# The Three Forms of Governance: *A New Approach to Family Wealth Transfer and Asset Protection, Part III*

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Generally, the concept of governance is such that its role may be misinterpreted as a set of rules to be followed. This does the concept of governance a grave disservice, which also means its most valuable benefits are eluding many families. Working with families and their advisors often shows that breaking the concept of governance into three segments that are aligned with the respective needs of the family entities they serve facilitates understanding of what governance truly is, the full scope of the benefits it has to offer, and how it should optimally serve the family of wealth.

Governance is the place where the progression of generational perspectives, family roles, and family dynamics meet. The three come together as the family makes decisions about all forms of its wealth, consciously and dynamically or subconsciously and with inertia. Thus, this series of articles serves as a crux point in family wealth management, for it is from the entrance of governance on the family wealth field that generational views, family roles, and family dynamics are solidified. This is the point at which family leadership begins to make decisions that will affect family members' lives for generations to come.

Governance in its right form serves the family as the "keeper of the joy." When governance is formed effectively, that is its most authentic role. Here is offered a different approach to governance, both in concept and in function. The three articles concluding with this one collectively offer an examination of

- family governance;
- family office governance;
- aspects of corporate governance pertaining to the fulfilment of the family's goals and needs for the successful growth of its authentic wealth as well as its financial capital;
- how each form of governance differs; and
- how each is essential to the others' overall service to the family.

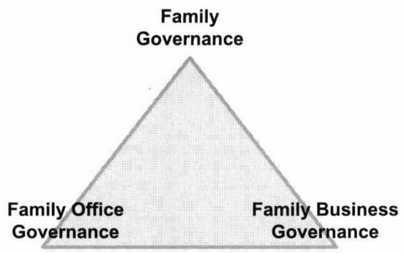
Governance is not the end all. It is a living instrument that can be invaluable in fostering the growth of the family wealth.

The relationship between the three forms of governance can make the family practically impermeable. Exhibit 1[1] employs the triangle to show the strength of support the governance system can offer the family's three types of entities. With family governance taking the lead, we see that the family office and the family business get their directives from the family and, in turn, support the development of the family's authentic wealth.

## FAMILY OFFICE GOVERNANCE

Now that we have established the proper role of governance in general, the importance

**EXHIBIT 1**
**The Three Forms of Governance**




*Source: graymatter Strategies, LLC.*

of family governance, and the role of family business governance in particular, we shift our attention to the family office and the role governance plays within that entity to support the achievement of the goals of the family.

The family office has a specific role to perform. It is essential to have a clear understanding of the correct relationship between family governance and family office governance. A significant part of this article will discuss operational family office governance; however, the reader is urged not to become completely absorbed by the operational aspects of family office governance, as they have absolutely no purpose without the application of the overriding element presented at the end of this article.

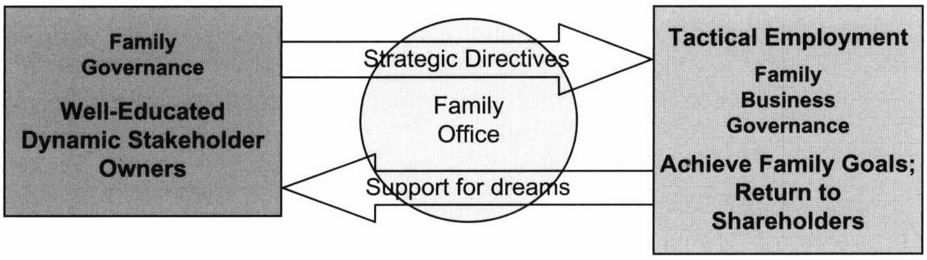
Exhibit 2 is a simplified view of the family office as the flow-through service entity that facilitates the Figure-8 flow of strategic directives from the family governance system and support for materializing the dreams of family members from the family business governance system back to the family.

## OPERATIONAL VIEWS OF THE FAMILY OFFICE

Today, families may draw from a much broader array of choices in family office services and structure. Many outsource certain services, especially those employed only on occasion. The issue of which services to outsource and which to keep in house is a significant one for many families. A family office may specialize in a certain investment strategy and may offer investment alongside the family to outside investors, in which case it more closely resembles another family business than simply a service entity. At the other end, a family may only require a few basic services to be provided in house and find it more cost effective to outsource the rest, particularly if the family's assets are not of a size that would comfortably afford the luxury of housing an entire staff of professionals.

