FAMILY OFFICE INVESTMENT MODELS®

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MARTIROS STRATEGIES

INTRODUCTION

Many successful entrepreneurs and families choose to set up family offices as a convenient and efficient way to coordinate the management of their wealth. Known as Single Family Offices or SFOs, these private companies are designed to serve one family or related family group. Single Family Offices should not be confused with Multi Family Offices, which are businesses that provide family office-like services to a number of clients.

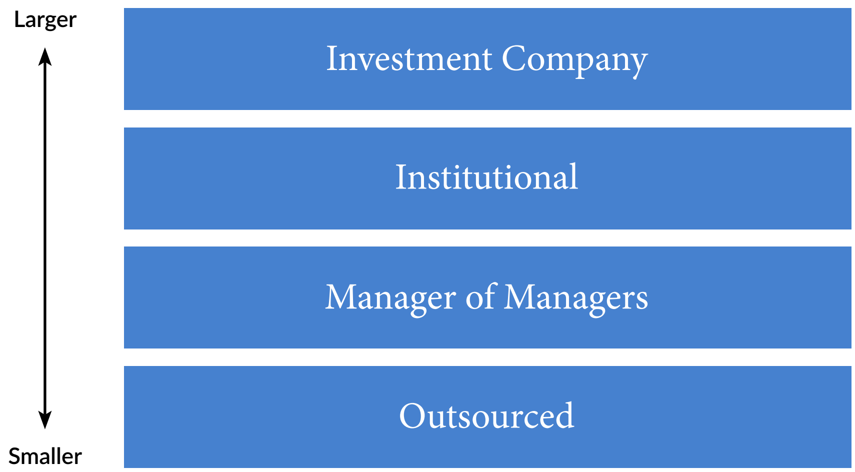
By and large, the activities of a family office can be divided into two main groups, services-related and capital-related (investments). This paper is focused on capital-related functions of a family office. The purpose of this guide is to classify and describe the investment models employed by Single Family Offices to help people better understand their options and the impact of their decisions.

One of the great advantages of a family office is the ability to create a customized investment solution for current and future generations. It is therefore essential that family members clearly identify their objectives and understand the true operating expenses and opportunity costs of their chosen family office investment model.

Each family needs to evaluate family office investment models based upon other criteria, such as the impact on their time and personal privacy, the potential for regulatory oversight and government reporting, the degree of control they desire over the process, and whether they want to use the family office as a means to develop the investment knowledge and skills of individual family members. In order to ensure a well-run investment operation, a strategic plan, operating budget, investment committee, formal governance structure, and annual audits are highly recommended.

FAMILY OFFICE INVESTMENT MODELS

It is widely assumed that family offices are by design, investment offices. And while most family offices are involved in overseeing investments, the actual investment process can be quite different from family to family. In fact, by examining the process by which investments are managed, one can identify four distinct models.



The Outsourced Model

With the Outsourced Model, the investment functions of the family office are outsourced entirely to an independent multi-family office or wealth management company that provides asset allocation, manager selection, analysis, and reporting. Typically, these service providers charge a bundled fee based on a sliding scale of assets under management. (Services like bill paying and property management may also be available through an outsourced provider.)

The Manager of Managers Model

With the Manager of Managers Model, the family office makes asset allocation decisions, and evaluates, selects, monitors, and tracks external investment managers. Those external managers then oversee the securities analysis and portfolio management process of the investment fund for which they're responsible. One of the challenges of the Manager of Managers Model is the need to evaluate a broad number of asset classes and investment managers with a small family office team—often numbering only one or two people. Family offices should consider supplemental research to support their internal research capabilities, and in certain asset classes such as hedge funds and private equity, fund of funds may be used as a way of offloading due diligence to a specialized research team.

The Institutional Model

With the Institutional Model, the family hires an independent investment consultant and creates a process that is similar to the process employed by an endowment or foundation investment committee. The investment consulting firm provides asset allocation and manager selection research, due diligence, and recommendations. The family office then decides whether and how to implement the recommendations, usually by a vote of the family office investment committee. The family office usually handles the implementation process (e.g., establishing accounts, wiring money, verifying transactions, etc.), although some investment consultants now offer this service for an additional fee.

The Investment Company Model

With the Investment Company Model, the family office is structured like an investment management company or hedge fund, with the entire investment process managed internally. The Investment Company Model requires hiring experienced investment professionals and building research, trading, operations, and compliance functions. Compensation structures are often tied to investment results with profit sharing arrangements. The family office investment team may include family members and may be separated both physically and legally from the family office service functions.

