

The Functions of a Family Office

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Families today face the challenge of keeping family wealth in the family, while continuing the legacy of the wealth creator. Many families believe that their family wealth is more than just financial capital and includes the human and intellectual capital of the family too. People are the most important assets that a family possesses. Each succeeding generation has the potential to carry the values of its predecessor. Families that successfully share values through generations will preserve and expand the family's wealth (Duncan [2001]; Hughes [1997]; Perry [2001]). Recent studies have pointed out that there are alternative approaches to building the financial, human, and intellectual capital of a family (Albrecht [2000]; Coroneos [2001a, b]; Kehr and Mendoza [2000]; Peterfriend and Hauser [2001]). The author believes that the most effective approach for a family of significant wealth to preserve and enhance its wealth through the generations is by the creation of a properly functioning family office.

The article starts with a discussion of the reasons for the creation of a family office and then considers the four principal functions it fulfills—investment, financial administration, fiduciary roles, and back office management. It concludes with a review of the costs associated with the management of a typical family office.

WHY CREATE A FAMILY OFFICE?

While there are many reasons why a family of wealth might want to create a family

office, the most common themes are control and service. A family office provides personalized focus and control over the financial affairs of the family while it provides the formal communication and customized service framework for the family. A family office allows each succeeding generation to develop further the family's inherent core competencies through education and practice, whether they're in an operating business, investment management, philanthropy, or other endeavors. A family office creates the opportunity for individual family members, in current and succeeding generations, to pursue personal happiness. The family office can also act as a mechanism to ensure privacy and confidentiality, and deepen resident knowledge and judgment. The family office can also strengthen and reaffirm family mission and legacy, and control costs for the family.

THE FAMILY OFFICE AS CHIEF ADVISOR

A family office shares many attributes with a family-owned business (Jaffe [1990]; Family Office Exchange [1998]; Goodman [1998]). One research paper last year noted, "...wealthy individuals mostly got that way by building and then often selling businesses. Through that experience they've learned to bet on people, and that mindset pervades this marketplace. The high end is driven by personal relationships..."¹ Likewise, another researcher from last year added that the "...chief advisor model is a basic description of the middle

ground toward which the major wealth management firms are headed. All the technology in the world cannot replace the advisor, whose value is fundamental; myCFO is a good example of a technology based wealth management firm that turned ultimately to investing in bricks and mortar.”²

The family office is typically a bricks and mortar, people-business built upon relationships of trust established between the family and family office personnel. The family makes its bet on the family office as its “corporate” chief advisor.

From another perspective, an authority on the made-to-order private trust company said earlier this year, “Wealthy families demand that their fiduciaries be flexible and responsive, by not only making available existing state of the art products and services and the most sought after service providers but also by customizing products and services to respond to particular needs and specifications. Fiduciaries that can combine the key features—devotion to clients, multi-competency, responsiveness and security—will succeed.”³

As chief advisor, the family office provides to the family personalized service and technical expertise, creative business leadership, management and planning, decision-making, and day-to-day responsibility for success. As chief advisor, the family office acts as quarterback for the family to all product and service providers, as well as all external professional counselors and advisers.

FUNCTIONS OF THE FAMILY OFFICE

There are four primary functions that are performed by the family office. They are the functions of investment management, financial administration, acting as trustee, and the provision of back office support services. The first three of these functions are directed in service to the family while the fourth function is in service to the first three and therefore indirectly serves the family.

The Investment Management Function

The family office serves as chief investment officer (CIO) for the family. The investment function is a process of management, analysis, and review of the financial capital of the family. It is composed of investment policy creation, manager selection, new manager review, asset monitoring, due diligence, and asset review.

A family entity needs an investment policy. The family should have an investment committee that sets the family investment philosophy into writing. The investment philosophy should identify return objectives, including any bias

toward growth or income, as well as the ideal allocation and appropriate benchmarks for comparison. The investment philosophy should also identify the appropriate risk tolerance, and any legal or tax considerations, as well as the relevant time frame and any liquidity requirements.

The investment committee can also discuss asset class weights and benchmarks. It should review returns of each investment as well as returns by asset class and family component. The investment committee should study prepared attribution analyses to determine how much of the return was generated by asset class weight versus manager selection. Finally, the investment committee should have a point of view on the macroeconomic outlook for the economy, the market, and individual asset classes.

A family office needs a process for new manager selection and review. The CIO for the family will lead the search and selection process for the family. The process of manager selection should start with an in-house review of historical performance and should continue with industry networking, review of media, industry conferences, talking to existing managers and family members. These are potential ways a family office can discover and select new investment managers.

Once the selection process is complete, the CIO can turn to a careful review of the new manager. This review includes reading the marketing materials, contracts, and agreements, including any offering document. The manager review also includes telephone conversations and a face-to-face meeting. The CIO should generate a written recommendation or declination report. The report should include the information gathered in reading and discussion, and on the site visit, as well as quantitative and qualitative manager screens.

