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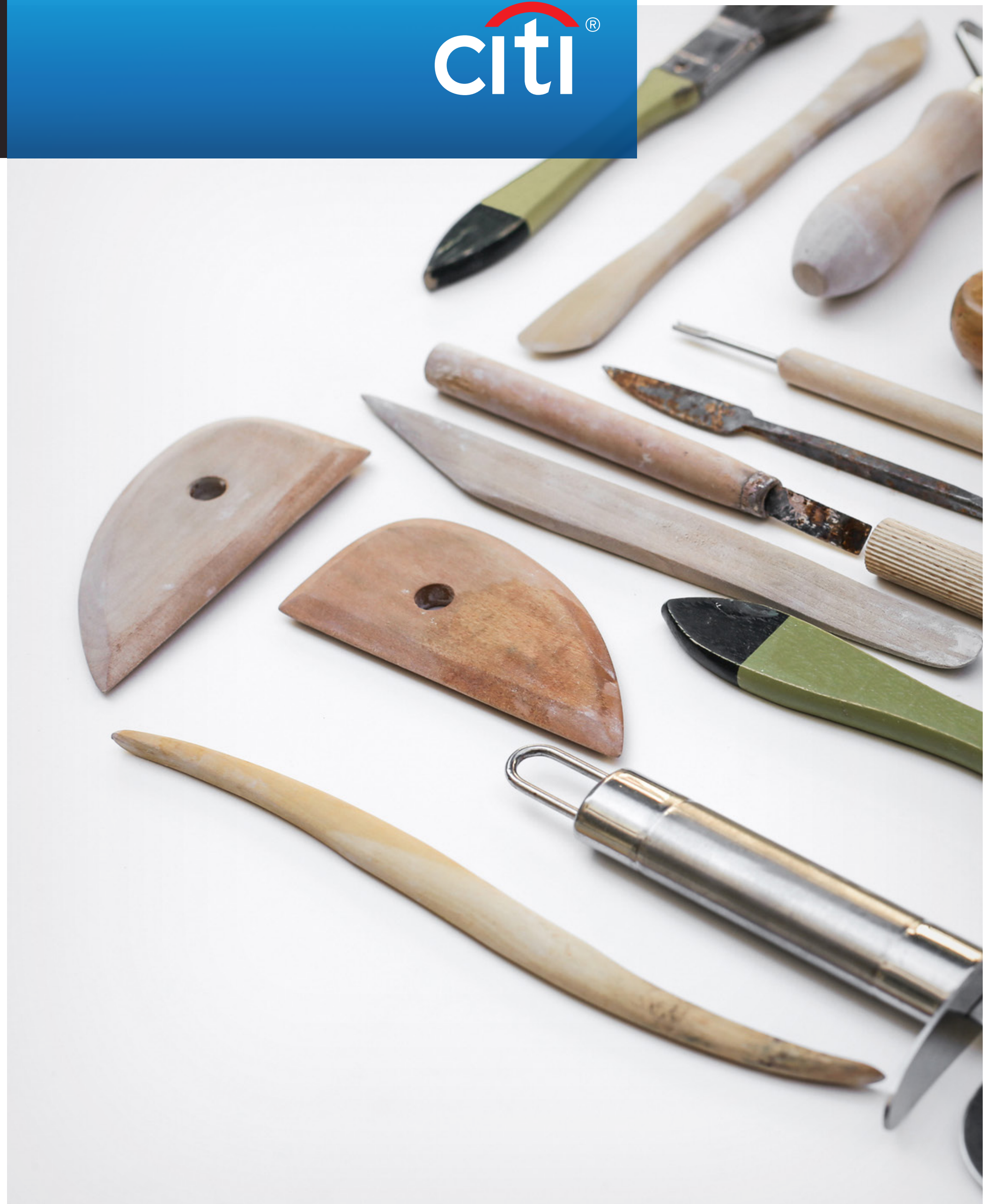

Investment management best practices for family offices

Citi Private Capital Group

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Introduction

Investment management is often seen by ultra-wealthy families as the main function of their family offices or as one of the most important determinants of their family offices' success. As a result, principals and family office investment professionals devote significant time and attention to investment decision-making. However, despite this intense focus on making specific investments, family offices frequently fail to achieve their desired portfolio outcomes, adversely impacting both families and their executives.