THE INVESTMENT PROCESS

While there are no structural limitations that would lead a family to choose one model over another, the total asset base of a family office will influence the cost-effectiveness of the chosen model. Families with relatively smaller capital bases will likely find an Outsourced or Manager of Managers model more attractive, while those with larger capital bases will find the Institutional and Investment Company models more cost effective. Let's look at why.

Assembling a deep team of investment professionals is an expensive undertaking that can be a drag on the family's overall portfolio return. For example, let's assume a modest investment team can be put together for an annual cost of $1 million. If a family's asset base is $100 million, the cost of the investment team alone is 1 percent of the family assets per year, and that doesn't even factor in technology, custody, accounting, legal, insurance, travel, office, and external investment management expenses. For a family with $500 million, on the other hand, the $1 million annual cost equates to a much lower drag of only 20 basis points per year.

The design of a family office investment model will depend upon which core investment activities are managed internally by the family office, and which are managed externally by financial and investment professionals.

These core investment activities can be broken down into the following categories:

- Asset Allocation
- Manager Due Diligence
- Securities Analysis and Portfolio Management
- Direct Investments
- Portfolio Reporting and Analytics
- Risk Management

Asset Allocation

Choosing among various asset classes such as cash, bonds, stocks, real estate, commodities, and alternative investments* (i.e., hedge funds, private equity, venture capital, etc.) is a process known as asset allocation. Each asset class constitutes a segment or "slice" of an asset allocation model. Asset Allocation establishes the general direction and boundaries for your investment strategy, and is usually undertaken annually with adjustments made quarterly.

Asset allocation requires balancing a family's objectives and risk tolerances with the risks and opportunities predicted under various investment scenarios.

* *Note: the term "Alternative Investments" is often misused to describe a single asset class when in fact it's a term that describes a number of asset classes including private equity, venture, and hedge funds. For example, a hedge fund may be classified as an alternative investment but it may be focused on stocks, bonds, or commodities. The proper classification of a manager should reflect the makeup of the underlying portfolio (i.e., stocks) and not the investment vehicle type (i.e., alternative investments).*

Manager Due Diligence

Deciding which investment managers or investment products to use requires ongoing due diligence and monitoring. The process usually involves evaluating investment managers based upon investment criteria that are established by the family office.

Investment managers tend to specialize and their results must be compared to both market indexes and managers with similar investment strategies. With thousands of managers and investment products to choose from, due diligence requires dedicated effort and expertise. In order to diversify risk, family offices often use several managers for each slice of their asset allocation plan, particularly in those asset classes that are considered high risk (e.g., hedge funds) or where investment cycles are a major factor (e.g., private equity, venture capital, or real estate).

So for example, if a family office's asset allocation plan has 7 asset classes (slices), each employing several managers, it's easy to see how the family can be working with dozens of different managers. That kind of complexity makes aggregated reporting and analytics vital. Family offices must be able to measure the results of their overall portfolio and the results of each manager on an apples-to-apples basis. Thus the time period and overall market returns must be compared accurately to make informed decisions.

Securities Analysis & Portfolio Management

The primary role of an investment manager is to evaluate individual securities (generally stocks, bonds, and futures), and create a portfolio of securities that balances risks with potential returns. This process is managed through one of the following types of investment vehicles: a separate account, a partnership, or a publicly available comingled fund (e.g., mutual fund, ETF, index fund).

Direct Investments

Many family offices make direct investments in start-up ventures, operating companies, real estate projects, loan syndicates, and a variety of one-off deals ranging from local investments in restaurants, hotels, and retail stores to technology start-ups in the medical, energy, and software industries.

While direct investments can be profitable, family offices must have the means to research and oversee their direct investments, which often require time-intensive hand-holding and active management. Some family offices share their direct investment due diligence with other potential investors to leverage their research capabilities.

Portfolio Reporting & Analytics

Family office investors need to simultaneously manage three major objectives: achieve long term growth of their capital with limited volatility; obtain predictable and growing cash flows from interest, dividends, rents, royalties, and capital gains; and minimize friction from taxes, fees, and investment losses. Investors also need to understand what they own, how they are doing, and what they should be doing in the future.

That's a lot of crucial information to keep track of, which is why portfolio reporting and analytics requires a dedicated effort. The truth is, many Family Offices struggle in this area because of the difficulty of obtaining comprehensive information in real time. And that's why reporting and analytics is often considered the Achilles heel of family office investment operations. The good news is that a number of master custodians and software companies now provide more automated and integrated reporting tools and solutions.

