10 Common Investment Missteps of High Net Worth Families

By Mark Mushkat

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Emotions play a large role in how people manage their money. This is true for everyone, including wealthy families.

The difference, however, is that the consequence of a flawed decision is greatly magnified for families of wealth, perhaps creating long-term negative implications for future generations. It can also have a large impact on charitable giving during the donor's lifetime. This article looks at some of these common missteps and how successful high net worth families learn not to repeat them, or even better, how to avoid these obstacles altogether.

1 "HOW HARD CAN IT BE? I'LL JUST DO IT MYSELF."

Most high net worth individuals can point to extraordinary achievements. They have built successful companies, invented products, created new technologies, or become recognized leaders in the art world. Because of the great success they have achieved in one area of their lives, they may feel they can easily master other areas, including the intricacies of managing their investment portfolios. They may do all their own research by reading books on investing, watching TV shows or speaking to friends about the topic. Others may leap into mutual funds without recognizing issues such as embedded gains, or enter into private equity partnerships with unacceptable sector concentration.

An observer can draw a parallel between managing a $200 million portfolio and running a $200 million company. Both situations require talented people, a disciplined business plan, a well-defined strategy, careful metrics and patience. We succeed when we learn to effectively use all the resources available to us: setting investment objectives, creating asset allocations, implementing the plan, measuring performance, and rebalancing, to name a few.

2 "MY FAMILY OFFICE WILL BE AWESOME, ONCE I IRON OUT A FEW (DOZEN) DETAILS."

Along with a custom built yacht and four homes, a custom built "Single Family Office" (SFO) can be another outward sign of significant wealth. The temptation with newly acquired wealth, whether through a liquidity event such as the sale of a business or some other windfall, is often to hire talented and expensive professionals who focus on best-in-class investing strategies and management. But this has become a highly competitive arena. Families often find that they may have underestimated the cost and time required to set up and successfully run their own single family office. SFOs on a tight budget may find that retaining mid-tier or part-time advisors presents challenges, including staff turnover, costs for oversight and compliance, and considerable delays in delivering services (such as manager due diligence, strategy implementation and access to top opportunities).

Outside of the investment realm, these SFOs may face other difficulties, including the inability to quickly access specialized skills, e.g., aircraft licensing or personal security, in order to meet a short term objective.

Creating the optimal family office is an important goal for many high net worth families: the best people, ideas, technologies, private equity and real estate pipelines, etc. It is a massive and complex task. New SFOs often find that they become bogged down by issues conflicting family needs, time constraints and divided loyalties. They soon face the challenge of containing costs or making the decision to spend millions of dollars to build a first rate enterprise. Meanwhile, their investments may languish in inefficient vehicles that end up costing the family a considerable amount in lost opportunities.

In addition, when a family member serves as the manager of his or her own family office, this quarterbacking demands a great deal of time, organizing, follow-up and implementation. It is not unusual to see an estate plan that was timely, brilliantly conceived, and then rendered worthless for lack of implementation. For instance, perhaps the lawyer responded to the family's needs, but the investment advisors failed to get involved to complete the transaction. Or sometimes a family member misses a crucial step, with very costly repercussions.

If you feel that you are too busy to follow through on tax, legal and financial details, consider outsourcing this responsibility to a trusted advisor or multi-family office. Then you will have a professional who can manage all this for you and keep you informed at every stage.

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3 "I'M ONLY WORTH $30 MILLION? I THOUGHT IT WAS CLOSER TO $100 MILLION!"

Who isn't tempted to live beyond one's means? We all dream of the vacation home in Maui or in the south of France, an 80 ft. yacht, or a new Ferrari. However, some people find themselves with a massive sum of money and forget that even this amount is a *finite* resource. Centi-millionaires must live within their means, too, or they'll find themselves without the cash flow to manage the upkeep of their homes, ranches, boats, private jets and other assets. For example, a $30 million yacht may require $3-5 million each year to operate and maintain. When added to the funds necessary to support several homes around the world as well as an airplane, it may force the liquidation of certain beloved assets or cause a serious disruption in an investment portfolio to meet current cash flow obligations.

Some clients do not like to believe that they have to budget their spending. Nevertheless, the best investors succeed by having a clear understanding of their anticipated expenses, income sources and available capital for investment. One technique that we use with our clients is an "Immunization Analysis." This involves meeting with the family to determine as best we can what they expect to spend on an annual basis over the next five years. The analysis takes into account living expenses, investment commitments, private business obligations, education and retirement savings, etc. We map out the expected spending — including taxes. Once we know what the annual costs are likely to be, we can then recommend an asset allocation strategy as well as growth objectives that address the client's income, spending requirements, and additional wealth accumulation.