The quantitative screens should include information on manager performance versus benchmark, an analysis of risk/return trade-offs, how the manager has done in good markets and down markets, and the relationship of the manager to an appropriate index. The qualitative screens will include opinions on the personal style or traits of the manager, the consistency of style, the experience levels, the personal financial commitment of the manager to the investment, the valuation of the asset class, and, of course, fees. Finally, other professional recommendations and reference checks should be documented to aid in the decision to invest, to pass, or to watch.

Once an investment is made, the CIO should monitor asset performance through frequent ad hoc reviews and through routine monthly communications with the manager. The ad hoc reviews should be frequent and should cover returns, including

comparison to benchmarks and similar investment strategies employed by other managers. The monthly reviews should be more formal in nature. These routine communications with the manager will take the form of telephone calls to discuss strategy and performance, phone calls to generate new ideas, and face-to-face meetings at least twice per year.

The face-to-face meetings should include a review of the operating environment of the manager. The operations due diligence process should cover the manager's organizational structure, the accounting and back office operations, the accounting and information systems used, trading and risk management, and legal and tax issues. The face-to-face meeting should also cover the liquidity position of the manager and how cash flow is managed.

Portfolio review and rebalancing completes the investment process for the CIO. There should be a regular review and update of the investment policy established. During the review all tactical and strategic issues should be examined. As a result of the review, the CIO should rebalance or reallocate the portfolio as appropriate.

Measures of success of the investment management function: specialization and focus; aggregation of assets to take advantage of lower fees; access to top external financial management.

The Financial Administration Function

The family office serves as chief financial officer (CFO) for the family. The administration function is composed of asset allocation, personal investment philosophy, tax compliance, financial control, project management, and financial reporting.

Each family member should have an individually prepared and delivered education program describing the current asset allocation plan. The family member should understand the effects of taxes, inflation, and expenses upon the growth of the portfolio. The education program must also include an examination of asset class return and risk characteristics, as well as efficient frontier studies. At the end of the education course is a description of individually tailored wealth projection reports that describe the probability of reaching target returns with target allocations.

Each member should have an individual investment philosophy and proposed program. The discussion should cover how risk is controlled and expected returns. The investment philosophy should also consider needs for income versus growth in the portfolio, whether or not there are asset class location constraints, and any cash flow issues. At the end of this process the CFO should review the proposed timing of implementation.

There should be a documented tax compliance process. The CFO should assist the family with tax planning and tax preparation. The proper planning for taxes is one of the primary goals for the CFO. Cash flow issues, coordination with trustees and investment advisers are fundamental. When it comes time to prepare the tax returns, the CFO should have overseen the supporting documents and schedules that are provided to the tax return preparer. The CFO should calculate and ensure timely remittance of the estimated tax payments each quarter.

Financial control is a key responsibility of the CFO. Financial control for the family includes liquidity and cash management, internal controls administration, personal financial statements, and financial reviews with the family. The family bases liquidity management upon forecasting cash flow sources and uses. The cash management program should be reviewed and rebalanced each month. Personal financial statements should be prepared for the family in the preferred format showing at a minimum net asset balances, revenues, and expenses. Preparation of budgets and the comparison of the budgeted figures to actual results are a key component of the personal financial statements.

Each family has special projects that need attention by the CFO. These special projects include real estate administration, hard asset management, and research. Families own personal real estate and the CFO should manage the buying, selling, closing, and credit aspects of the transactions. The CFO can also bring strong business acumen to bear on family-owned operating businesses and related activities. This is especially true where the family requires business prowess in coordination with outside professionals.

The CFO should conduct a financial review of the personal financial statements and the investment asset allocation program with the family. These reviews should be held at a minimum on a quarterly basis, while ad hoc reporting is essential to the family remaining connected with performance results.

Measures of success of the financial management function: world-class service; coordination of financial issues.

The Trustee Function

The family office serves as trustee for the family. A trustee is loyal, independent, and possesses multiple competencies. A trustee is also responsive, flexible, efficient, cost conscious, and security minded. The trustee function includes education and mentoring, trust administration, communication, and philanthropic management.

Education and mentoring of the family are important characteristics of the trustee function. The trustee should help the

family discover its mission and vision. Like family members involved in a family-owned business, the family is involved in interlocking systems of family, business, and ownership. The trustee can aid the family in determining the family values and its view of family legacy. What are the values that stand behind the mission? The trustee can facilitate the family in a values inquiry. A family credo can say what the family stands for and help guide behavior, as well as offer meaning and purpose. The trustee education program provides a list of suggested readings for the family. The trustee serves as a counselor to the family and promotes the family's nonfinancial objectives. A trustee can encourage grantor and beneficiary training on roles and responsibilities. At the end of the education process, the family will develop a multigeneration planning horizon.

The trustee administers the trusts and helps the family review estate plans. Trust administration includes keeping the assets safe, investing the assets for wealth preservation, and distributing the income and principal of the trust in accordance with the trust document. The trustee should read and annotate existing estate plan documents, diagram and explain in plain terms to the family. The trustee will coordinate with the attorneys and other professionals who play a role in drafting or implementing changes to the estate plan.