The investment management process is subject to numerous complexities and complications. However, failure to achieve long-term target returns and required cash flows – or suffering unexpected portfolio volatility – may actually result from an absence of robust investment processes and/or investment experience.

Increasingly, many family offices manage large and complex multi-asset portfolios spanning global markets. These often include direct investments in real estate, venture capital, and private equity. Yet, unlike some of their institutional counterparts, family offices and their foundations can lack awareness of the strengths and weaknesses of their investment processes and staffing.

Despite this intense focus on making specific investments, family offices frequently fail to achieve their desired portfolio outcomes, adversely impacting both families and their executives.

Regrettably, many family offices only take stock of their investing skills and practices after suffering sizable portfolio losses, typically due to a lack of diversification or the substantial underperformance of a larger investment. While family offices often monitor their portfolios and measure individual risk factors – such as geography, currency, sector, or counterparty exposures – family office staff and principals typically do not evaluate competency risk.

Competency risk is the threat of a fundamental mismatch between principals' expectations for the portfolio and the actual skills and experience of the family office staff. Families and their offices should not assume that there is alignment simply because both parties appear to be 'on the same page'. Effective management strategy requires an understanding of:

- The behavioral characteristics of the principals or families with respect to return, risk, and volatility
- The financial characteristics of the principal or family with respect to cash in- or outflows, unexpected drawdowns, liquidity, long-term returns, and tax/estate sensitivity
- The communication and decision-making characteristics of the principal or family
- The values of the principal or family, including intimate views on wealth, consumption, and giving

Similarly, having created an asset allocation and investment framework, there needs to be a candid assessment of the readiness of the investment resources, both internal and external. This includes determining the efficacy of the resources – staff, advisors, research, data, and systems – relative to the family's investment objectives.

This paper sets out a fundamental investment framework that embraces the best practices we have observed when working with leading family offices around the world. Central to our observations is that consistent, long-term portfolio returns are only achievable through a systematic and repeatable process, proper resource alignment, and rigorous communication amongst key participants.

Initial questions

Family offices seeking to assess the readiness and adequacy of their investment capabilities should begin by asking these three fundamental questions of themselves:

- Do we have a rigorous and repeatable investment process, a well-articulated and periodically reviewed investment strategy, and a regular assessment of results in relation to pre-defined benchmarks?
- Do we have the required in-house and/or external investment experience, people, content, and technology for proper management of the amount, type, and complexity of assets under management (AUM)?
- Do we actively manage communication between the investment team, principal(s), external advisors, and family?

The investment process

Consistent internal or outsourced investment processes have six common elements:

1. An investment policy statement (IPS) that sets out the specific objectives, timeframes, and benchmarks for the family portfolio
2. An asset allocation program that reflects family members' true risk tolerance
3. Effective portfolio construction, based on rigorous investment research and analytics and ongoing monitoring
4. Periodic in-depth performance reporting against benchmarks and goals
5. Risk management practices to manage downside risk and excessive volatility. Family office audits examining how the process works in practice can yield important information as to ability to deliver desired investment returns consistently
6. A clearly articulated decision-making and communication process

Investment policy statement (IPS)

The IPS is the cornerstone document that:

- Defines the objectives of the family's investment process
- Sets the investment parameters, including limits on individual positions and market exposures
- Delineates responsibilities, authority, and committee structures
- Specifies portfolio rebalancing frequency
- Establishes standards for benchmarking performance

The IPS also specifies the roles and responsibilities of staff, asset managers, custodians, and advisors. The process of developing a family's IPS represents a unique opportunity for family members, staff, and core advisors to identify and discuss inputs. It should foster critical dialogue and be revisited at least annually to reflect market conditions, changes in family objectives, and past experience managing the portfolio.