Risk Management

Risk management is the continuous process of staying abreast of changing market conditions. At the heart of a risk management process is an information management system that allows the family office to measure and monitor risks in an accurate and timely manner. Some of the more common investment-related risks that require ongoing monitoring are: issuer risk, manager risk, counter-party risk, interest rate risk, liquidity risk, currency risk, and geo-political risk.

Some of the more common methods for managing investment-related risks include diversifying portfolios across a number of asset classes and investment managers, hedging risks, and simply avoiding risks.

FAMILY OFFICE INVESTMENT MODELS COMPARED

The family office investment model will be determined by where core investment functions are managed—either internally by the family office or externally by financial service providers. The following tables show how the family office investment models compare.

IN-HOUSE INVESTMENT ACTIVITY BY TYPE OF INVESTMENT MODEL

	Outsourced	Managers of Managers	Institutional	Investment Manager
Asset Allocation	No	Yes	Yes	Yes
Manager Due Diligence	No	Yes	No	Yes
Securities Analysis & Portfolio Managment	No	No	No	Yes
Direct Investments	In some cases	In some cases	In some cases	Usually
Portfolio Reporting & Analytics	No	Yes	No	Yes
Risk Managment	No	Yes	Yes	Yes

Outsourced

Key Skills and Roles
Executive Director, Executive Administration

Technology
Most technology is provided by outsourced wealth manager. Secure family portal and document storage.

Cost Structure
Outsourced registered investment advisors charge annual management fees typically ranging from 30 to 60 basis points based upon complexity, scope of services, and wealth level. In addition, asset management fees charged by investment managers range from approximately 20 basis points for index managers to 200 basis points plus a carried interest for many alternative asset class managers.

Manager of Managers

Key Skills and Roles
Chief Investment Officer, due diligence analyst(s)

Technology
Asset manager databases, master custody, account aggregation, economic research, portfolio accounting. Secure family portal and document storage.

Cost Structure
Internal due diligence team compensation. In addition, asset management fees charged by investment managers range from approximately 20 basis points for index managers to 200 basis points plus a carried interest for many alternative asset class managers

Institutional

Key Skills and Roles
Chief Executive Officer, Investment Committee Members, Controller

Technology
Master custody, account aggregation, portfolio accounting. Secure family portal and document storage.

Cost Structure
Executive compensation and board member compensation. External investment consulting services, which typically have minimum annual fees between \$100,000 and \$250,000 and/or 20 to 25 basis points on assets under management. In addition, asset management fees charged by investment managers range from approximately 20 basis points for index managers to 200 basis points plus a carried interest for many alternative asset class managers.

Investment Manager

Key Skills and Roles
Chief Executive Officer, Chief Investment Officer, Controller, Portfolio Manager, Portfolio Analysts

Technology
Portfolio management system, trading systems, accounting systems, investment research services. Secure family portal and document storage.

Cost Structure
Skilled investment professionals are generally highly compensated and difficult to retain in a family office setting without a profit-sharing arrangement. However, by employing the Investment Company model, a family office saves on many of the fees associated with asset allocation, manager due diligence, and asset management. Technology costs and information service subscriptions will generally be higher than other models.

SUMMARY

One of the great advantages of a family office is the ability to create a customized investment solution for current and future generations. It is therefore essential that family members clearly identify their objectives and understand the true operating and opportunity costs of their family office structure. Given the financial resources involved in family offices, a strategic plan, annual audit, operating budget, and formal governance structure are highly recommended. Finally, each family needs to evaluate alternatives based upon other criteria, such as the potential impact on their personal privacy, the degree of control they desire over the process, and whether they want to use the family office as a means to develop the investment skills of individual family members.

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Stephen Martiros is a wealth—management expert who has advised private investors and family offices for more than 25 years.

Stephen is the founder of Financial Building Blocks®, a modular education system that helps people master the basics of personal finance. This proprietary software application is effective for both individual and group learning, and is easily tailored to the specific needs of individuals, families, companies, and organizations.

Previously, Stephen founded and served as CEO of Summitas®, an award—winning cloud software company that provides family offices and investment advisors with a secure platform for creating a virtual family portal and an encrypted digital vault. He was awarded multiple patents for interactive advertising and an animated user interface for computer displays.

Stephen also served as the Managing Partner of CCC Alliance, where he helped build America's largest private knowledge network of single—family offices, and led CCC Alliance to the "Family Office of the Year" award presented by Institutional Investor's Private Asset Management magazine.

Stephen began his career as an investment advisor with E.F. Hutton (now Morgan Stanley) and later worked with Alex. Brown & Sons (now Deutsche Bank). He received his BS and MBA from Babson College, where he serves on the Board of Overseers, and is a recipient of the college's Snyder Award for Distinguished Service. He lives with his wife and children in suburban Boston.