Decisions, Decisions: Creating and Governing a Sustainable Family Office

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When a family office is set up, the primary goal often is to protect and grow family wealth by providing high-quality, dedicated services in a secure, confidential environment. For families with the level of wealth required to support the cost structure, the benefits of a family office are evident. What is less evident are the challenges families face when they take on the oversight of the office without the education and engagement required by the task.

The oversight process is most manageable when a single wealth-creator is responsible for building the family office. That person has a clear vision for the office and desire to provide strong oversight. It becomes trickier when the rising generation becomes decision makers.

Governance Structures are Necessary

To participate effectively in oversight of the family wealth, family members must be prepared just as they should to participate in any family business. In addition, the decision-making structure of the family office needs to be prepared differently once the wealth creator is no longer directly involved. A board of directors to oversee the functions and executives of the family office and an investment committee are excellent examples of good structural elements.

The number of decisions and their implications may be most significant when the family office is created, but choices that are made on an ongoing, day-to-day basis are just as important. While third parties may participate in these decisions, strong family oversight is highly recommended because family members expect more involvement around their liquid, investable wealth.

The best way to provide this oversight is through an engaged board of directors composed of family members, independent directors and the head of the family office (if not a family member). The family office is in the business of managing the family's wealth. Like any family business, the office benefits from a strong board with independent representation to provide expertise, objectivity and accountability. That said, family office boards typically have more family representation and are less independent than a family business board due to the nature of the decisions. Investment committees often have more non-family professional membership working under the direction of the board.

Decisions the family office board and investment committee must make include:

Selection of services. The service menu is often set at the start by the creator(s) of the family office. Yet, it will be tested constantly as family members request help with additional services such as banking or mortgages. While family office staff may decide in many of these cases, some of these requests would best be reviewed by the board.

Providing services. The decision to manage services in-house vs. outside contracts is typically done at the outset. However, these decisions may need to be revisited as the office grows and client base (along with family tree) inevitably expands. Services that were initially more cost effective to contract outside may now warrant an internal resource. Or when a trusted family office employee retires, the board must decide to replace that individual or outsource the services she provided.

Evaluating providers. Family offices typically engage a broad network of service providers. It is the responsibility of the family office board to ensure that service providers are meeting their clients' needs. To do so, they should oversee an evaluation process implemented by family office staff that includes objective performance measures and input from family office clients. Some offices put advisors up for review and re-contracting every few years to ensure they are getting the service they need. It is also a good practice to set annual goals with service providers against which an evaluation should take place.

Oversight of expenses. Similar to any business, the family office will have a P&L or income statement. The cost to serve clients is an important metric to evaluate and is driven by decisions around what services to provide and how to provide them. Owners often focus on investment performance as the overriding metric. In addition, the cost to provide investment and other services should be watched closely.

Cost allocation. Cost allocation involves decisions around how the costs of the office are distributed across the client base. Typically, this decision is made at the outset of the family office. However, similar to decisions around services, the cost allocation should be periodically reviewed by the board, with input from the family owners, to ensure it fairly distributes costs. A family office may start out with an allocation to clients based on assets under management.

As the office grows and takes on other services, it may find that certain family members have access these services while others do not. Evaluating how clients pay for these services is crucial to maintaining client satisfaction and family harmony. In one family office, disputes over the family office having addressed Christmas cards for one family member led to a complete revamping of their cost allocation model.

Evaluation of staff. As in any business, it is important for the head of the office to review staff members' performances against defined metric. In turn, the family office board is responsible for evaluating the performance of the head of the office and addressing performance issues in the senior team.

Dividends and distributions. The family office board often has the responsibility for determining how the returns of the office will be distributed. This decision may be memorialized in a policy that only requires periodic review. Or, the investment committee and board may be involved in an ongoing dialog that adjusts payouts throughout the year.

Ownership succession. Estate plans and/or a shareholder agreement often govern how family office assets transition from one generation to the next. However, the board of the family office needs to be aware of the asset transfer's potential impact. If rising generation family members have an opportunity to exit the office at a certain age, the board should keep a pulse on family clients' satisfaction with the office to avoid unexpected withdrawal of assets.

Investment structure. Many family offices subscribe to the "walk before you run" philosophy. They start with a simple asset structure as they learn to manage their investments. Over time, opportunities to invest present themselves, and the asset structure's complexity may increase. In the example of one family office, it was decided at the outset that all family members would participate in the same investment vehicles. However, they acknowledged that family members may want to opt in or out of certain investment opportunities over time.

Allowing family members personal discretion over their investment allocation can help retain them as clients. The family office board may also be tasked with revisiting the investment structure periodically as family members are presented with investment opportunities. While board members will have their own perspective as investors, they have the fiduciary responsibility to represent the interests of all family office clients.

Client management and communication. The family office staff is responsible for maintaining an agreed upon level of client service and communication. The family office board's oversight obligation is ensuring that the clients' service expectations are met. The board should also oversee the process for individual or group meetings with clients and the format, content and frequency of client communications.

As you can see by this list, there are important ongoing and periodic decisions that must be made by the family office board to ensure that the overarching goal of protecting family wealth is met. This list doesn't take into consideration the investment-related decisions typically delegated to an investment committee. These include investment allocation, evaluation of investment advisers, and depending upon the level of discretion given to advisers, and may include manager or fund selection. The investment committee should also ensure adequacy and accuracy of reporting. Depending upon the charter of the investment committee, they may be involved in some of the board decisions outlined above.

Preparing the Next Generation to Oversee the Family Office

As the rising generation matures and shows interest in the oversight of their wealth, they need to be prepared to participate in family office governance. There are many roles they can fill such as family office board member, investment committee member or trustee. Each role requires an in-depth understanding of the family office intent, structure and investments. Even if a rising generation member is a client without any governance responsibilities, he or she should have a clear understanding and appreciation of the family office.

I recommend creating an education process for the rising generation to understand general management and investment decisions, estate and trust structures and investment terminology. Those who will serve on the family office board should understand how to manage internal personnel and advisers, review financial statements and strategically decide how services are provided.

The following steps will help guide members through developing the education process:

1. Align the family around the need for education.
2. Ensure that rising generation family members opt in and understand the requirements of participating in the family office board.
3. Create an education plan and timeline.
4. Identify education resources. Many investment advisors and groups offer educational opportunities for rising generation members. Another option is enrolling in an executive education program offered through a university.
5. Take it one step at a time. It's important to set up a process that provides gradual exposure to new concepts. If participants are overwhelmed, it can deter them from participating. Creating opportunities to interact with peers in their own family or other families can make the education process more enjoyable.
6. Continue to invest. Investment concepts and board responsibilities will be a new experience for most family members. A one-time program will not be enough to establish comfort in the board role. Ongoing exposure efforts such as meeting with investment advisors or observing board meetings will help to increase their confidence level.

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