

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Family Offices Insights

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I. Introduction

Family offices seem to increase in number on a continual – and a global – basis. What are they and why are they increasingly popular? What sort of family is a good candidate for a family office? For a family who are interested in creating their own family office, where do they begin?

Families with significant capital resources have long used defined processes and systems to organise their financial affairs for maximum utility, security and peace of mind, driven principally by a desire to preserve and perpetuate the benefits of wealth for future generations. More recently, the central role and purpose of the family office has evolved to provide a distinct set of services designed around the wider needs and objectives of the family.

We offer this Special Report as a practical guide on how to decide whether your family would benefit from having a family office and, if so, to explain how to go about its creation, operation and expansion.[1]

1. What is a family office?
First, some background. Where did the term 'family office' come from? Arguably, it is not a new concept but a new label, originating during the era of the industrial barons in the United States – the Rockefellers, Bessemers, Morgans, Pitcairns – all of whom had family offices. Of course, the concept of staff dedicated to the needs of a family has

3.4 Form a 'hybrid'
This model, promoted by Barbara Hauser in her early writings, remains a sound proposition today. The idea is to have a very small number of full-time family office staff.

Pros: A small group interacts closely with the family, understands their needs and outsources as necessary.

Cons: A small group may be overwhelmed by the number and variety of duties, eventually wishing to hire additional staff.

3.5 Partner with a multi-family office
In this model, you retain your own identity as a family office to interface with the family, and give the administration and investment management function to a third-party multi-family office.

Pros: The back office of a large multi-family office can provide a number of skilled administrative services. See, for example, the multi-family office of Pitcairn, which promotes on its website that it is glad to be the back office partner of an SFO. We predict that these 'private label' family offices will become more prevalent. You and your family could spend some instructive time interviewing a number of those offices willing to provide back office services.

Cons: You remain a client of a family office with a number of other clients and may therefore need to understand the priority attaching to investment opportunities and how your needs fit with their other clients' needs as part of an overall workflow.

4. The need for a family office
Has there been a liquidity event that produced, or will produce, a large number of liquid assets for the family to manage, resulting in a new need?

Historically, family offices have been created to manage wealth generated from the ownership of private businesses or, in more recent times, the combined rewards of high earnings as a successful executive and long-term incentive components such as share options. However, the incidence of significant wealth realisation events over the last twenty to thirty years has been a significant contributor to the large increase in the number of new family offices. Funds generated from the sale of an operating business or the realisation of equity in a public company represent a transformation of capital and the nature of the wealth held, and are usually new territory for the successful entrepreneur.

As Figure 1 illustrates, capital transformation events bring with them a change, not only in the nature of the owner's relationship to that wealth but also in the nature of the decision making that surrounds it.

Figure 1. The evolution of family wealth

Family in business ('active wealth')	Capital transformation ('active wealth creates passive capital')	Financial family ('capital is held intergenerationally')	Business family ('active management of passive wealth')
• Reinvestment or earnings • Liquidity • Ownership • Succession • Leadership • Creation and development	• Development of social capital • Diversification of financial capital • Diverse ownership • Distributions • Sale of business assets	• Entrepreneurship • Stewardship • Leadership development – human capital • Family commitment • Risk management • Governance	• Revised ownership structures • New business development • Commitment to family ownership • Transition of leadership • Realignment of family values
Need for improved reporting and compliance	Need for different approach to wealth and risk management	Generational change requires planning and strategy	Sustainability requires governance and oversight

As the top row illustrates, the first transformation is typically from wealth represented by the ownership of an active asset like a family business, to wealth held in a more liquid form, as passive capital. This doesn't necessarily mean that the whole of the wealth is transformed; it could be that the business is so successful it generates capital in excess of its needs, and wealth in the form of dividends and distributions accrues to the owners and needs to be reinvested, with proper thought given to how it is managed.

