ULTRA-HIGH-NET-WORTH AND MULTI-FAMILY OFFICES

Proscriptions and Prescriptions

By James H. McLaughlin

Serving complex families is, well, complex. And the market that provides these services has likewise become complicated. Ultra-high-net-worth (UHNW) families are confused by myriad configurations of advisors and commercial providers and often choose to serve themselves by forming a family office. For most families, a family office cannot be recommended simply given the costs. The number of family offices in the United States is uncertain—some estimates put the number at more than 5,000, but a more helpful guideline is to consider when a family office is economically efficacious. I put that number at $1 billion, which is a rarified level of wealth where *Forbes* estimates there are 530 families in the United States. This might imply a very large number of family offices don't make economic sense, but one needs to understand the complex anthropology of wealthy families to make any judgment on the merits of forming a family-office structure based on the economics alone.

I'll set our course with a taxonomy of family offices for context and then switch course with a discussion of multi-family offices, the presumptive answer to families who in whole or part need some additional resources or advisory services to manage their affairs.

A Taxonomy of Family Offices

Although there may be a community of families and professionals with some common interests, we fall into an easy trap when we refer to a so-called family-office "market" or "industry." There is no such monolith and there is no such market, at least not yet.

This community has some economic aspects of a market, but many other identifiers are entirely unmarket-like; some are even economically perverse. As such, it might be worth considering a taxonomy or classification system for family offices. I'll proffer three key divisions for such a system.

Economic orientation. A primary division is economic orientation. Many (I would suggest most) family offices exist to serve a family. In a manner, they reflect characteristics more like a not-for-profit entity. Other family offices, but a minority, are constructed both to serve a family and to maximize outputs, including profitability. These tend to develop a distinct culture where strategy, tactics, and organizational structure reflect some conscious form of marginal utility. A subset of the economic orientation division is the existence of an operating business, which is, with very few exceptions, the source of nearly all great wealth. The mere existence of an operating business creates a different economic orientation, but it also introduces the characteristic of illiquidity, which brings about the family's investment orientation. A secondary subset of the operating business division might be the degree to which the business interest has been liquefied and whether or not the family retains a control or majority interest.

Generational orientation. A second and long-recognized classification of family offices is the generational orientation of the wealth. The founder patriarchal/matriarchal generation (G1) demonstrates many behavioral motivations that are quite different from subsequent generations. G1 is often entrepreneurial; following generations have tended to be less entrepreneurial.

Investment orientation. The third major division is the investment orientation, which is largely the inherent basis for the family office. Nearly all family offices have some form of investment delivery—in-house, co-sourced, or outsourced. This is a fertile and dynamic area where patterns and trends are shifting, particularly since the 2007–2008 capital markets tumult when families came to an acceptance that investment management due diligence and research had outstripped their internal resources and capacity. Whatever the platform of investment delivery, the family's orientation usually involves a spectrum with stewardship/preservation at one end and growth/wealth-maximization at another end. This pattern is correlated, of course, to a great degree by the generation of the family and the Malthusian effects on the family office's sustainability in outer generations.

Of course, the investment orientation is correlated to the economic orientation of the family and the generation of the family, so these three core divisions can be viewed as interdependent.

As a result, the execution of many family offices, across delivery platforms and processes, varies widely. What is common, however, is a preference for disinterested advice, a desire for sustainability (not simply growth), and sufficient resources to manage risks. One increasing risk is information risk, the process by which information has outstripped the fixed capacity of all family-office investment staffs.

In that regard, the most prudent families will look for outside resources, in part or whole, to manage this morass of information. When they conclude (perhaps in capitulation) that they need such supplemental resources, they are met with woefully few options that are not part of the manufacturing and distribution complex of large commercial enterprises, which are hardly disinterested parties.

This environment leads many UHNW families to explore alternatives that reach beyond the single-family solution. Specifically, they may find the array of services delivered by various advisory firms, also known as multi-family offices (MFOs), a more natural fit in whole or in part.

