FAMILY OFFICE BEST PRACTICES

November 2019

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NEPC Private Wealth

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NEPC's Private Wealth practice has been advising wealthy individuals and families for over two decades. As a result, we have had the privilege of partnering with many successful and high-functioning family offices. We take this opportunity to outline some of their best practices as investing strategies and the business of managing them grows increasingly complex and sophisticated.

These recommendations are based on our discussions with single-office clients—most with assets over $200 million—and experts working with wealthy families, including specialists in investing, family office services, fiduciary services and banking.

We've organized these recommendations into the categories of:
1. Governance
2. Communication and Decision Making
3. Structure and Management
4. Estate Planning and Trust Structure
5. Investment Trends, Philanthropy and Impact Investing
6. Custodians, Banking and Lending

Please note that NEPC cannot provide tax or estate planning advice, and all strategies should be reviewed by an appropriate professional before implementation.

1. Governance

The management of significant wealth should be structured like the management of a business. The one big difference is your business colleagues are also your family members! Given this web of wealth and interpersonal relationships, sound governance is key. To this end, we recommend the following:

i. Be it a mission statement, manifesto, or even an informal conversation, it is important to articulate clearly and thoughtfully the shared values of the family, and its goals and objectives across all generations.

ii. Monitoring the dispersion of wealth among family members and/or branches of the family is important. Large differences in wealth can cause conflict especially with each passing generation. Of course, there may be legitimate reasons why wealth levels differ over time but if it is due to mismanagement, we suggest early conversations with the family where this is an issue. NEPC can help by providing analyses projecting the path of portfolio growth over time, including various spending levels.[1]

iii. Family structures have increased in complexity. To this end, it is important to plan for life events such as death, divorce, re-marriage and step-families. We still observe situations where a lack of planning for these events has a material negative impact on family wealth.

iv. Establish family policies around conflict resolution. It is often minor issues that cause big conflicts, for instance, who rides in the private plane or who uses the summer home. Having written policies around these types of issues to avoid conflict is helpful.

v. Complete a strategic plan for the family office, taking as much emotion out of decision making as possible. Successful businesses have transition plans and so should family offices; it is also a best practice to have a plan for disaster contingency and data security.

2. Communication and Decision Making

Real decision-making power and adequate information are necessary for family members to stay and feel engaged. Informational sessions, especially for younger generations, on investment products and strategies can be valuable for most families. This is also true for other complex areas such as estate and tax planning. At NEPC, we can customize an educational session for a family, tailoring it to their unique needs.

Some families may feel intimidated by individual(s) who earned the wealth. It is vital to recognize that this person may not have all the answers in every area. We recommend recognizing individual strengths and assigning a role to those in the family who wish to contribute. If the decision-making process is dominated by the wealth creator, other family members will not be engaged. An external facilitator can help families streamline their communications.

3. Structure and Management

Our clients have structured their family offices in different ways: some rely on outsourcing while others prefer to build out resources in-house; some work with multiple branches of a family, while others are focused on a single family. Similarly, vendors and professionals specializing in working with wealthy clients also do things differently: some offer a multitude of concierge services, for instance, bill pay and vacation planning, to the family, while others focus on key services such as investment, tax and estate planning. The best structure is the one that works well for the individual family, but we recommend considering the following issues:

(a) Services and costs

i. Be clear about what services will be provided, to whom they will be provided, and total cost/cost allocation method. Do not surprise any family with a cost allocation. For younger generations just starting out, the cost of family-office services can be difficult to absorb, and they may need assistance.

ii. Also, be clear on the services that the family office will provide internally and those it will outsource, or not provide at all. This should be captured in the business plan for the family office. Clearly communicating this up-front can help prevent service creep, that is, requests outside of the scope of the family office which can negatively impede its efficiency and cost management.

iii. Consider surveying family members to determine the effectiveness of the family office and the services it provides. It is important to understand the family's perception of the value added by the family office.

iv. If some desired services fall outside the scope of the family office, consider developing a list of preferred external providers that can be used as a resource by family members.

v. Key to the success of a family office is to be a central planning point for all family members. Do not have family members act alone because they do not want to incur the fees of the family-office; the outside actions of one person should not compromise your estate plan.

(b) Staffing

i. Have set rules and criteria regarding the employment of family members in the family office, to avoid the appearance of nepotism. The individual's skill set should add demonstrable value to the family office. Successful and high-functioning family offices often also require the family member have some experience working outside of the family office.

ii. When staffing an Investment Committee, have a governance document detailing who can serve on the Committee, the responsibilities of its members, the decision-making process (unanimous versus a majority vote), and the compensation of the Committee members. Investment committee members outside of the family or the family office with specialized expertise can bring objectiveness, enhance decision making and add knowledge. NEPC Private Wealth typically documents this within our clients' investment policy statements.

It is important to understand where the time and efforts of family-office professionals are best spent.

(c) Operations and Budgeting

It is important to maintain accurate and up-to-date records and develop an audit process to safeguard the document management system. These include financial records and an accounting system; custodial errors can be costly if not caught.

For family offices, paying the salaries of staffing professionals is typically the largest cost. Therefore, it is important to understand where the time and efforts of family-office professionals are best spent, for instance, negotiating big-ticket items such as leases or managing the costliness and effectiveness of service providers and vendors. Handling taxes and portfolio investments are often high value-add activities that should be prioritized.