Asset allocation

There is a large body of academic research that confirms the critical importance of asset allocation and its effect on portfolio returns and volatility. A sound asset allocation model is one that embraces both the investment attributes and estimated return scenarios of global asset classes with the return, risk, liquidity, and behavioral biases of the family, as set out in the IPS. The output of the asset allocation process will express the optimal asset class weightings within the family's portfolio, as well as the range of probable outcomes within a given portfolio's risk parameters and liquidity requirements.

This approach involves four core elements:

1. Identifying families' primary needs and preferences as to after-tax returns, fees, volatility, risk exposure, liquidity, and areas of avoidance or preference, such as so-called 'sin stocks' or emphasis upon social impact investments
2. Analyzing asset class returns under varied volatility, correlation, and extreme downside risk scenarios
3. Assembling a range of investment allocations across core asset classes and sub-classes
4. Exercising thoughtful judgment as to the optimal mix of assets, giving proper weight to the family's true risk tolerance

Effective asset allocation demands sound quantitative skills, as well as investment judgment and experience. While modeling will produce a range of possible allocations, fine-tuning the portfolio to reflect the behavioral nuances of the principal or family is often the difference between success and failure.

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Portfolio construction

The development of an appropriate investment portfolio has two core elements: rules associated with portfolio construction and manager or portfolio content selection.

The rules associated with portfolio construction establish minimum and maximum exposures according to asset class and geography, rebalancing rules, timeframes, and the degree to which tax and fee efficiency are primary elements of strategy implementation.

Manager selection is a means by which the portfolio is implemented. It begins with an assessment of whether passive indices or active management is preferable for each asset class/sub-class and/or geographic exposure of the portfolio. For example, the ability of an active manager to add alpha – excess return adjusted for risk – after taxes and fees is a primary consideration. The use of alternative investment managers is also a key consideration for suitable investors, given the risks and long-term nature of these investments and their potential role in portfolio diversification.

Being able to construct and manage portfolios effectively relies heavily upon robust investment research, from individual manager research to macroeconomic analysis. Effective family offices develop external resources that allow this often overwhelming amount of data to be accessed, synthesized, and evaluated efficiently. Often, these resources include investment advisory boards, consulting firms, and private banks. The role of the family office is to select these external resources carefully and deploy them in order to implement the IPS. The goal is to seek superior risk-adjusted returns, regardless of where the investment management content originates.

Increasingly, family offices engage a more diverse range of asset managers based on their style, asset type or geographic focus.

Performance reporting

As investment portfolios have grown in complexity, size, and diversity, performance reporting has moved center-stage. Increasingly, family offices engage a more diverse range of asset managers based on their style, asset type, or geographic focus. This makes it exponentially more difficult to integrate, analyze, and report performance, given the variety of factors from currency to infrequent asset valuations. Many family offices turn to master bank custodians or consolidated reporting solutions to address the integration of tax-lot level account data, processing of corporate actions, and report preparation. The best solutions provide performance data versus custom benchmarks for each asset class, asset manager, and family branch, identifying key portfolio characteristics and risk metrics.

Risk management

Risk management begins by identifying core risks that may impact the portfolio. These portfolio risks fall into two broad categories: systematic or market-level risk and non-systematic or security-specific risk. Based on this analysis, family offices must define practices that measure and monitor these risks, as well as identifying pre-defined risk mitigation strategies. For example, families with concentrated stock positions or large interest-rate sensitive liabilities will often employ hedging strategies. Additional key areas of portfolio risk management and reporting include:

- Exposure risk: factors that give rise to positive and negative returns
- Counterparty or agency risk: concentration or absolute exposure to one or more firms who issue, manage, hold, transact, or control assets
- Illiquidity risk: the likelihood of being unable to access portfolio funds within one or two quarters, largely due to bankruptcy, lock-ups, side-pocketing, extensions of fund life by general partners, or unpredictable portfolio exits

Competency risk

In many ways, competency risk is the least acknowledged and discussed risk in family office practice. This is particularly true for offices that have complex, multi-asset portfolios, but also limited staff resources or investment experience. Competency risk can be further increased by investments in hedge fund strategies or direct private equity and venture capital investments, which require even greater depth of experience and skill on the part of family office staff. The same can be said for executing complex capital markets transactions.

