

WHAT DOES IT TAKE TO SET UP AN EFFECTIVE “FAMILY OFFICE”?

By Jorge Becerra, John Rose, and Cristián Caraff

IN HIS RISE FROM bookkeeper to oil baron, John D. Rockefeller amassed a family fortune that would be worth hundreds of billions today. Although matching the Rockefeller family’s fortune may be beyond reach, many business leaders succeed in generating substantial wealth from family-owned businesses.

Managing family wealth presents unique challenges, because the required capabilities are, in many situations, quite different from the entrepreneurial skills that enabled the family to build its thriving business. Recognizing the challenges, most family-business leaders establish a separate organization—a “family office”—to manage assets unrelated to the business operations.

Although there is no single standard to follow, a family can set up a family office that is well suited to managing its wealth and that can provide a broad array of other services. In addition to taking into account the size and diversity of the family portfolio, it is critical to consider the family’s invest-

ment objectives, risk appetite, and desire to maintain control over wealth management. The needs and objectives of different generations are also important factors in determining the right approach.

An Evolving Mandate to Support the Family

Family offices usually begin as small operations focused on managing the wealth generated by existing businesses. Typically, financial advisors and wealth managers run the family office, although a family member with investment experience might play a leading role in some cases. Over time, as the wealth increases, roles and responsibilities within the family office evolve, reflecting the range of skills required to manage different types of assets effectively and to do a better job of responding to the family leader’s objectives. Many family offices also take on additional roles in support of the family, providing, for example, concierge services, tax planning, personal estate planning, and assistance with philanthropic activities.

Beyond these core responsibilities, some family leaders use the family office to mentor and empower the family's younger generation. To "pass the baton," the family leader, in many cases working with trusted advisors, takes the opportunity during family office meetings to share his or her knowledge of business topics. Also, the leader and advisors discuss developments in the global and local economies and the opportunities and threats these represent. The leader can likewise share his or her hopes for future generations, instilling values that will perpetuate the family's legacy. In family office meetings, the leader can provide such mentoring with much more freedom than would be possible within the context of day-to-day business operations, which may involve investors who are not family members.

Family offices with the broadest mandate can combine their "hard" responsibilities, those related to managing liquidity and deploying capital, with "soft" responsibilities, which are aimed at helping the family set and achieve its aspirations. The family office might support the family in determining the best uses—for example, building an entirely new business portfolio or pursuing new initiatives in philanthropy—of the liquidity that results from the sale of a business unit.

In one case, a family office was the vehicle through which a family with businesses heavily concentrated in one country managed to diversify its geopolitical risk and protect its wealth for future generations. To help the family expand its investment activities globally, the family office focused on building a portfolio of international fixed-income instruments aligned with the family's desired risk-return profile. To perpetuate the family's know-how and values, the family leader enlisted the help of trusted advisors on the family office's board of directors to mentor the next generation.

Another family sold its business after many decades as a leading national food retailer and set a new aspiration: to become a global financial investor. To accomplish this transition, the family decided to move the

family office's base of operations from South America to New York City and strengthened its management and governance capabilities.

Segmenting the Portfolio: Financial Assets Versus Real Assets

As a first step in evaluating how to set up its family office's wealth-management services, a family should segment its portfolio into different asset types, distinguishing purely financial assets from those over which the family intends to exert management influence.

Financial assets are securities or other investments that do not give the family influence over the management of the underlying asset. Examples include minority ownership positions in companies and investments in hedge or real estate funds. In general, the portfolio of financial assets is diversified and investments are liquid positions that can be easily sold. To manage financial assets, the family office must possess the capabilities to, for example, allocate risk effectively within the portfolio and conduct market research. Furthermore, to be cost competitive relative to external providers, the family office should ensure that its front and back offices and its transaction systems are optimized for operational efficiency, the specifics of which will vary with the amount of capital managed.

Real assets are those that allow the family to exercise some degree of management authority over the underlying asset. These might include majority ownership positions in another company, minority positions with board representation, or real estate investments that entail active involvement in development or management. Real assets are long-term investments that cannot be easily sold, and a real-asset portfolio is usually concentrated on fewer assets than a financial-asset portfolio.

Given their entrepreneurial background, many family-business leaders regard investing in real assets as being closer to their core skills and experience than purely

financial investing. Still, it is critical that the family not underestimate the attendant complexity and challenges. To invest in real assets, families and their executive teams must maintain a broad network of contacts within the business community and government. In so doing, they can learn about and pursue opportunities that may not be accessible to the broader market. The family must also have capabilities to evaluate the economics of opportunities and to negotiate and close deals. Ideally, such investments are guided by a strategic plan for pursuing initiatives outside the main family business. Additionally, to foster value creation, the family needs to oversee and evaluate the strategies, governance, and management of the businesses over which it maintains control or influence.

Designing the Office

In order to implement the right structure and mechanisms for its family office, the family should delineate responsibilities, establish governance, and measure performance.

Delineate Responsibilities. Family offices need to explicitly define what they will and will not do. In general, the family office should retain responsibility only for activities whose value gained from in-house performance outweighs the additional cost and complexity. Other activities can be outsourced.