Jon Carroll, CPA, and president and CEO of Family Office Metrics, LLC, notes that some families delegate substantive parts of their family office management while others do not. For example, non-U.S.-based families are much less likely to outsource family office activities than American families. Although this trend seems to be shifting, non-U.S. families currently tend to build family office functions in-house. American families have more heartily embraced the outsourcing of noncore business activities, especially the role of chief investment officer and related back-office accounting and administration. In doing so, they strive to find the best quality service providers for the lowest price. Families may delegate or not but family offices that control their affairs will "pay for themselves" and provide a positive return on the family's investment in the family office.[2]

**EXHIBIT 2**
**Figure-8 Flow Through the Family Office**




*Source: graymatter Strategies, LLC.*

It might be prudent at this point to temporarily segue to a brief discussion of costs involved in both setting up and running a family office and/or a private trust company. An analogy which readily comes to mind when helping a family decide if a family office makes sense for them is the popular anecdote about John Pierpont Morgan. As the story goes, he was once asked what it costs to keep a yacht. His response is usually quoted as, "If you have to ask, you can't afford it." However, versions that may be truer to what was actually said include, "You have no right to own a yacht, if you have to ask that question," and, "If it makes the slightest difference to you what it costs, don't try it."[3] Regardless, the point is sufficiently made that family offices, like yachts, are luxuries that may not be feasible for families with assets under $150 million to $200 million. Fortunately, there are family-office-like structures that afford families with smaller assets access to some level of family office services. So-called virtual family offices are highly customizable and flexible and, of course, multifamily offices are a popular alternative.

The costs of setting up an office, the annual expense of running it well, technology costs, as well as expectations regarding the costs of outsourced advisors are well treated in other sources. For our purposes here, it is worthwhile to note that not only are there hard costs such as those mentioned above, but there are also the soft costs of the time spent by the family on: a) hiring staff and advisors; b) monitoring and coordinating outsourced advisors; and c) educating staff on the goals of the family and ensuring a thorough understanding of how staff and advisors are expected to support the family in achieving those goals. If the right professionals are hired, their high level of expertise will make the management job more complex. Today's marketplace provides competition as well and some families have experienced difficulty retaining top talent. This adds to the soft costs in the extra time required to search for new talent of similar caliber. In fact, the soft costs of time and energy are the *real* costs of owning a family office and should be weighed along with the hard costs and proposed benefits the office might provide.

Some of the services a family office may provide include

- designing and implementing family education programs;
- providing personal family services;
- family bank processing;
- family event and meeting coordination;
- bill paying, chartering air and other travel, real estate investment purchases in foreign countries;
- family foundation management;
- coordinating family advisors;
- investment, tax, and estate management;
- estate planning; and
- implementation of financial and wealth management education programs.

The family office also must manage internal elements, such as

- internal operations, cost containment, governance implementation;
- hiring and retaining staff and executive leadership;
- determining the roles of staff;
- setting up and maintaining a policy and procedures manual;
- overseeing compliance issues on wealth management, especially if the office becomes a multifamily office or it becomes another family business through investment management specialization like hedge fund or private equity;
- family legal and wealth transfer structures, such as Family Limited Partnerships (FLPs) and Family Limited Liability Companies (FLLCs);
- the coordination of trustees, attorneys, accountants, and other advisors; and
- providing the trust protector function (this could be a board function).

Hughes [2004] noted another critical aspect rarely considered by families setting up new family offices is the fact that a "buy" or "make" decision must be made regarding each family office service.[4] This is a highly important decision, particularly in light of the soft costs an office might incur. The decision of whether to hire a corporate trustee or create a private trust company (PTC) is a perfect example. Duncan says that a private trust company can do everything a family office does and more and, if the PTC is set up right, it should cost no more than $100,000 annually over the costs of a high quality family office.[5]

A family setting up new trusts or hiring new trustees for existing trusts weighs the costs of obtaining the highest quality trust services (a buy decision) against what it would cost to create its own trust company (a make decision). PTCs offer many benefits, some of which include the "right to create common trust funds to permit the pooling of individual accounts and the ability of the PTC to be a repository for the family history." A family may be willing to pay more for the high quality, user-friendly services a PTC can offer if such an entity fits the governance system criteria the family has developed.