Invariably at this point the wealth owner and their family are faced with a need to manage an increase in reporting and compliance obligations, as the number and type of legal structures deployed to manage their capital increases.

And as the amount of passive capital accumulates, so the complexity associated with its management increases, and with that the need for the family to rethink their approach to management of risk. This may involve thinking strategically about the nature of the risks facing the family and how those risks can be managed.

"For many, contemplating setting up a family office only occurs after the realisation of their active assets. Such an event is normally preceded by significant planning to maximise the value realised from the sale, and minimise the impact of taxation; but including within that planning how to manage the wealth that is realised, and specifically the possible role and structure of the family office, will reap great long-term benefits."

For some, the primary risk is preserving capital, so thought will need to be given to mitigating the risk of the value of their wealth decreasing because of market movements or poor investment decisions.

Over time, naturally, the number of family members affected directly or indirectly by the management of the passive capital increases. With this transformation comes the transition of passive capital derived by one generation into capital owned for the benefit of descendent generations and what many advisers have referred to as the 'financial family'.[9] Ensuring that wealth owned by the family remains in their collective control and ownership requires planning and strategic thinking.

Finally, there is metamorphosis into a 'business family' whose role is the management of the family's wealth in a businesslike fashion – at which point the transformation from a family business to a business family becomes complete.

Through this process the family office becomes an integral component of the family's wealth management scheme, focusing initially on the investment and management of financial capital and ultimately on management of the family's overall capital, including that attributable to:

- the value of the family members themselves (human capital);
- their engagement in their community (social capital); and
- their accumulated wisdom (intellectual capital).

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5. It's not all about assets

One of the most common questions we are asked is: How much wealth does a family need to own in order to think about setting up a family office? Not surprisingly, the answer is not as straightforward as you might expect.

Some say the threshold should be at least $50 million in assets, others as much as $250 million; but the most commonly quoted figure, according to Russ Allan Prince, is $100 million, that sum being sufficient to offer a cost benefit to the family in managing the money themselves as against using a third-party investment manager.[10]

However, to break the answer down into a simple cost–benefit analysis is perhaps to over-simplify the question. For example, investment management is but one element of the costs associated with the administration and management of wealth in general. Other costs include legal and professional services fees, which can all be effectively insourced. We'll be examining the nature of family office costs later in this report.

In addition, there may be other reasons besides cost for arranging an office to look after the family's interests, including direct financial benefits and broader benefits like maximising the value of the family's overall capital. We touched briefly above on how many successful families spend more time on maximising the value of the family's human and social capital through deployment of funds towards education of family members, and philanthropy, than on managing their financial capital. A family office can provide the framework for forums on these matters.

Again, some family offices exist for the primary purpose of maintaining the family's name and reputation across generations through the shared responsibility of managing a family foundation.

Finally, the level of complexity of the family's affairs may mean there is benefit in having one central point of contact to coordinate the administration of the family's affairs, perhaps resulting in short-term cost benefits but ultimately providing longer-term planning benefits by ensuring that the family's estate plans are consistent and congruent with the vision to manage the family's wealth for future generations.