The trustee is the lead communication facilitator for the family. The trustee can play a significant role for the family as it develops or modifies its governance structure. Family governance structures can include family councils or boards of directors. The family should meet at least annually to conduct business, reaffirm its mission and vision, and elect new members to the governing body. The trustee can provide agendas and programs for the annual meetings.

The trustee can further the philanthropic goals of the family. Appropriate structures, program development, and program management can enhance charitable giving. Often, the trust is the original funding source for the family private foundation.

Measures of success of the trustee function: family cohesiveness; improved governance systems; education programs.

The Back Office Function

The family office back office supports the CIO, the CFO, and the trustee. The back office provides investment and partnership accounting, client reporting, internal controls, and technology.

The back office delivers a process of data collection, accounting, and reporting. This includes accounting software that comprehends various investment and partnership activi-

ties, as well as other types of business activities. There are multiple software applications that account for investment portfolios and these can be interfaced to the general ledger system. Reports should be produced in hard copy or digital format for physical or virtual delivery. Users of the reporting want data integrity, timeliness of information delivery, and integration of various activities into a unified and concise picture. Portfolio consolidation is a process of direct data feeds, common data formats, family authorization, data management, a portfolio accounting engine, and a comprehensive network of providers. This can be done by the family in-house or by custodians and prime brokers in a managed service provider model.

The back office delivers or administers the technology platform. This includes office productivity tools like word processing, spreadsheets, and e-mail, network administration, help desk, proprietary programming, and telecommunications.

The back office delivers the knowledge base management. The knowledge base is the family information database. It includes important documents, such as wills, trusts, estate plans, advisor agreements, deeds, contracts, tax returns, birth certificates, passports, and other paperwork. This knowledge base can be supported via a document management system.

The back office delivers a compliance program. The compliance program is built on a set of internal control policies and procedures that support the privacy and confidentiality objectives established by the family. The compliance program ensures that relationships between staff and advisors and vendors conform to the ethical standards of professional practices promulgated by the AIMR, the AICPA, and the ABA. The compliance program establishes the frequency and scope by which outside examiners perform audits, reviews, or agreed-upon procedures. The compliance program reviews business activities to ensure conformance with contracts or covenants. The compliance program should deliver via continuous review and should provide regular reporting to the family.

Measures of success for the back office function: simplicity; cost control.

THE PROCESS OF BUILDING AND MEASURING VALUE FOR THE FAMILY

The CIO, the CFO, and the trustee, supported by the back office, implement the process of building value for the family. Each function plays a significant role in developing and enhancing the financial, human, and intellectual capital of the family.

The family office enhances the family's cycle of wealth creation. The cycle of wealth creation is composed of the following elements that the family office facilitates: discovery of family objectives and priorities; marshaling of family financial assets; identification of family dynamics and governance systems; documenting financial plans and objectives; implementation of family education programs; and facilitation of regular communication and reaffirmation of family mission and vision.

Measuring family office value added by function depends upon the scope of service provided by the family office to the family. The best method for a family to measure the value added by the family office to the family is through a confidential family survey. In questionnaire format, the survey can capture the qualitative measurement of performance as identified by the family. Other more quantitative measures of performance could be established to round out the performance picture of the family office. For example, the investment management function could be measured by comparing risk-adjusted portfolio returns net of fees versus appropriate benchmarks. Likewise, the financial administration function might be measured principally by the ability to accurately forecast and manage cash flows. The trustee function could be evaluated based upon improved understanding of identified responsibilities by beneficiaries, for instance. Back office functions might be measured by effectiveness and efficiency standards, such as number of audit adjustments and back office cost per employee, respectively.

WHAT DOES A FAMILY OFFICE COST?

A simple but technologically sound family office should cost about \$1 million per year. That breaks down to roughly \$750,000 for compensation of personnel, and \$250,000 for other operating expenses, such as rent and systems. All of this expense is in addition to any outside investment management or consulting fees, fiduciary fees, or other extraordinary expenses. With these kinds of numbers, a family office probably only makes economic sense where family assets are greater than \$200 million.

CONCLUSION

The CIO, CFO, and trustee functions described in this article can support the objectives of a wealthy family that wants absolute control over its own affairs, completely customized and personalized service, and privacy. Thoughtfully managed, the family office is the best chance available for a family to successfully share its values and its wealth with succeeding generations.

ENDNOTES

¹Bernstein Research, "The Future of Money Management in America," Sanford Bernstein, March 2000, pp. 141ff.

²Goldman Sachs Global Equity Research, "Driving the Green: Serving the High-Net-Worth Individual," Goldman Sachs, October 16, 2000, p. 23.

³John P.C. Duncan, "Sophisticated Clients and Nimble New Competitors: The Challenge for Wealth Management Fiduciaries." Presentation made to the Institute on Family Wealth, New York, NY, May 3, 2001.

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