Defining a Multi-Family Office

Many families are confederating formally and informally, but this article will focus on commercial MFOs. Models vary widely and cut across regulatory channels. A large majority are organized as registered investment advisors (RIA), and the cohort also includes trust companies and commercial bank private-banking lines of business. All generally stand on the presumption of an agency relationship with a family. This relationship is anchored to advisory services rendered in an alignment of interest with the family as distinct from the more transactional models of manufacturers and distributors.

The fragmented RIA channel is perhaps best positioned to serve families who are looking for an alignment of interests between the firm and client, but they suffer from weak capital structures, weak brands, weak organic growth, and deteriorating cost-income ratios—all of which pose challenges. If this isn't clear to families, contrast the RIA channel with wirehouse brokerages that enjoy national brands, strong organic growth, and an abundance of capital, and which, targeting the UHNW, have shifted largely to a comparable fee-based model.

Clients are Confused

In this narrow context, the MFO sub-market is predictably confusing for even the most sophisticated families. MFOs lack brand awareness as individual firms and as a cohort and are best described as heterogeneous with varying types. Some are integrated "whole client" providers; some are more investment-centric/outsourced chief investment officer (CIO) service platforms; others primarily offer noninvestment "family office services." As a result, each has differing staffing models, cost structures, and pricing models.

Demand is Shifting

The good news for MFOs is that we are in the very early stages of a secular global transformation of client demand. Without unduly oversimplifying, the root of the shift lies in the premise that the ultimate economic buyer will favor firms that provide advice largely free of conflict. In tandem, pricing power could shift to advisors despite what remains a fragmented industry, which would suggest the opposite effect. Clients, long yearning for advice (and often unsatisfied), increasingly will be willing to pay for impartial and differentiated counsel.

Transactional business models, where firms act as manufacturers and distributors of products and also advise clients on those same products, struggle with an inherent conflict. They will be forced or induced to adapt to a new reality where transparency and disclosure will be increasingly in favor. A sub-theme fueling this demand shift is the client expectation of an improved level of technology that can provide greater data visibility and assimilation.

In summary, a secular trend is underway that portends the disintermediation of an increasingly concentrated group of manufacturers and distributors and favors a more fragmented market of firms and professionals that provide impartial, quality advice.

Further, at the very high end of the market, there is widespread evidence that clients now value the non-investment components of firm service models at least as much as investment performance. However, firms have been slow to use this latent demand to modify their pricing strategies for non-investment-related services.

The Concept of Design

The market leaders in wealth management understand there is a pronounced demand shift and have moved from delivering products and solutions to a focus on how solutions are provided. In this post-product era, we have entered a design period where firms differentiate themselves by designing a client experience. Designing the experience can improve the level of diagnostics and discovery and affords opportunities for a firm and advisor to become more deeply connected with a client.

Such experiences, first conceived in consumer and retail product sales, are applicable equally to wealth management. Names such as Tiffany and Ritz-Carlton come to mind. Design discipline requires input from employees, clients, and, potentially, other alliance partners and professionals, on how they want complex products and services delivered. It includes a careful review of all interactions such as work flow and work process and their effect on the ultimate delivery to the client.

The process can take time and is often iterative as firms explore and determine client preferences, rationalizing what matters most.

The Client Experience

In this post-product setting, some clients are yearning for something more existential, even impactful, best described as an experience. "Existential" is not so abstract as to be transcendent; rather, it's an experience that goes beyond a discussion of a family's prosaic financial affairs to a deeper level. Unfortunately, most clients have little reference for other possibilities that lie beyond their customary relationship with their advisors and they have only modest or low expectations.

The most successful firms understand this need to create a client experience and will be led by business managers who have had client-facing duties and know what drives this client experience.

What is this experience?

- First and foremost—a compatibility in values and culture
- An alignment of interests—true disinterest and impartiality
- A relationship with an advisor and team where no one "owns" the client relationship
- Solutions not products—access to the best thinking (contemporaneous infor-

mation and advice) whether in-sourced or out-sourced
- Privacy and security
- Data assimilation—simplicity in the face of increasing information complexity

MFO Business Economics

The post-2008 period has been challenging for all wealth-management firms, particularly the smaller, less well-capitalized MFOs. Like many emerging industries, the relatively brief history of the MFO is one where the business economics remain extremely challenging. Costs are high and few firms have any scale and, therefore, few firms enjoy any operating leverage.