That last point — growth of current assets — is especially important. The assets generating the income need to appreciate in order to generate more funds in the future to stay ahead of inflation's corrosive effects.

> "Who isn't tempted to live beyond one's means?"

4 "I WANT TOP DECILE RETURNS WITH BOTTOM DECILE RISK."

This is a version of the often-mentioned "free lunch" on Wall St. Just because someone has a net worth of $1 billion and won't spend even a quarter of that amount in his or her lifetime doesn't imply contentment with conservative investment performance. Many of the wealth creators we meet have risen to the top of their industries and expect the performance of their financial portfolios to be similarly stellar.

The challenge is this: We all hear about portfolios that generate 30% or 50% returns, but at what risk? What about volatility of returns and after-tax performance? Or the net return after calculating fees? Also, can this performance be reliably replicated?

The risk equation is at least as important as the return considerations. If, over 20 years, an investor achieves S&P 500-level returns and does so at the risk level of an intermediate bond portfolio, then that is indeed a remarkable achievement. It may not leap out as the best returning portfolio, but it may be the best performing one for that level of risk.

5 "BUT I'VE HAD THIS STOCK FOR MORE THAN 20 YEARS."

Sometimes people hang onto a large, concentrated stock position for sentimental reasons, to avoid capital gains tax, or in the hope that their heirs will receive the "stepped up" value on highly appreciated stock. Or perhaps they are convinced that the stock is going to take off — in the very near future — reversing years of decline. Somehow they have become wedded to the stock and now it represents a disproportionate share of their portfolio.

The risks of continuing to hold these concentrated positions, when there is no regulatory or corporate reason to do so, often dramatically outweigh the potential gains. There are many ways to sell a concentrated or low-basis stock in a tax-efficient manner, including sophisticated derivative strategies that can unlock the value of the stock while providing additional benefits.

6 "I HAVE SEVEN BROKERAGE ACCOUNTS. IS A HORSE RACE SUCH A BAD THING?"

The likely answer is yes. It's a bad idea for several reasons. Who determines if all seven portfolios are invested in a way as to minimize risk and avoid duplication? How do we know the way each portfolio performs relative to the others? Diversification doesn't mean spreading one's assets across many providers without a specific, quantifiable, and comprehensive strategy. It means balancing asset types and amounts in ways that are most likely to achieve your goals. Ideally, there should be a stress-tested asset allocation strategy which governs the funds placed with all management teams, along with ongoing due diligence for each manager. Metrics must be applied to each portfolio's returns, and measured against industry benchmarks, peer groups, volatility, capture ratio, and more.

A significant factor in evaluating each account is whether the team you initially selected to manage these assets is still in place. In other words, if you selected a U.S. small cap portfolio, is the management team still on board or have they left to form another company and been replaced by junior managers? This is significant because the qualitative aspects of any management group are just as important, if not more so, than the quantitative ones.

Successful families follow guidelines developed by, surprisingly, the Department of Labor. By embracing the Employee Retirement Income Security Act (ERISA) and the Prudent Investor Rule, U.S. pension funds have clear directions for the diversification, independence of advice, fee disclosure, performance measurement, and record keeping of their funds. Many wealthy families today follow in the footsteps of these successful pension funds.

7 "I HAVE A BUDDY WHO SEEMS TO KNOW THIS STUFF. HE CAN RUN WITH IT."

Choosing close friends or relatives to manage all or a portion of your investment portfolio can often strain important personal relationships and may noticeably damage returns. One senior executive trusted his large portfolio to a college friend of 30 years. The decision was based on, "I can trust him and perhaps no one else," yet this loyalty sometimes overrides financial efficiencies and prudent investing. This is fine if both parties acknowledge up front that the friendship is a critical investment element, and risk-adjusted returns may be a secondary consideration.

Using the example of running a $200 million company again, ask yourself: Would you hire a college roommate or a sibling to run the firm because you like the person or out of obligation or family ties and think he or she will grow into the challenge? Or would a disciplined, objective strategy with independent metrics and highly qualified professionals more likely lead to success?

8 "I'M WORTH SO MUCH MONEY, WHAT'S ANOTHER 1% OR 2% IN PORTFOLIO APPRECIATION?"