Family offices experience competency risk in different ways. At the extremes, some do not build adequate comprehension of investment strategies and products, and instead delegate the knowledge and responsibilities to third parties, believing their interests will be well-served. Others adhere to the belief that there are few limits to their ability to manage investment assets, skill, and experience notwithstanding. Not recognizing their limits and how to mitigate the risks thereof can lead to disastrous outcomes.

The best way to understand and mitigate competency risk is by candidly and thoroughly identifying the strengths and weaknesses of the family office resources – staff, technology, content, and investment practices – relative to the investment demands being made of them. Based on the outcome of this assessment, competency gaps can be identified and filled internally or externally, or investments can be avoided.

Numerous external alternatives exist for family offices that wish to address their shortfalls in research, investment, trading, or manager monitoring. Even the most sophisticated family offices or family investment companies can experience such shortfalls.

Family offices experience competency risk in different ways.

Communication

Communication among family members and family office executives and staff is a critical element for success and a major risk factor. We often observe that communication is overlooked or taken for granted. A comprehensive approach[1] to managing communication has four dimensions:

- **Principal communication plan** – understanding the principal's behavioral and decision-making patterns, defining the mode and frequency of communication, and creating a 'common language' to enable clarity and efficiency of interactions between principal and family office.
- **Investment team communication** – having essential team meetings and communications organized around the lifecycle of the portfolio, examining returns, risk, managers, fees, performance attribution, and other factors. This all needs to be organized so as to avoid 'groupthink' and 'personality cult' tendencies, such as emulating the attitudes and behavior of the principal. Proper minutes and records of team communication should always be maintained.
- **Family communication** – a careful delineation should be made of what content needs to be shared with specific family members. This should be based upon role and asset ownership, the form and frequency of communication, education, and decision-making based upon member preference.
- **External advisor/manager communication** – most often, this will cover macroeconomic and market updates, changes in investment thesis, reviews of allocations and investments, and a forward-looking view of the portfolio and factors that would trigger changes in it. The frequency of such communication and meetings is based upon the nature of the advisor/manager role and relative importance to the portfolio. Written records of suggestions, actions, and follow-ups should also be maintained.

[1] Stephen Campbell, "Impact of Communication in Family Office Investing", Family Office Elite Magazine, 2017.

The investment process inventory

Inventorying investment policies and practices, as well as their effectiveness, should be a periodic exercise. Some family offices assess their own capabilities, while others use consultants to assess operational effectiveness. Regardless of approach, answering the following questions is critical:

1. Do we have core investment processes in place or do they need to be put in place given any unique characteristics and changing needs?
2. Are our investment processes implemented in a consistent way?
3. How do our portfolio returns compare to relevant benchmarks and peer group data?
4. Do we have the right resources – people, experience, data, and systems – to carry out these processes consistently and effectively over the long term?
5. Does it make sense to augment or substitute these activities by outsourcing them?

Family offices often report the greatest confidence in their skills at the peak of bull markets and the lowest confidence after suffering meaningful losses.

Build or buy

Following the global market turmoil of 2008, many family offices came to realize that they lacked the necessary staffing and skills to manage their investments properly. But as memories of that episode fade and rising markets produce strong returns, many family offices are at risk of reverting to their prior over-confidence. Tellingly, family offices often report the greatest confidence in their skills at the peak of bull markets and the lowest confidence after suffering meaningful losses. When it comes to management of wealth, family offices generally face a choice between building up resources and capabilities such as people, technology, and research, or limiting their investing activities based on their available resources or skills. Problems often occur when there is a fundamental mismatch in two areas:

1. Too few resources or too many resources and costs
Family offices are prone to ending up at both extremes. They attempt to invest with insufficient resources, or overpay relative to their investment returns and risk exposure, particularly when both direct costs – staff – and indirect costs – manager fees, carried interest, and custody fees – are factored in.