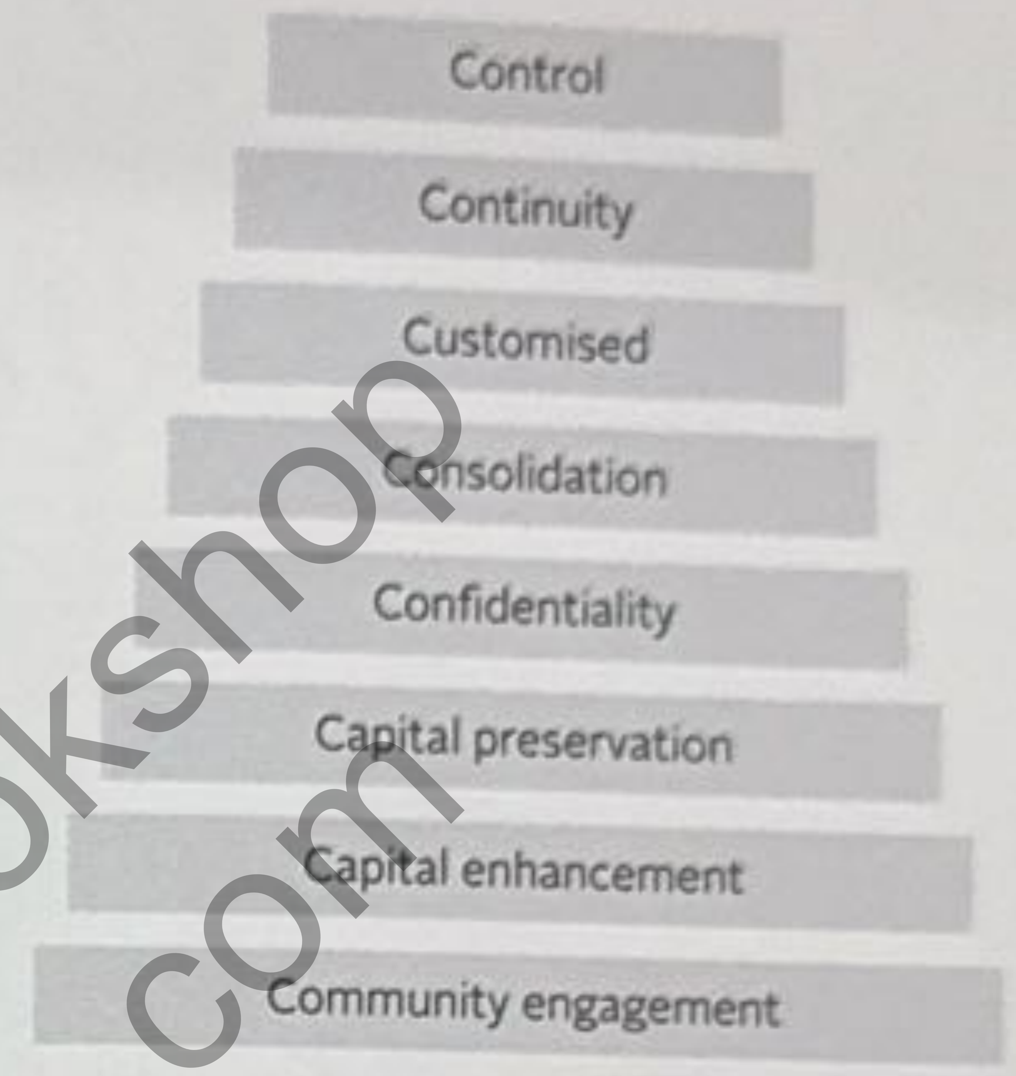
In conclusion, there is no hard and fast level at which it becomes beneficial for a family to set up their own private office. Granted, it probably makes sense financially where there is a significant amount of capital that can derive economic benefits from scale and efficiency, but establishing a family office can offer far more than that.

6. The benefits of having a family office

Essentially, what the family office should offer is a sense of control; a feeling that you will be able to put your finger on all the different aspects that affect your ownership of wealth, not in the sense of being able to change the nature of the risks attaching to ownership, but of being able to more confidently manage them in order to preserve, manage, grow and diversify the family's capital.

We mentioned control, but the letter 'C' offers several other descriptors of the benefits families seek to achieve through their family office:

Figure 2. Benefits of a family office



Any or all of these benefits, to a greater or lesser degree, may be relevant to your own and your family's situation.

"Essentially, what the family office should offer is a sense of control; a feeling that you will be able to put your finger on all the different aspects that affect your ownership of wealth."

IV. Preliminary matters

Before getting too immersed in the design process, bear in mind that you might already have a functional family office in place, albeit showing signs of the stresses highlighted in chapter III.