The same principle applies to any service the family would provide itself through the family office. If families could come to the realization that the soft costs are the real costs of a family office and that each service to be provided requires a "make" or "buy" decision, they would save themselves years of trying to "reinvent the wheel" and could make much more efficient use of highly qualified service providers and consultants.[6]

According to Rankin, families are beginning to realize that the complexity of a family office is, in actuality, like another family business.[7] Hiring internal staff is one of the most complex aspects. Family office executives are in a unique position to serve the family. They may serve on the family council, in which case, they may be called upon to work with the family as it develops the family missions and goals and fine-tunes its governance structure. They can play a pivotal role in balancing all aspects that are unique to the family office business.

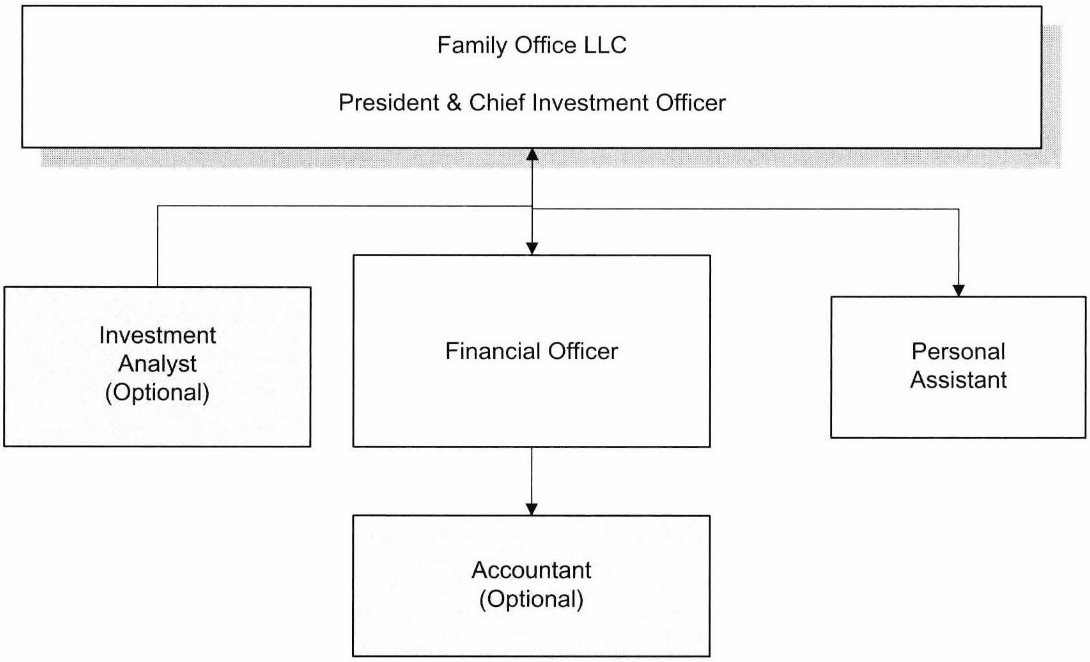
"The family office staff is really an office of very bright professionals who help the family make better decisions about what happens with the wealth. Consequently, expectations around the types of people who should be hired into the family office and their experiences and abilities have changed—they are no longer just caretakers. There needs to be a process that builds consensus around the mission and goals for the family office and how that translates into the nature of the jobs performed and the factors that will impact job performance before conducting an in-depth search in the marketplace for people that have more than technical skills. Hiring only becomes a crisis when you're looking for a quick hire and the short list of candidates to place in a job," explains Rankin. "Family office executives need to understand how to facilitate development of family missions, goals, and governance structure" and to have the patience to deal with all of the aspects that are unique to the family office business.

Linda Mack of Mack International, LLC, confirms the dual role of the family office. The business of the office needs to be managed in a way that ensures the high quality and cost-effective delivery of services to the family. Simultaneously, the family office executive needs to work in partnership with family leadership by bringing best practices to bear in helping the family effectively accomplish its goals. "The family office executive should facilitate clarity, consensus, and alignment of family office services with the achievement of the family's goals. He or she should also facilitate the family's development of missions, goals, and strategic plans to create sustainability for future generations," says Mack.