Further, and perhaps most importantly, no firm has any meaningful market share or brand. Consequently, pricing power remains with the client/buyer. If there is pricing power it's been with the investment component of the MFO delivery and not with the non-investment components, principally, planning-related services and the administration of household financial management. Unless firms are very disciplined and "stick to their knitting," delivering on the non-investment components has tended to systematically erode their operating margins.

If the historical context is not challenging enough, the effect of the 2008 market collapse put pressure on MFO economics with an ugly combination of asset-based fee compression, lost business, negligible new business with less money in motion, increased service requirements, and increased costs, primarily for staff, compliance, and technology. Although the promise of the MFO remains noble, woefully few MFOs have succeeded in scaling their businesses or achieving any operating leverage in this extremely challenging market cycle.

MFO Financial Markers Improve but Remain Inherently Weak

With few exceptions, MFO capital structures are weak and concentrated and, until recently, capital sources have been limited. Firm valuations (i.e., multiples) are expanding as the business cycle has improved, but the continued aging of key principals and delayed succession planning has had a dampening effect on potential valuations. Further, normalized organic growth has been tepid at best.

In spite of this, increased capital sources and the low-interest-rate environment portends increased merger activity, recapitalizations, and consolidation.

The Sales Paradox

Given their strict conflict-free agency mission and service cultures, MFOs continue to wrestle with an affirmative approach to sales, preferring to use the softer term "client acquisition." Organic growth rates (i.e., compound annual growth rates) in the low single digits are common, but there is hope as MFOs increasingly understand client-acquisition strategies (i.e., client-to-client propagation rates, development of external referral channels, and improved onboarding processes), they can drive both margin expansion and firm enterprise value.

PRICING

The single biggest economic challenge facing MFOs and wealth-management firms generally is right-sizing pricing in the face of increasing complexity for non-investment services, i.e., services where firms traditionally have lacked pricing power due to an unsystematic demand from client families.

Firms must demand to be paid for services rendered at a reasonable level of profitability. They must eschew families buying their services on price alone by simply walking away. The definition of an attractive and actionable client segment in any service industry is one where a firm can acquire and retain a client over a full business cycle, and at a predictable and attractive price point. Currently, there are no unique value propositions, just good ones—so it's all about doing just enough to acquire a client family and then ruthlessly managing costs. Sharper, more-disciplined pricing practices can get firms off this treadmill.

The first, immediate observation related to pricing is the remarkable variation of fee arrangements that exist. They are primarily bundled (where investment and non-investment services are combined), but unbundling due to increasing client demand for non-investment services is occurring.

Where firms use asset-based fees there are some clear clustering patterns, but almost all firms that use asset-based fees use non-uniform discounts for clients above $50 million. These discounts may be offered to gather assets, but it's economically perverse because these families are predictably more complex.

Where firms offer unbundled arrangements separating investment from non-investment services, there is little evidence that the non-investment service fees are derived from any reasonable or systematic cost-accounting model or controls. Many firms use a notional price for non-investment services best described as a professional service firm "time and effort" pricing model where the firm is taking a mark-up on its presumptive cost of time. In the absence of time tracking systems this is, at best, a notional pricing system where, in the absence of controls mitigating against "service creep," there is ample evidence that many firms are delivering many of these discrete services at a loss.

Pricing for Non-Investment Services

Supply and demand suggests clients will pay a fair price for any service rendered, but this has been, largely, untested for non-investment services such as planning and administration (i.e., accounting, household financial management, and related data assimilation).

In fact, given firms' traditional asset-based pricing models, clients have been socialized that they can get non-investment services for free embedded in a single bundled price. Firms have long used the pricing power of the investment mandate to cross-subsidize the non-investment services, but with demand shifting, families increasingly rank non-investment services as high-value prerequisites in their choice of provider. Further, they don't want or expect to receive something for nothing, but firms have been too passive and have lacked the collective will to confront this issue.