Experts in the family office should set the overall strategy for risk and allocation of financial assets, but activities such as stock picking can generally be outsourced to a financial institution. To manage real assets, the family office should define the investment guidelines that describe which deals to look for and the decision process for determining which deals to pursue. Whenever necessary, the in-house team should seek expert advice from investment bankers, lawyers, and consultants.

A clear delineation of the family office's responsibilities is not always easy to accomplish. Family members and executives may change their preferences regarding the investments that are worth pursuing, so it is

often challenging for the family office to enforce guidelines for investment decisions.

Because the management of financial assets requires capabilities that are different from those needed for the management of real assets, separating the management responsibilities is usually the most effective approach. For each asset type, the family should appoint managers with the appropriate skills for pursuing its investment objectives. It should also ensure that managers' compensation and incentives are aligned with the investment objectives for the assets they oversee. For instance, one family office sought to maintain investment performance comparable to certain endowments, but at lower cost. To achieve these objectives, it aligned managers' incentives to the benchmark targets.

In another case, a family business group used one team to manage investment decisions related to both financial and real assets for several years and then decided to foster increased focus by creating separate management teams for each type of asset. Although the individual teams now have their own offices and supervisory boards, they remain in continuous communication. They share insights relevant to investment opportunities, such as analyses of market multiples and macroeconomic projections, and critical metrics, such as targets for the internal rate of return, to guide the investment process.

Looking beyond asset management activities, the family should decide whether it wants the family office to have responsibilities for financial planning, tax and legal support, and philanthropy, as well as for mentoring the younger generation. Some family offices also provide management services relating to family homes and other personal assets that are not primarily financial investments. In these cases, best-in-class family offices generally keep for-profit investing distinct from philanthropy, also separating both of these activities from personal services. By ensuring that a dedicated team has the right capabilities and clear and focused objectives, this separa-

tion of responsibilities helps maximize the value of each type of activity. Finally, to foster effective mentoring of the next generation, family offices can use meetings of their governance bodies, such as the board of directors or specific committees, as forums for systematically sharing the knowledge and values of experienced family members with younger members.

Establish Governance. A family office needs clearly defined governance mechanisms. In addition to helping oversee the family office and steer it toward achievement of its target returns, effective governance mechanisms can also foster family cohesion by ensuring transparency and thus prevent disputes or facilitate their resolution.

Best practice entails appointing a board of directors for the family office and creating oversight committees for specific aspects of the office's operations. Board members should have expertise in the specific financial and real-asset investment classes that are most relevant to the family office. In addition to family members, the board should include external professionals with appropriate expertise in, for example, financial, private-equity, hedge fund, or real estate management. Charters for the board and committees should clearly delineate roles and responsibilities and set requirements for the frequency of meetings and reports.

Measure Performance. Family offices should consistently compare their performance with benchmarks. This is not always easy, however, because it may be difficult to find a benchmark that is directly comparable to the family office's overall portfolio. In such cases, portfolio segmentation can help identify comparable benchmarks for the performance of each type of asset. Beyond the benchmarks themselves, the process of deciding on benchmarks often helps family members and asset managers clarify their return objectives for different types of investments. This process can also foster valuable discussions on the creation and measurement of value.

Assessing the Status of the Family Office Today

To assess how well a family office's current setup meets the family's objectives, family leaders can consider the following questions:

- Have we defined a long-term aspiration for the family office, including the scope of its activities and its investment objectives?
- What roles will family members play in the family office? Have these roles been defined to foster family trust and cohesion in addition to effective management?
- Have we established clear investment-policy guidelines that delineate the expected returns, risk metrics, and mix of asset classes? Have we made our investment objectives clear to both internal and external asset managers? Are their management incentives well aligned with our objectives?
- How diverse is our investment portfolio? Do we invest in both financial assets and real assets? To achieve our long-term objectives, does the allocation of asset types need to change?
- How well does our current approach allow us to match the right management capabilities with each type of asset? Does the current division of activities between our in-house family office and the broader market allow us to apply a cost-competitive approach to creating the greatest value?
- Are effective governance mechanisms in place for the oversight of the family office? Have we brought in independent external professionals with the right mix of capabilities to strengthen our board? How formal is the governance of our board and committees? Do we specify requirements for, for example, meeting frequency, agenda setting, minute taking, and clarity of decision rights?
- Do we systematically evaluate the performance of the family office at

regular intervals? Have we identified the relevant benchmarks for each asset type?

- Beyond wealth management, does the family office take on additional tasks, such as oversight of philanthropic initiatives, tax and personal estate-planning advice, and concierge services? If so, are the various roles, responsibilities, and incentives aligned to promote effective support in these areas?
- Does the family leader plan to use the family office to mentor the younger generation? If so, are trusted advisors and a program or process in place at the family office to help pass the baton?

In many cases, the answers to questions such as these indicate that the family has opportunities to clarify the family office's objectives for wealth management and its additional roles, as well as to improve the office's structure.

IN 1882, JOHN D. Rockefeller established an office of empowered professionals to manage his family's wealth. Needless to say, the results have been impressive. By setting up an effective family office, today's family-business leaders can similarly promote the growth of their wealth and perpetuate their legacy for the benefit of generations to come.

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