The emphasis on the facilitation role of the family office supports the notion of the family office as a service entity rather than a governing entity. This positions the office to function in its authentic role as an advisory resource which works with the family in bringing the family's goals to fruition. Exhibit 3 shows an example of a single-family office organization with notes outlining the reporting/accountability matrix and basic qualifications for personnel. The chart shows the positions of president and chief investment officer, financial officer, and personal assistant as in-house functions with the option of outsourcing the tax and investment pieces. Legal advisors, philanthropic advisors, estate management, and other advisors may also be outsourced. Advisors providing counsel on the sale of art collections, purchasing foreign real estate, coordinating estate management staff, the purchase or sale of a yacht, and the purchase or partial purchase of a private jet are other services that are perfect candidates for outsourced arrangements (see Exhibit 3).

Deciding which services the office should provide the family is not an easy task. Family office services involve much more than the management and transfer of the financial assets of the family. There is a fine art to managing a family's assets—both the physical assets and the intangible assets of a human, intellectual, and social nature. Astute advisors can contribute greatly to the prudent management of the family's wealth in a variety of respects. For example, Natasha Pearl notes that one of the main considerations families should include in their planning is their spend rate. "That's highly influenced by whether you purchase a plane, use fractional, use charter, or fly commercial. It's highly influenced by whether you buy your fourth house or whether you'd be content to stay in a hotel. It's highly influenced by whether you have to stay in the penthouse suite or whether you can stay in a comfortable room with a king-size bed. I don't think advisors are talking enough about the spend rate and the factors that can increase or decrease it."

## Exhibit 3
**Single-Family Office Organization**




| Position | Experience |
|---|---|
| President & CIO | 10+ years in investment management |
| Financial Officer | 7+ years CPA with tax background |
| Personal Assistant | 3+ years in a professional office |

**Optional Staff Depending Upon Circumstances**

| | |
|---|---|
| Accountant/Tax | 5+ years public accounting |
| Investment Analyst | 3+ years in a investment business |



"Private staff is another example," says Pearl. "You either go into homes where literally three people rush up to get your coat or, on the other hand, where there's no one there and the people are washing their own dishes. Maybe that makes them happy. On the other hand, they could be doing something more fulfilling with the time they're spending washing the dishes. There are a lot of people who feel there's still some virtue in having caretakers at each residence or a household manager at each residence while trying to be the estate manager and effectively supervise all four—that's crazy! There are people out there who have resort hotel experience who are good property managers and can take advantage of volume discount purchases so that you have consistency across your residences and don't go into one of them asking, 'Where's the corkscrew? I can't find it anywhere!' It's penny wise and pound foolish not to have an estate manager."

All those considerations become part of the family office's operational governance structure: Which services to provide, who will provide them, how they are incorporated into the overall service mix ranging from the types of services described above to the investment and other financial wealth planning services. Those are concerns that have to be prudently governed and balanced by the family office entity for the overall benefit of the family. So, as is any enterprise, the family office is concerned with providing services in the most efficient and cost-effective manner. Outsourcing should be decided based on the quality of service obtainable relative to the price the family is willing to pay.[8]

## FAMILY OFFICE CONSIDERATIONS IN TODAY'S MARKETPLACE

Indeed, the family office may be viewed as a simplifier or manager of complex wealth management issues. Yet each family office will reflect the dynamic composition of the family it serves. The family's generational maze determines the dynamics of the family, which, in turn, determines the specific governance structure of that family along the guidelines set forth in part I of this series (Fall 2007 issue). Each family office will have a different "flavor" depending upon the generation starting it, the event that initiated its conception, and the family entity's "differentness."[9] The specific operational needs and goals of an office also will differ based on those factors. The dynamics of the family, born of the generational perspectives embedded in the archetypes at work in the generational cycles, have a critical bearing on the success of the family office entity. Carroll notes that generational issues are very important in governance from the standpoint of clarifying the founders' roles and the roles of the next generation as well as putting together the right board of directors. The family office chief executive officer (CEO) reports to the board or the family council and the selection of those board members or council members is influenced by generational issues, which, in turn, influence the family office.

Rankin also observes that family offices change depending on the family dynamics, the generation in charge, and the needs of the family. Consequently, the governance structure has to be flexible and responsive to the evolution within the family. There may be years when a family member runs the family office. That family member will be the CEO and the employees of the family office will report to him or her. Or, if there is a family board and the office is self-sufficient, governance is going to function differently than when the patriarch played a direct role in management.