Many families who own a business use the services of employees for personal assistance. In many cases this informal arrangement amounts to the functioning of a family office; and indeed it is now referred to as an 'embedded' family office. Eventually, for tax and other reasons, it makes sense to discontinue this "free" use of executives within the business and to separate out personal family services by forming an actual family office.

Even without an operating business, many families have developed adviser and personal assistant roles and relationships over the years, which together cover many of the services of a family office. At some point, however, the services become so numerous and the various functions so uncoordinated that the family becomes susceptible to financial loss through negligence or fraud.

We will assume that after discussion with your advisers and family, and any friends who may have taken the step of establishing their own office, you have determined that for the reasons explored above, having a family office dedicated to the needs of your family makes sense.

1. The nature of the capital to be managed

As a first step, it's worth gaining an understanding of the status quo by asking the following questions:

- What wealth does the family own?
- How is the wealth of the family held?
- What are the current costs of managing the family's wealth, including direct third-party costs and any indirect costs that may be subsidised by the family business?

A good place to start can be any documentation and materials that supported you in the development of your estate planning and testamentary provision. Your lawyer and accountant will naturally be helpful in this audit process.

It may be that there are certain assets you own that you don't want the family office to manage on your behalf. These could include your home and any lifestyle assets that may or may not be used by the family as a whole.

Assuming that the family agree in principle that there is a benefit in being collective owners of wealth – that is, in becoming a financial family – agreeing what is and is not a family asset is vital for the effective management of the family portfolio and agreeing what the family office does for its members. Absent agreement on these issues, conflict could arise between family members given their varying expectations of the family office.

In this regard, the family's capital should not be considered simply by reference to its financial resources. What can be overlooked (and therefore undervalued) are the various other types of capital that a family may own – your own networks and professional relationships and your membership of associations, for example. These can usefully add to the pool of resources that can be called upon. Indeed, your contacts may be useful to you as you consider the staffing of the family office and decide which services may be outsourced to third-party providers, and which insourced within the family office.

Perhaps most importantly, you and your family are the human capital that can be deployed by the family office. Don't underestimate the value of your human capital and the skills, experience and know-how of individual family members. Think about what skillsets exist inside the family and as far as possible identify how those skills may be deployed – it may be that this influences how much you choose to outsource. For example, someone with an accounting background can play a vital role in underpinning the financial foundations by establishing accounting and reporting procedures. Alternatively,

"You and your family are the human capital that can be deployed by the family office. Don't underestimate the value of your human capital and the skills, experience and know-how of individual family members."

someone with investment management experience may be useful in establishing rules around the management of capital, substantially reducing third-party costs.

Having a good understanding of the extent and depth of the family's overall capital is the first step to determining how best to utilise those resources within your family office.

2. The purpose of your family office

It will be useful to document the basis of your decision to start a family office. At some point you may need to confirm why the family office was set up in the first place, and what you see as being the main role of the family's wealth – perhaps as part of a regular review of the office's operations, the introduction of new family members, the marriage of children or the passing of a senior elder of the family.

Quite often families do this through the development of a shared purpose or mission statement, encompassing a broad range of aspirations of which more than one may be relevant:

- They may see the opportunity for the family to be financially secure for the rest of their lives and their descendants' lives, if the wealth is properly managed.