Insidious Complexity

A final comment related to complexity deserves to be mentioned. MFOs must recognize complexity and anticipate it in their pricing, not rely upon families to understand their peculiarities or level of complexity because how are the families to know? Generally, they have no reference group. Some of the markers of complexity include the following:

- Lots of professional advisors
- Lots of decision-makers
- Weak family-governance structures
- Multiple generations and households
- Varying levels of sophistication of family members
- Transnational families/multiple jurisdictions/domiciles
- Weak information-technology systems for information exchange and security
- Widespread illiquidity including interests in closely held operating businesses, real estate, and other limited-partnership (LP) investments

Serving Complexity Confers Pricing Power

Complexity lies at the heart of why commercial service-providers either don't serve the UHNW market segment or do so accepting (intentionally or unintentionally) lower margins and, as important, why families perceive they are not well-served by most commercial models, often choosing to do it themselves.

Wealth-management and professional firms of many different stripes (ranging from investment management-only outsourced CIOs to accounting firms) covet larger, inherently more-complex clients, but they are too often unable to deliver the needed services and, somewhat self-destructively, unable to be profitable serving these highly customized needs.

With the above as context, clients increasingly are aware that their complex service requirements have eclipsed many of their incumbent service providers such as investment firms, accounting firms, or other professional advisory firms.

Consequently, demand increasingly favors an approach anchored to a fully integrated service platform that requires specialized staffing and is at the heart of serving the whole client. Such an integrated platform will place MFOs in a position to earn client primacy[1] and, in time, improved business economics as primacy confers pricing power, which will act as a prophylactic against increasing asset-based fee compression.

Business Economics Collide with Client Experience

Separately, all wealth-management businesses including MFOs depend on top-line growth to some degree where performance and compensation management systems often favor asset gathering over client service delivery. Consequently, the discovery process is not fully disinterested and often comes with a sales bias where persuasion trumps analysis and the more nuanced feathering out of the true client need is often overlooked or neglected.

In summary, there is a great tension between firm business economics and the client experience.

In this environment, clients increasingly will seek to disintermediate manufacturers and distributors and should be more willing to pay the true costs for advice. Firms need to commit capital to staff at appropriate levels to provide this advice and or confederate with other advisors to meet this demand and, importantly, need to have the derring-do to test clients' willingness to pay. Discounting and pricing concessions in this environment are a race to the bottom. Firm business economics are weakened and families remain unserved.

Success Factors

MFO success depends on four interdependent factors: capital, leadership, strategy, and disciplined execution.

As noted, few firms have strong capital structures, but this is changing because outside capital sources are supporting MFO equity transitions and seeking to exploit the pronounced client demand for the MFO business model. Leadership also must adjust; many MFOs are led by two general cohorts—either dynamic, externally oriented principals and/or capital market mavens. A new generation of business operators increasingly will be needed to manage MFOs.

Finally, both MFO strategy and execution are far too variable. Too few firms have adopted best practices from their industry peers. The best-in-class firms will be deeply networked, have competitive field intelligence, and will be innovators ready to modify their strategy and execution in anticipation of client demand.

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Endnote

1. "Client primacy" can be defined as being in the position to get or command the first call among many professional advisors.

Appendix

Core vs. Adjacent

The economic future for all MFOs will be to stick to their knitting as they lead in the provision of myriad core or adjacent services. Families don't believe any firm can do everything well and firms are fooling themselves if they think that they can provide everything.

I use a "Master List of Services" (see table A1) as an analytical tool for multi-family and single-family offices to explore the efficacy of their service platforms. Should an MFO or family office faithfully complete this as an exercise, it presents a host of implications for maintaining client primacy and for their economics.

Core services are internally delivered services—services no one else can do better, that secure client primacy, and that can be delivered profitably.

Adjacencies are those remaining services required to maintain client primacy, but which cannot be delivered profitably.