Carroll positions the family office CEO as the gatekeeper between the family and the rest of the world. The person serving the family in that position has to be able to help the family understand the issues, make plans, and execute those plans. He or she not only has to have technical skill, but also has to have the ability to lead and to be a mentor.[10]

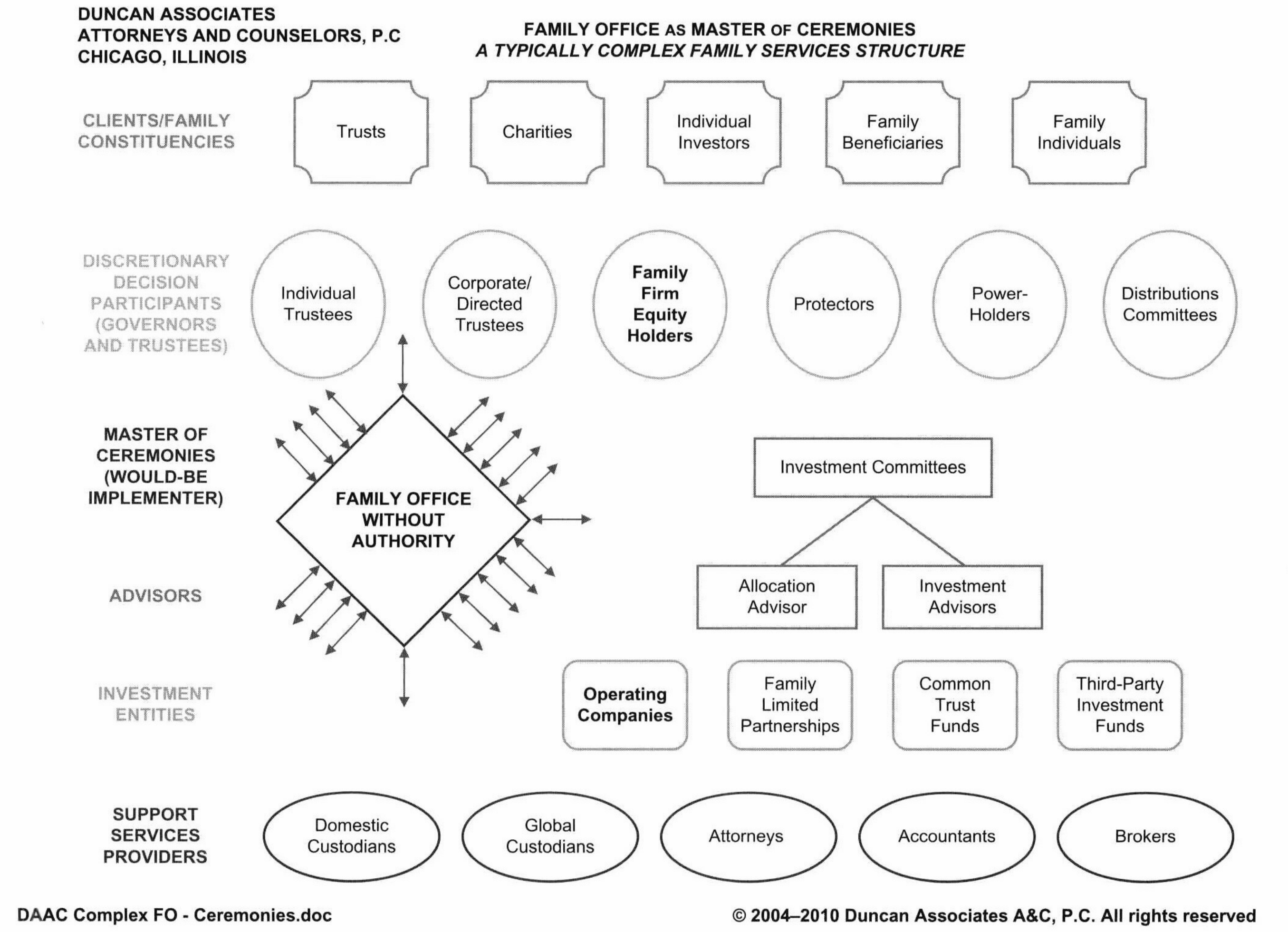
If a liquidity event has occurred, the family office may become the new family business, setting into motion an entirely different set of family office governance parameters. A new entity, such as a limited liability company, may be formed to serve as a sort of holding company for other businesses the family owns and/or partnerships in which the family is involved. In such cases, the family may wish to set up a PTC that would function as the family office for the family, with the multifamily office investment firm becoming the operating business. Exhibit 4 shows a typically complex structure providing family services, which can be enhanced by the PTC structure depicted in Exhibit 5.