4. Estate Planning and Trust Structure

Estate planning is a major priority for our clients. As stewards of wealth, the emphasis is on building estate plans in line with their beliefs on inheritance and philanthropy. Based on our conversations with clients and estate planners, we believe it is important to talk to multiple estate planners before selecting a firm. There are different approaches available and it is difficult and costly to modify an estate plan structure once established, so understanding your provider's approach and being comfortable with it is key. The following is what we have gleaned:

i. Many clients stress the importance of appropriate communication of estate planning within the family. While there may be valid reasons for not disclosing full details of estate planning to all family members, one should have a plan regarding how and when to disclose details.

   On the topic of communication, spouses need to be on the same page on inheritance and the level of wealth they want to pass on to their children. For instance, we have observed conflict between spouses on this issue, with one spouse wanting to limit inheritance to maximize the children's self-motivation, while the other being concerned about the children's diminished lifestyle.

ii. Be thoughtful about income tax basis when doing lifetime gifting transactions. Leave low-basis assets in the estate to receive a stepped-up basis at death. Use grantor trusts (with which the older generation can do tax-free asset swaps) to ensure that only high-basis assets are transferred through a lifetime gift.

iii. A defective grantor trust also allows the senior generation to pay income taxes on behalf of the trust which constitutes an additional gift as a tax-free transfer to the beneficiaries of the trust.

iv. Establish private trust companies in favorable states such as South Dakota. This manages the liability associated with having an individual be a trustee and can be cost effective when compared to using a corporate trustee.

v. Emphasize building in flexibility when trusts are structured. One option is the use of trust protectors who can hire and fire fiduciaries, make changes to trusts and change jurisdictions.

vi. Focus on state income taxes and avoidance of same by setting up trusts in jurisdictions without a state level income tax and accumulating income in these trusts until needed by beneficiaries.

5. Investment Trends

Our clients have great investment ideas. They are often well-connected, especially in the industries that were the source of their wealth. Private wealth clients have significant flexibility to invest in unique opportunities that are outside of the typical investment portfolio. With this flexibility also comes the responsibility to manage risk appropriately. We've observed the following investment trends:

i. There has been a growing trend of family offices taking greater interest in direct investments[2] outside of funds. This includes investments in co-invest opportunities, direct private equity and direct real estate. Some clients may also provide seed capital to a new manager for a share of the general partner interest or highly preferred fees.

   A family office's decision to execute a direct investment program requires a commitment to invest in resources within its office to source and monitor these investments. There is a risk of building out resources that are not fully utilized.

If investments are sourced in-house, it is important to have a plan on how those investments will be monitored going forward, especially if there is a change in the family office personnel where the individual who sourced the opportunity leaves.

ii. As we anticipate lower returns in the future, the tax impact and cost of investments are increasingly important. Some of our clients have developed methods to review their investments in-house on an after-tax basis.

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NEPC's Private Wealth practice incorporates the tax consequences of investing throughout our investment process, from asset allocation to investment manager selection and implementation. Our research has shown that it is very difficult for most active managers to add value after-tax for taxable clients, so the use of active managers is selective.

iii. Given this view on tax efficiency, we see clients using passive strategies for exposure to public markets and seeking alpha opportunities via illiquid investments.

iv. Coupled with a focus on taxes, negotiation of investment management fees is important. We are very active in negotiating fees with our recommended managers to reduce the cost of investing for our clients.

v. It is important for family offices to closely analyze the structure of pooled partnerships.[3] If feasible, having one pool to aggregate investments for the family is cost effective operationally, but it limits flexibility of partners. In evaluating the best structure, the family office should weigh the cost of the structures versus the desired flexibility, and think about how it will work as the family grows and its needs change over time.

vi. Impact investing[4] is becoming more common with families, especially given the push from younger generations. It is important to define what impact means to the family. When establishing an impact program, define expectations beforehand, including return expectations and ways to measure the success of the program. That said, giving can be divisive due to conflict between family members who want to promote different causes. Talking to everyone up front is important.

vii. Many clients promote the management of their family foundation to assist with family governance and unification. It is a good way for members of the younger generation to begin working with the family office.

6. Custody, Banking and Lending

Sophisticated management of banking relationships and the use of credit lines and leverage is an important skill set for family offices. This is what we have found:

i. Some of our private wealth clients recommend having at least two banking relationships;

one for custody of investment assets and one for banking/lending activity.

Related to this, we have observed a disruption in the custody business, where fee pressures have caused some custodians to discontinue working with smaller-fee clients while adding minimum fees. NEPC Private Wealth can assist clients with evaluating their custody relationship, including evaluating proposed pricing.

ii. Leverage can be useful, but it is important to think through different scenarios for margin calls and repayment if the value if the collateral drops.

iii. In discussions with banking professionals, we found that basket collateral—using a combination of different types of collateral—to secure one credit facility is increasingly being used to secure credit facilities. Each asset type has its own advance rate and the aggregate of the collateral value forms a borrowing base.

CONCLUSION

Every observation noted above may not apply to every family, but hopefully there are at least some that will resonate. NEPC's Private Wealth practice appreciates not only the uniqueness of each of our clients, but also the commonality that unites them. We look forward to sharing our experience and insights, which we believe form a valuable part of our service offering.

RESOURCES

1. *Determining Spending Levels for an individual Portfolio*, July 2019;
www.nepc.com/insights/determining-spending-levels-for-an-individual-portfolio
2. *Direct Investments*, March 2019;
www.nepc.com/insights/direct-investments
3. *The ABC of Family Partnerships*, May 2019;
www.nepc.com/insights/the-abc-of-family-partnerships
4. *Make an Impact in the Season of Giving*, December 2018;
www.nepc.com/insights/make-an-impact-in-the-season-of-giving

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