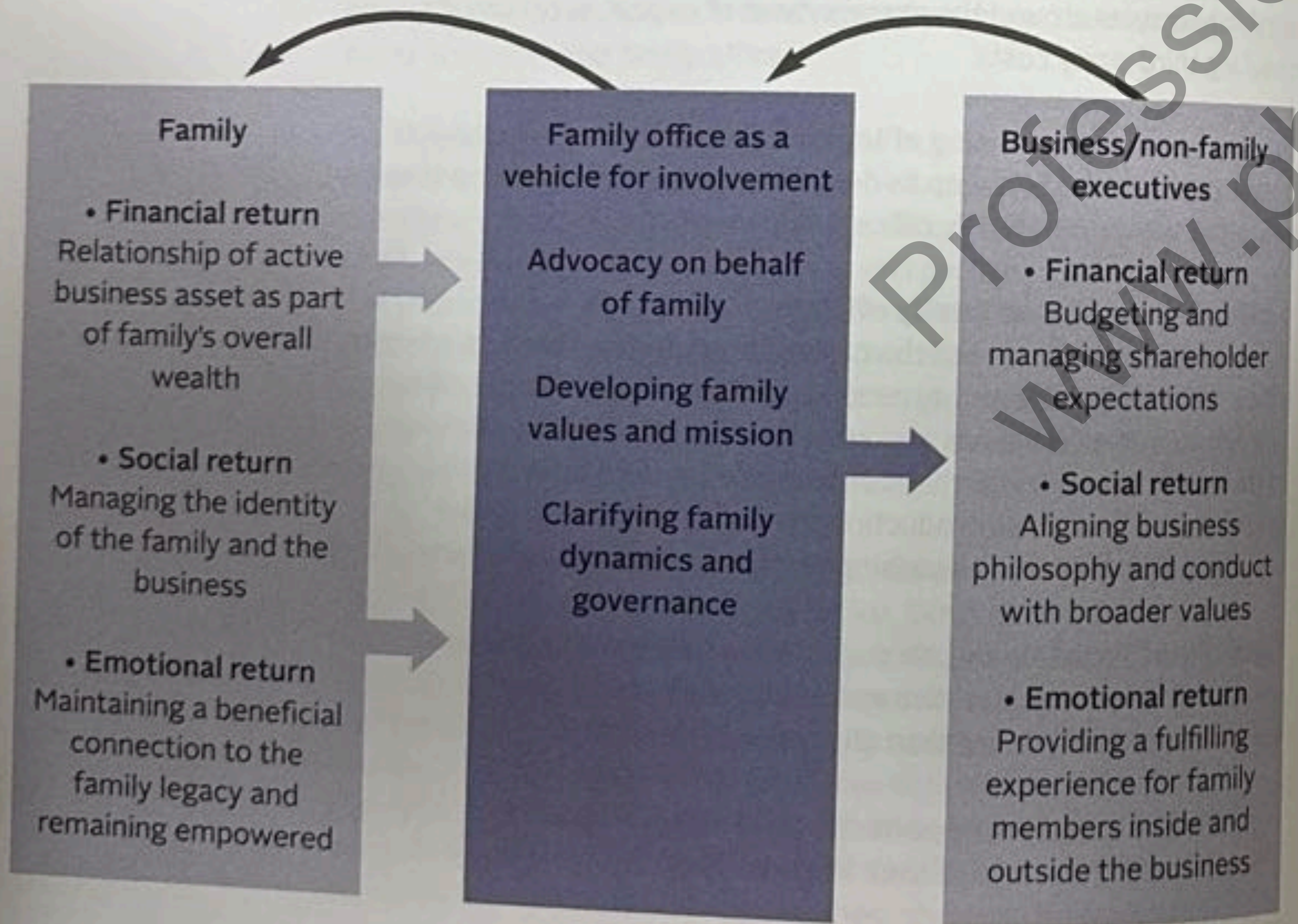
- They may reflect on whether there would be a significant marginal benefit in accumulating more wealth.
- They may take the view that the wealth should be applied towards enhancing the family's social capital through philanthropy or by providing resources to support a meaningful and useful education for family members.
- They may want to encourage entrepreneurship amongst family members by offering opportunities to invest in their ideas.
- They may feel that a family office will help separate the family from the business (see Figure 3 below).

Whatever your family decides is the best expression of its shared purpose, make sure that this purpose is recognised and respected by the family as a whole. The mission statement can then be used to explore the role of the family office in detail.