Many of the families we work with realize that their expenditures for the next few decades will not exhaust the capital they have accumulated. Occasionally, though, indifference or indecision or resources that are tied up can compromise the implementation of a family's investment plan. The dollars that *could* have been earned are often sizable. In total, high net worth families across the country are collectively leaving billions of dollars "on the table."

Why leave those assets behind when, with manageable risk, you could earn a significantly better return? Even a 1% or 2% difference on a multi-million dollar portfolio adds up to an enormous sum after a few decades. For example, an additional 1% return on a $100 million portfolio compounds to $22 million after 20 years.

We are living in an age when many of the world's wealthiest families are engaged in an unprecedented level of philanthropy. Ted Turner, Warren Buffet, Bill and Melinda Gates and many others are making exceptional strides in global healthcare, education and other humanitarian causes. A number of our clients have philanthropic goals that are clearly defined and rigorously pursued, as well. Imagine what an extra $10 million to $20 million earned over time could accomplish for charities around the world.

9 "THE MARKET IS CRASHING…THE MARKET IS SOARING."

We know from studies in behavioral finance that people tend to make decisions about the future based on current events, rather than historical trends. It's just human nature. So when the markets heat up, an 8% risk-adjusted return set out in an Investment Policy Statement seems meager. It's tempting to want to shoot for 10% or 12% or more in a red hot financial environment and deviate from the plan. But all too often this attempt to "time the market" backfires.

The reverse is also true. When markets are sliding, people get nervous and begin to dial back the risk—perhaps switching out of equities to more conservative fixed income investments. But now they could be looking at 5% or 6% annual returns which, over time, may not generate enough income and growth to meet their 5- and 10-year targets.

The key is to stick with a disciplined investment strategy and rebalance on a regular basis, perhaps once or twice a year, to ensure that your portfolio stays within the constraints of your investment policy.

10 "DON'T WORRY, I'M USED TO FLYING THE PLANE I BUILT — WITHOUT INSTRUMENTS — AT NIGHT."

Sure, the craft is airborne and it appears to be making progress. But wouldn't meeting safety standards and measuring performance make sense, too? This touches on the cocktail party claim of great portfolio returns without acknowledging both the risks assumed and whether the returns are compared to appropriate benchmarks.

Many investors claim to outperform the benchmark funds. While it may be true that they outperform an index, it's likely they do so with considerably more risk. So we discuss re-configuring their portfolios to match the benchmark's volatility with greater returns, or conversely, to match the benchmark's return with less volatility. This can help them reach their investment goals over the long term. And it can open their eyes to a whole new world of risk-adjusted returns by learning about such concepts as the Sharpe Ratio, standard deviation and upside/downside capture ratio.

Another critical measurement is your portfolio's *real return*. This is the net performance after accounting for all fees, taxes and inflation. It is the true measure of whether your financial assets are meeting the objectives that you and your advisors have established for them.

WHY WORK WITH ADVISORS

In the final analysis, it is important to realize how emotional we are about money. Many of us have patterns of behavior with respect to money that date back to our childhoods. One person may feel comfortable gambling $5,000 a month in Las Vegas, while another person wouldn't set foot in a casino if you handed him $5,000 to put at risk.

Successful high net worth families have learned to avoid the common obstacles noted in this paper. They employ the services of highly qualified, professional advisors who can help minimize the costs of running a family office, establish well-defined strategies, measure performance with valid metrics, and benefit from all available resources.

Much like a top athlete and his or her personal trainer, your advisor is a central participant in maintaining your financial strength. This person can remind you of your goals and keep you on track when you are tempted to stray.

This financial professional can help you in other ways, too. He or she can vet potential investments you have sourced, assist in retaining other professionals to help with specialized tasks, and dispassionately find ways to accommodate the varying needs and perspective of a multi-generational family. Success in even one of these functions can easily pay for many years of a professional's fee.

With clear thinking, planning and execution, portfolios of all sizes can become a more potent force in your retirement, benefiting you and your loved ones, and in improving the lives of countless others around the globe.

Mark Mushkat, Managing Director, is responsible for investment advisory services and works with clients to analyze their current and projected cash flows, develop and implement asset allocation strategies, and review after-tax performance reports. He has more than 25 years of financial services experience, specializing in investment management consulting for affluent individuals. Mr. Mushkat earned a bachelor's degree from the University of Cincinnati and has completed postgraduate course work in asset management at The Wharton School of Business. Mr. Mushkat lives in San Francisco where he is also involved with the Rescue Mission and the Golden Gate Audubon Society. He is a certified member of the Investment Management Consultants Association.

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