In Exhibit 4, we see the disparate relationships between the various family member groups (clients) at the top, the governing bodies on the second level of the chart, the family office and other advisors in the lower levels, and service providers at the bottom. Both Exhibits 4 and 5 show the clients at the top of the chart and the advisors in the bottom half of the chart with the board, family office, or PTC and other functional entities in the middle. Exhibit 5's PTC chart shows the authority given that entity to govern relationships between all levels. The clients at the top of the chart include ownership entities both inside and outside the original entity of family. Such external ownership may include other families who have been invited in to participate in the family's investment focus, making the new family business a multifamily office.

The family entities who exercise control (those who have the power to make discretionary decisions) of the owned assets are on the second level. The board acts as protector to make sure various internal trustees do their jobs. The investment and distribution committees manage the assets of the trusts and make appropriate distributions. The audit committee ensures the assets are managed prudently and that the distributions are documented correctly. On the lower half of the chart, entities in which the owners are invested are advised by investment and allocation advisors; service providers and other types of advisors are shown as support entities. A PTC enables the family to house its own trustees rather than hire corporate trustees or other individuals. The PTC

**EXHIBIT 4**

**Complex Family Services Structure**



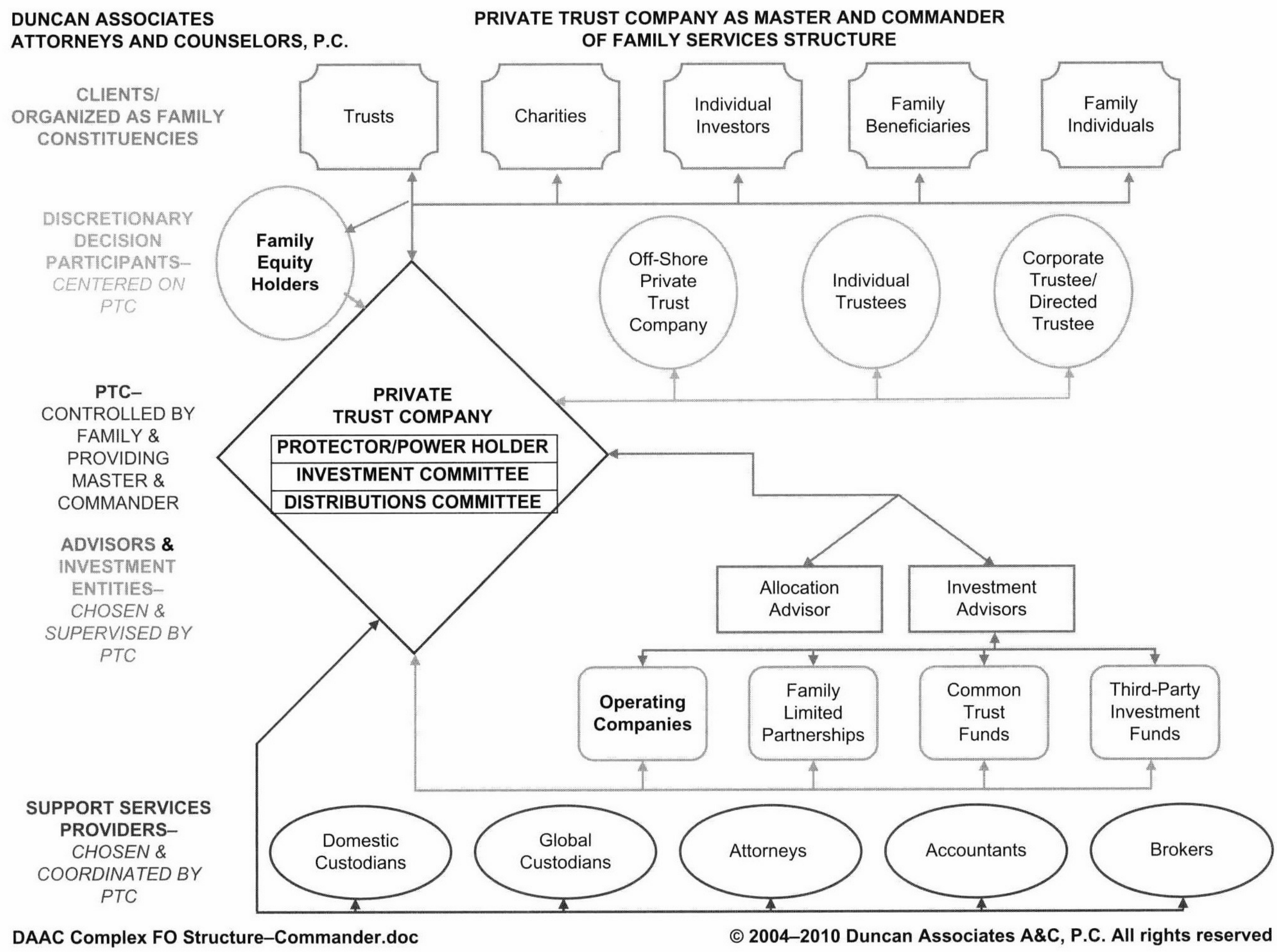

as a whole is then viewed as a trustee of all the entities contained within the family office structure. PTCs set up for single families should, according to Duncan,[11] become the family office, "For a family with significant wealth, the two should essentially be the same in order to avoid a lot of duplication. A private trust company can do everything a family office does and more."

Duncan says an advantage of positioning a PTC as the implementation arm of the family structure is that this trustee can make decisions more consistently with the family's wants and needs. "An individual or corporate trustee may make decisions they view as being consistent with the family's wants or what they've been told are the family's wants, but the decisions that a private trust company makes as trustee are informed by a governing body that's been created by the family and represents the family as a whole."