For a close-knit family, the mission statement might be simple:

> *To preserve our family's wealth so that it can be applied to enhance the wellbeing of our family members.*

Figure 3. Improving lines of communication around the important issues



Or, this is how one SFO defines its mission:

> *MFI is a provider of long-term, patient and supportive capital and its investments are designed to support the financial future of the family and its philanthropic pursuits.*[11]

Figure 3 demonstrates how a family office is typically deployed by a family with an operating business. The family office provides a conduit between family and business for communicating what is important to the family in terms of its value system – particularly important where the growth of the business has meant that family participation has become diluted compared to that of owners.

3. The scope of the family office
Fundamentally, the family office should do what is necessary to ensure that the family's shared purpose is delivered and its mission achieved.

If the shared purpose is to preserve wealth for the benefit of the family and subsequent 'blood' descendants, and to provide for their education and wellbeing, then the family may adopt a long-term approach to managing family capital, reduce as far as possible the impact of consumption and costs as leakages from the portfolio and work on how family wellbeing can be defined and ultimately delivered.

You can see here that the definition of 'purpose' becomes extremely important and your family will benefit from ensuring that this has been discussed thoroughly at the outset. It is possible, for example, that there will be an ambition for the family office to do specific, purposeful things such as engaging in philanthropic endeavours through the establishment of a private foundation.

Being very explicit on what the family office will and won't do can be particularly useful where you employ staff to supply services to the family. We talk about this more fully in chapter V, "Starting the process".

4. Will the family play a role?
This might seem like an odd question, but it is not necessarily a given that your family will play a role in the family office. What is without question, of course, is that the family office exists solely to meet the needs of your family.[12]

There are some key questions that you might want to think about in considering how the family would work with the family office.

- Do you see yourself as being able to work alongside your family in managing the family's wealth?

"Understanding the extent to which a family member is willing to tie their destiny to the family is key to the design of the family office and the nature of what it does and how it thinks about the management of family capital."

- To what extent would you like your children to be involved in managing the family capital in the future?

Agreeing to work together as a family provides significant opportunities in the context of economic empowerment, cost-efficient services, access leverage and social connections – but all family members will need to agree on the benefits. Whilst the benefits may be obvious, particularly the financial ones, be aware that there may also be responsibilities and accountabilities that need to be adopted.

Whether your family plays a role will be dependent upon what the family office is set up to achieve and the relevant skills and experience that family members possess.

It is not generally a wise idea simply to create a position for a family member inside a family office, without there being a clearly defined role. In your own business, or in any professional services environment, you will know that it is better to have the right people in the right roles. The audit you've conducted of your family's capital will help here.

It is also a good idea that, having agreed a shared purpose, the family should be engaged in the design process as far as possible, and in this context the family may wish to ask the question: Who is the family

office for? Being very clear as to who the family office serves is extremely important. Should its services extend to parents, siblings, nephews and nieces or even further to aunts, uncles and cousins? At some point it may well be that the family office will serve not just your own needs and those of your children, but also the needs of their families.

What is meant by 'family' is typically determined by the founder's family relationships. A lot can be inferred by checking the beneficiaries of pre-existing structures such as family discretionary trusts. Again, the pre-planning you've done to understand your current situation will be extremely helpful in this regard.

Questions you may want to ask yourself as the founder are:

- How important is your own financial independence from other family members?
- Do you want to consult with family members on matters affecting the family?

For family members, being able to provide for one's family independently can be important in developing self-esteem, and many create their own financial plan with the fruit of the family's capital tree. Accordingly, don't be surprised if some family members do not choose to be a part of the family office.

Understanding the extent to which a family member is willing to tie their destiny to the family is key to the design of the family office and the nature of what it does and how it thinks about the management of family capital.

It is probably best in the first instance to set up the family office to meet your own direct family's needs, and then to widen the number of those entitled to use its services, as appropriate.