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Families first: Can single-family offices survive?

Charles Lowenhaupt - 28 April 2009

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What is the future of the single-family office?

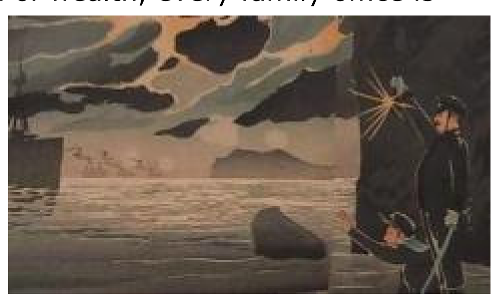
It's a question I hear from wealthy families around the world. It's a question being asked by many who work with and for single-family offices. It emerged as the central question in the **Family Wealth Alliance**'s recent survey of single-family offices.

And the answer is clear enough: the single-family office as we know it today is in trouble.

For some time, single-family offices have been struggling with a series of issues.

- How to provide for smooth transitions to next-generation office staff?
- How to align the interest of employees with those of the family?
- How to handle multi-jurisdictional families and investments?
- How to provide comfort to multi-cultural families?
- How to give family members the freedom to live their lives as individuals without the burden of managing the family office?

Now, in a world shaken by the collapse of **Lehman Brothers** and the **Bernard Madoff** scandal and the widespread destruction of wealth, every family office is facing budgetary and operational challenges. With high fixed costs and investment portfolios down, the percentage of the family's wealth needed to run the office is now much higher than it was a year ago. Unlike "multifamily" offices or investment advisories, where fees are often fixed as a percentage of assets, a single-family office pays salaries that bear no direct relationship to the value of the family's wealth. In addition, this increase in the percentage of wealth required to run the office comes as operational costs increase because of a greater need for "due diligence" processes.



Of course *multi*family offices are under pressure from lower asset values and higher due-diligence costs, but they can generally attract new clients while maintaining their cost structures, and build efficiencies through technology and various platform adjustments. A single-family office is designed specifically to meet the needs of a single family -- often in areas well beyond their bare investment needs. Efficiencies of scale and platforms adjustments aren't always possible where individualization of service and personal attention remain core missions.

Reckoning

Weighing increasing costs and against increasing needs is likely to result in a shakeout as families and their staff focus more closely on family-office management.

The CEO of single-family office recently told me of a visit from the family patriarch. "We are now spending 100 bps on this office and it used to be 60 bps," the patriarch said. "Our portfolios are down 40%, even though we spent money on all kinds of experts." The patriarch then asked for a budget of 50 bps for 2009. As it happened, the CEO had been preparing a proposal to increase the budget of the office to develop new diligence and practices as protection against further decline in value and to develop new methods of dealing with family members who were themselves re-evaluating their own budgets.

Economic pain has also opened up the long-standing issue of aligning the family's interests with that of the staff's. A family member who uses his family office told me recently that the office had an innovative compensation program for its executives to encourage them to be entrepreneurial in their investment philosophy. The result was that the family office staff was compensated on the basis of annual "profits" (much like the staff at **Harvard**, he said). Over the past 10 years, substantial bonuses were paid, even as the family's portfolios depreciated. "Where is the alignment of interest?" the family member asked.

Many single-family offices have been created over the past fifteen years. They have been designed around investment performance and exalted the hedge funds and alternatives that were being sold by the "smart" institutions. Frequently, investment perspective was short-term relative to the time horizons of the family and sometimes highly leveraged to the point of recklessness. Though there might have been focus on "governance structure" and family continuity, fundamental principles about how the wealth is to be managed pursuant to sound, disciplined process were not in place in many family offices. That's why single offices were among those hit hardest by the Madoff debacle. Too many offices allowed him to manage their entire portfolios -- just as many others were among the most blind to Lehman's now obvious vulnerabilities.

One effect of the past 18 months on single family-office professionals is a stark recognition that costs have increased and must increase further. Even a "bare bones" family office takes more of the family's wealth today than a year ago -- and it is less adequate to meet a family's needs. And these realizations come as more than a few family members are losing faith in the single-family office and its systems as a result of investment performance in 2008 and the general increase in distrust of those in the financial-service industry.

Sound process

One way to restore trust is to embrace principles like those set out in **Principles of Private Wealth Management**. However, a key question is whether single-family offices weakened as they are have the resources to implement them.

Embracing and implementing those principles and continually assessing whether they are being met will require additional infrastructure costs at a time when owners place a premium on cost reduction. For example, there is additional expense to hire an independent custodian or to engage an auditor to monitor the transparency of managers. Family after family has told me that the adoption of sound wealth-management principles is crucial and worth the cost. But how can a single-family office justify that while the frustrated patriarch who just lost 40% of the family's legacy is looking to cut the budget by 50%?

The re-evaluation of the single-family office is moving family by family, often silently. We are finding that family offices are coming to us asking whether we can help them reduce costs and improve service. Others knowledgeable about family offices are receiving similar inquiries. Building efficiencies into family offices is not difficult. But it must be strategic, with the focus on reducing costs -- where they can be reduced -- without destroying the fabric of individualized service.

We can see that many single-family offices are not working -- that some in fact have failed. At the same time, there are few, if any, options for families that want customized, discreet, caring, dedicated service to last over generations. After all, many families build the single-family office to eschew platforms and efficiencies built into the functions of most banks and multi-family offices.

So what is likely to happen?

Over the next year, the well run single-family offices that want to remain single family offices will conclude that costs should go up relatively and absolutely. The 80 bps currently being paid to run the single family office will likely require an increase to 150 bps because the short-cuts of the past can no longer be tolerated in a post-Madoff world. Thoughtful consideration will reveal that a functioning single family office is about service not economies, but economics will take new precedence for many. For those wealthy families that want a dedicated office, the road ahead is likely to be bumpy. -FWR

The illustration for this column is a detail from a Japanese woodblock print in the Charles A. Lowenhaupt Collection.

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