Exhibit 5 shows how a PTC can effectively organize the complex functions of investment, oversight, and implementation required of a family office. The board and other functioning entities serve as internal checks and balances for the family's financial assets.

Indeed, the family office entity or private trust company may serve the family as a platform through which the portfolio of the family's wealth can be managed. A PTC can actually be a vital instrument for family governance by serving, as Hughes [2004] describes, as a "family seat or center to which family members can look for leadership and services in their individual pursuits of happiness." A PTC also encourages the use of protectors

## Exhibit 5
**Private Trust Company Organization**




as an alternate source for trustee/beneficiary dispute resolution. A family office or PTC can provide investment management, tax planning, estate planning, and other financial and investment management for the financial assets. It can work with family members to plan family meetings and facilitate the implementation of other family governance projects to foster the family's human capabilities and the "spirit of family." It can provide educational planning, set up apprenticeships, provide access to external support for entrepreneurial ventures to support the family's intellectual capacities or it can offer support for networking, the family foundation, community involvement, and political influence for the family's social capacities. Those activities revolve around the family and its various forms of capital; no family office activity occurs for the exclusive benefit of the family office itself. Therefore, the role of governance of the family office entity is to provide support to the governance systems of the family and the family business.

If the family experiences a liquidity event as discussed above, the family office may develop a specific investment specialty, such as real estate, or some type of hedging strategy. Ehlern [2006/2007] notes it may offer this specialty to other families. The nature of the family office changes and its needs more closely resemble that of a family business—in essence, because it has *become* the family business. In this case, the three separate entities do not disappear into two; but the entities of the family office and the family business combine to form a unique family entity. Exhibit 4 is an altered version of the Exhibit 2 shown in Part II (Fall 2008 issue) where the business and the family office are shown side by side as service components within the overall governance delegation of authority.