2. Insufficient skill and experience to manage large and complex multi-asset portfolios. Family offices can be costly endeavors and principals may be tempted to overreach in an effort to economize on outsourced services. Much like any business, family offices must determine where and how they will spend so as to achieve a competitive advantage. Mediocre investment staffing rarely produces desired results. Periodically assessing the costs, benefits, and investment readiness of an in-house investment organization invariably leads to the question of whether to build, buy, or pursue a hybrid of these two approaches. The factors influencing this decision include:

- The inability to hire and retain experienced investment talent
- Rising costs of staffing
- Inability to achieve scale efficiencies (too many resources to support too few AUMs)
- Difficulty accessing best-of-breed asset managers
- Complexity of new alternative investments
- Portfolio losses
- Lack of confidence in staff
- Behavioral traps and uncertainty about the investment climate

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Selection of an advisor

Many family offices wish to create a core set of investment processes and practices that are independent of the staff they may have today. This can help sustain family wealth over many generations even when the personnel running and working for the family office changes over time. Family offices should thus select an advisor who:

1. Has a genuine **open architecture approach** to screening and recommending asset managers rather than favoring certain providers' in-house products and funds. Exceptions to this rule may include cash, core fixed income portfolios, use of passive investments, or when the advisor also acts as discretionary asset manager

2. Is **fully transparent** about all fees and conflicts

3. Has **broad experience** and **substantial staff** in such areas as asset allocation, manager research and monitoring, financial reporting, and risk monitoring/management

4. Has the **technical capacity** to monitor and help direct all other asset managers or sub-advisors

5. Has a **central focus** on family offices' unique needs that is not simply a by-product of advising large endowments and foundations or smaller clients with smaller AUM

6. Can offer **technology solutions** to the family office, as well as provide training and education for family members and staff

7. Can effectively **support the investment decision-making** of the family office

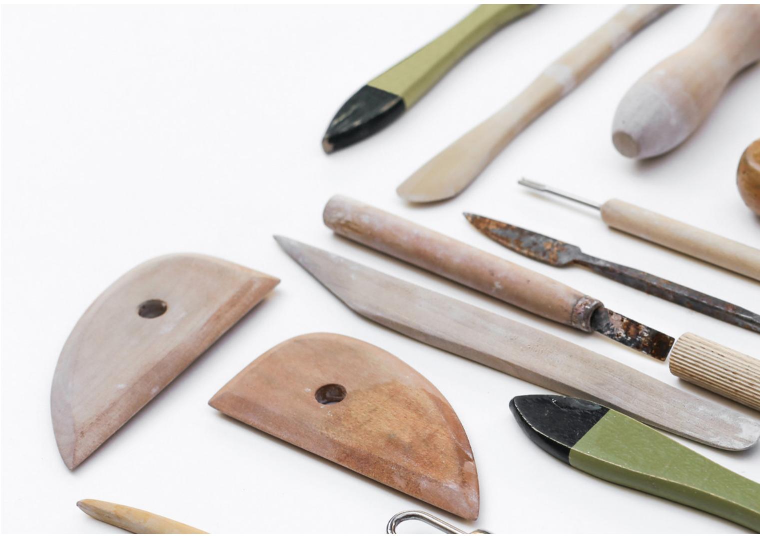
Third-party provider models

While many outsourcing models and providers exist, family offices most often select from a range of consulting firms, private banks, brokerage houses, trust companies, and multi-family offices (MFOs) to find the solution that makes sense for them. The basic provider models include:

- **Quarterback**
  In an American football team, the quarterback plays a pivotal role, directing the team's attack. A 'quarterback' advisor analyzes and monitors all assets, regardless of which firm is managing the underlying accounts or funds. Private banks, certain brokerage firms, trust companies, and select MFOs are often the principal providers.

