SURVIVAL OF THE SFO

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The Single Family office ('SFO') is under assault. Bruised and battered by the recent financial turmoil, a number of SFOs are now considering their future.

Many are no longer financially viable but some can survive if they adapt to meet the needs of today's market.

According to the recent Cap Gemini Merrill Lynch World Wealth Report, the number of ultra high net worth individuals (UHNWIs) fell by nearly a quarter. This group's wealth dropped 23.5%, pushing many down into the mid-tier millionaire pool.

Last year was indeed an 'annus horribilis' for the wealthy investor. Global equity markets fell by nearly 50% and faced unprecedented volatility. Diversification strategies failed as correlations between previously uncorrelated asset classes increased. The hedge fund asset class had the worst performance in their history with the average fund recording a loss of around 15%. Many commodities saw a boom-to-bust cycle and real estate losses intensified towards the end of 2008.

What went wrong with SFOs?

Interestingly, the Cap Gemini Merrill Lynch Report stated the sharp decline in UHNWIs as compared to the lower fall experienced by HNWIs largely resulted from a partiality for more aggressive products. But whilst these products tend to deliver greater–than-average returns in good times, they also carried more risk. UHNWIs may not have understood what those risks were.

Weaknesses in due diligence and risk assessment practices also came to the fore; negatively impacting clients when it appeared many firms had failed to recognise market fraud.

According to the Cap Gemini Merrill Lynch Report, many wealth management firms failed to assess and fully convey to clients the implications of product risks. Client portfolios suffered as products and asset classes failed to behave as anticipated – in outright performance and compared to the risks implied in their credit ratings. For example, some firms lumped together an extensive range of diverse products into a single category, such as US Treasuries and certain structured products into a 'fixed-income' bucket. Even when such products were comparable from a credit ratings standpoint, some key inherent characteristics such as liquidity, potential downside and complexity were different.

A number of SFOs themselves have cited they lacked sufficient expertise to evaluate many of today's complex investment vehicles and strategies. One in five heads of SFOs cited this as a major concern in a recent Family Wealth Alliance study.

It is this lack of capability pushing many SFO heads towards closure. Some SFOs are no longer financially viable and the decision for them is effectively already made. However, there are a number who could and would like to continue if they could address this expertise concern.

It is also clear that a number of families would like their SFO to continue.

Client demand continues

The principal objective, as identified in last year's Wharton report on SFOs, for families in having a SFO was to manage the transfer of wealth between the generations. This objective is especially important at a time when post World War II entrepreneurs look towards retirement. It is estimated by the European Commission that within the next 10 years one third of this group will decide to call it a day. To give this some context, in concrete terms, that will affect almost 700,000 companies in the European Union and just under three million employees every year. A similar picture exists across Asia and the US. Robert Avery and Michael Rendall, two Cornell University economists, estimated in 1993 that $10.4 trillion would be transferred to the Baby Boom generation via inheritance from their parents over the period from 1990 to 2044. The exact figures may be debated but the trend is clear.

A critical component of wealth management is risk assessment, mitigation and control. So spending time and resources in developing that capability is clearly something SFOs are interested in.

Addressing the risks

What are the risks that need to be evaluated in today's investment vehicles and strategies? And what could have been done differently to evaluate and mitigate the risks seen in 2008?

The principal areas of risk that caught a number of people by surprise in 2008 was the fact that hedge funds failed to provide the required liquidity and that counterparty risk was a real issue. Jurisdictional issues also came to the fore as national solvency regimes crossed global financial markets.

Choice of law clauses were reviewed as litigants found themselves arguing between litigation forums. Claims for mis-representation by investors against banks have in the main not materialised as the risk warnings in contractual documentation have been held up by the English courts.

In 2009 there are predicted potential limited partner defaults as investors find that they do not have the liquidity to pay capital calls by private equity funds. Investors are also examining partnership agreements to see whether they can dispose of their remaining commitments and interests.

Addressing the problem

Proper contractual reviews need to be undertaken of any investment agreement, however, 'standard' it may be. 'Standard terms and conditions' means standard in the eyes of the counterparty. Contracts are there to be negotiated and whilst many investors feel the balance of power is against them, there are still provisions that are unacceptable and may be altered.
In any event, if it is decided that a risk will be accepted then that needs to flow through to a risk reporting and monitoring process so the appropriate people know about it and can take action if something blows up.

This is an important factor in effective crisis management. If you think about what the risks are in advance and have thought about what actions you might take, you may well improve your position by taking action early.

A proper contractual review will also point out liquidity characteristics and any unusual complexities in the relevant investment products.

SFO's need to ensure proper due diligence on underlying managers is performed. There are many useful guidelines provided by alternative investment manager associations such as AIMA, BVCA or EVCA, or this function can be outsourced.

It is also vital an understanding at a macro level is reached -whether the person bearing the financial brunt of the legal risk understands what that means and what they have agreed to it. This is about ensuring the legal risks are matched at a portfolio level to the investment policy and flagged in a manner so it is clear to see what is really going on. A crisis management plan should be prepared so that if need be action can be taken quickly.

If the SFO takes the time to develop a capability to understand the risks in the investment vehicles and strategies of today and in the future then not only may it survive, it may look to prosper.

A CRITICAL COMPONENT OF WEALTH MANAGEMENT IS RISK ASSESSMENT, MITIGATION AND CONTROL. SO SPENDING TIME AND RESOURCES IN DEVELOPING THAT CAPABILITY IS CLEARLY SOMETHING SFOS ARE INTERESTED IN.