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Table A1: Family Office Master List of Services

Service Category	Core vs. Adjacent
Family Governance	
Family Coordination and Cohesion	
Propose and Maintain Family Decision-Making Structure	
Family Strategic Planning	
Family Meetings – Coordination and Facilitation	
Next Generation Education	
Family Communication	
Family Office Administration	
Manage and Maintain Administrative Structure	
Coordination of Outside Professional Advisors	
Investment Management	
Investment Advisory	
Asset Allocation Strategy, Review, and Rebalancing	
Investment Policy Statement (IPS) Design	
Review of Private Capital and Venture Opportunities	
Investment Implementation	
Manager Search, Selection, and Monitoring	
Coordination of Investment Advisors, Managers, Custodians	
Fee Negotiations with Managers and Product Providers	
Investment Administration and Reporting	
Consolidated Reporting	
Alternative Investments – Tracking, Cost and Tax Basis, Notice, Redemptions, Capital Calls	
Performance Measurement and Review	
Advanced Planning	
Wealth Transfer Planning	
Estate Planning Trust Strategy, Development, and Structuring	
Entity Formation and Implementation	
Financial Planning	
Budget/Cash Flow Planning and Reporting	
Debt Management	
Retirement Planning (Qualified Retirement Plans)	
Education Funding (UTMA/UGMA and 529 Plans)	
Philanthropy	
Family Philanthropic Planning and Review	
Entity Formation and Implementation	
Private Foundation Management, Administration, Compliance	
Charitable Trusts and Donor-Advised Fund (DAF) Management/Administration	
Grantmaking Oversight and NFP Evaluations	
Business Consulting	
Business Transition and Succession Planning	
Mergers and Acquisitions Strategy	
Coordination of Investment Banking/Mergers and Acquisitions	
Buy/Sell Agreements and Funding	
Prenup, Postnup, and Divorce Facilitation and Negotiation	
Trustee Services	
Trust Administration and Reporting	
Estate Administration – Executor/Personal Representative Services	
Selection/Training of Trustees and Protectors	
Investment and Beneficiary Education	
Individual Trustee Services	
Tax Planning and Compliance	
Tax Advisory and Planning	
Domiciliary (State and Trans-National) Planning	
Offshore Trust Planning	
Family Limited Partnership Planning	
Family Foundations	
Managed Funds/GP Planning	
Entity Structuring and Transaction Analysis	
State and Local Tax Nexus Analysis	
Estimated Tax Planning	
Tax Compliance	
Federal, State, and Local Income Tax	
Estate and Gift Tax	
IRS Audit Defense	
Partnership Accounting	
Sales and Use Tax Returns	
Personal Property Tax Returns	
Payroll/Excise Tax Compliance	
Tax Notices and Administration	
Risk Management	
Insurance and Risk Transfer	
Comprehensive Risk Management Summary	
Cybersecurity and Privacy Risk Advisory Counsel	
Property and Casualty Facilitation and Coordination	
Life Insurance Oversight	
Disability Insurance Oversight	
Long-Term-Care Insurance Oversight	
Personal/Family Security and Analysis	
Medical Insurance Coordination and Administration	
Household Financial Management and Analysis	
Household Financial Management	
Balance Sheet	
Income Statement – Cash Flow and Lifestyle Planning	
General Ledger Reports	
Full Service Bookkeeping	
Bill Payment and Expense Reporting	
Customized Reports	
Property/Hard Assets Management	
Real Estate Acquisition Assistance and Analysis	
Second Home/Ranch/Farm/Stable Management	
Aircraft/Yacht Acquisition, Assistance, and Analysis	
Collectibles Inventory and Management	
Financing – Mortgage and Refinancing Assessment and Coordination	
Construction Project Management	
Personnel Management	
Hiring and Management	
Payroll Administration	
Personnel Background Checks	
Manage Employee Benefits	
Concierge Services	
Travel	
Family Events	
Educational Advisory	
Private Banking/Lending	
Private Banking Relationship Coordination	
Intrafamily Loans/Family Bank – Structuring and Tracking	
Secure Document Storage and Management	