  Benefits: The family has a comprehensive asset allocation, research, monitoring, reporting, and risk framework. This model is often beneficial to families who do not want to hire in-house investment staff and want to invest with a variety of firms.

  Drawbacks: Closed architecture firms – those that recommend their own funds – may create potential conflicts. Skill and experience may vary greatly by firm.



- **Investment consultant**
  A consultant focuses largely on manager research and portfolio construction using a defined universe of manager coverage (core, alternative, and specialty funds). Consultants may be small boutique firms or large advisors that serve endowments, foundations, private clients, and corporations.

  Benefits: Access to a broad range of manager research, global reach, institutional quality, and well-resourced teams. Family offices can isolate manager research and selection from all other aspects of asset allocation modeling, reporting, and risk management, which can be provided by other firms or carried out in-house.

  Drawbacks: The large consulting firms often cover larger funds to be able to provide access to their sizable client base, generally charge higher fees, and potentially react slowly to changing market conditions. There are potential challenges scaling to the personal requirements of a family.

- **Manager of managers**
  The manager of managers assembles custom portfolios – for example, asset managers, funds, and separate accounts – often in strategies that are difficult to research, access, or monitor without the benefits of a larger team and purchasing scale. Assets may be managed on a discretionary or advised basis. Banks, private banks, select mutual fund companies, brokerage houses, and MFOs are the primary providers in this area.

  Benefits: Family offices can hire advisory firms with specialized skills and depth in specific asset areas to create one or more customized portfolios.

  Drawbacks: Often higher fees, limited fund selection, potential for conflicts and liquidity management.

Outsourcing

Which family offices most often benefit from outsourcing investment processes and advice? Outsourcing works well for family offices whose families who have a clear understanding of their needs and are comfortable sharing their information with third parties. Outsourcing is not necessarily a binary decision. Many will outsource services if:

- The cost of outsourcing – including all fees – is less than what it would cost to perform these services internally. Fixed income and cash management are often cited examples of such services
- The expertise required to manage the assets effectively exceeds internal capabilities

Some families choose to maintain an in-house investment team of varying sizes and skills to assist in processing advisor recommendations, to undertake specialized investments not offered by the advisor – such as direct venture capital or real estate – or to augment the advisor team's specialized research efforts.

The benefits of outsourcing investment process often include access to:

- A wide range of investment resources - often worldwide – such as sector specialists, country specialists, economists, manager research, and due diligence teams
- A diverse range of asset managers and sophisticated ideas
- Technology, content, and tools that would not be cost effective if sourced directly
- Ability to augment specific content, skill, and experience gaps internally

Much of the value provided by such external advisors comes from the investment discipline, ideas, and focus they bring to the investment process. Effective advisors will listen, but also push back when actions taken deviate from sound investment practices or the stated policy parameters agreed with the family. The most often cited problems associated with outsourcing include:

- Hiring the wrong advisory firm given a family office's unique needs
- Poor portfolio results or failure to deliver on promises of alpha
- Lack of transparency around potential or actual fee conflicts
- Necessity to 'piggy-back' the firm's investment themes of the firm
- Perceived loss of control or customization

Conclusion

The failure to achieve consistent long-term portfolio returns is often incorrectly attributed to poor investments, adverse economic conditions, or hiring the 'wrong' asset managers. However, the underlying causes of poor or inconsistent portfolio returns in family offices can often be traced back to deficiencies in process, resource allocation, and communication. Examining, understanding, and codifying practices around the factors outlined in this paper can provide the essential architecture to support consistent long-term portfolio outcomes.

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Previously, he was Chief Investment Officer of a Seattle-based family office, and has held senior investment and technology roles with Fidelity Investments in Europe and the United States. Stephen was Founder and Chief Executive Officer (CEO) of two financial technology companies, and has led investments in numerous early-stage companies.

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