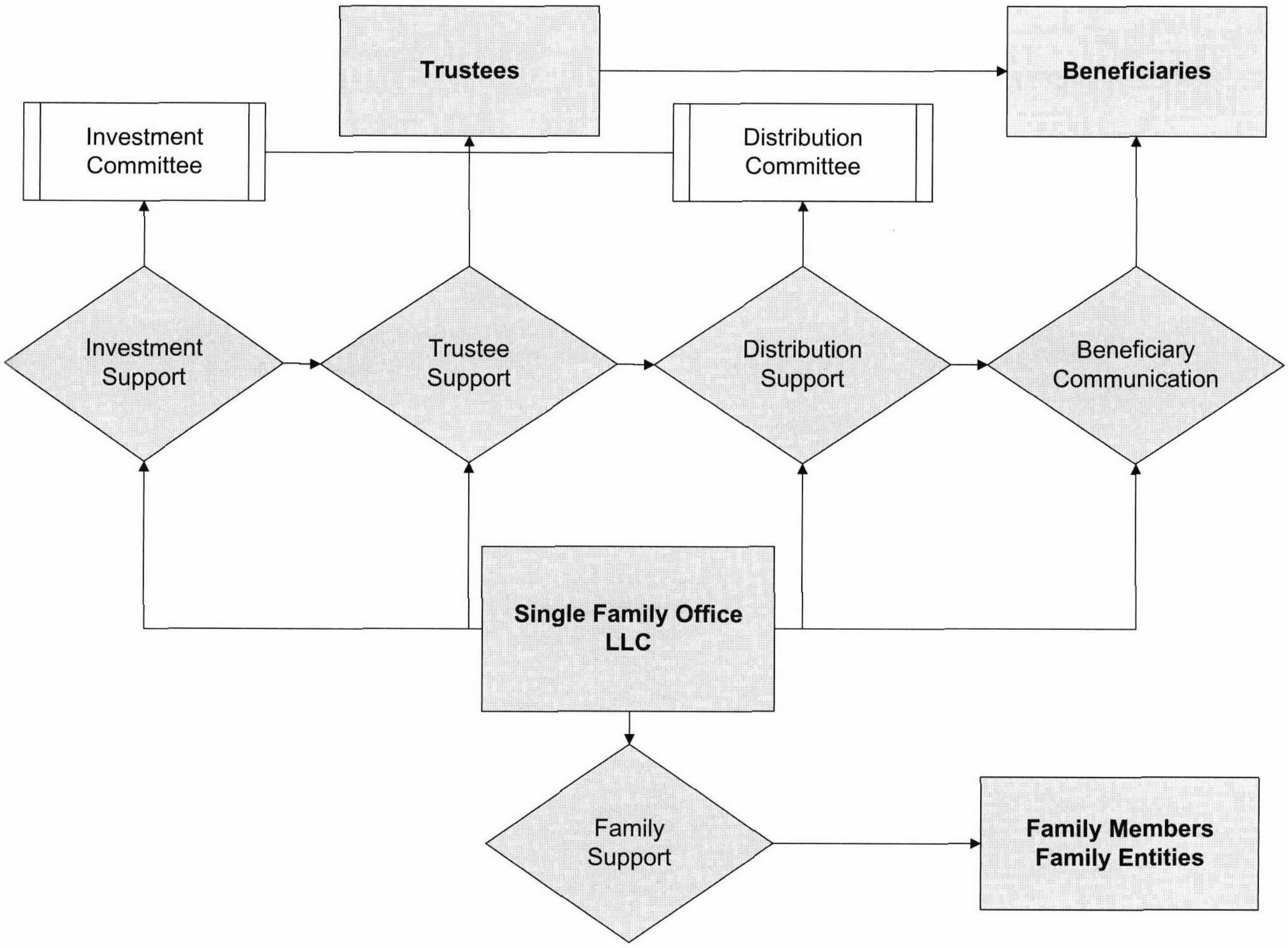
In Exhibit 6, the chart reflects the shifting of the service provisions the family office entity was expected to provide into the realm of family governance with the creation of a post entitled "family president" to oversee the functions of education and family committee activities. For example, the family president may ask a family member to take on the role of project manager in working with family office staff on a specific task. By appointing a family president, the family council effectively frees the family office of the more personalized aspects of service, allowing the multifamily office to more fully incorporate a family business governance structure designed to generate financial profits. This frees the family office to give greater attention to the needs of the business of managing the family's financial assets and maximizes the relationship between family governance and the governance of the family office entity.

## OPERATIONAL GOVERNANCE OF THE FAMILY OFFICE ENTITY

To this point, we have examined each primary family entity and the facets of appropriate governance for each. We have seen how vital the respective support processes are to the entity being served and that none of the three entities stands completely on its own. Just as

**EXHIBIT 6**

**Family Office Support Flow Chart**



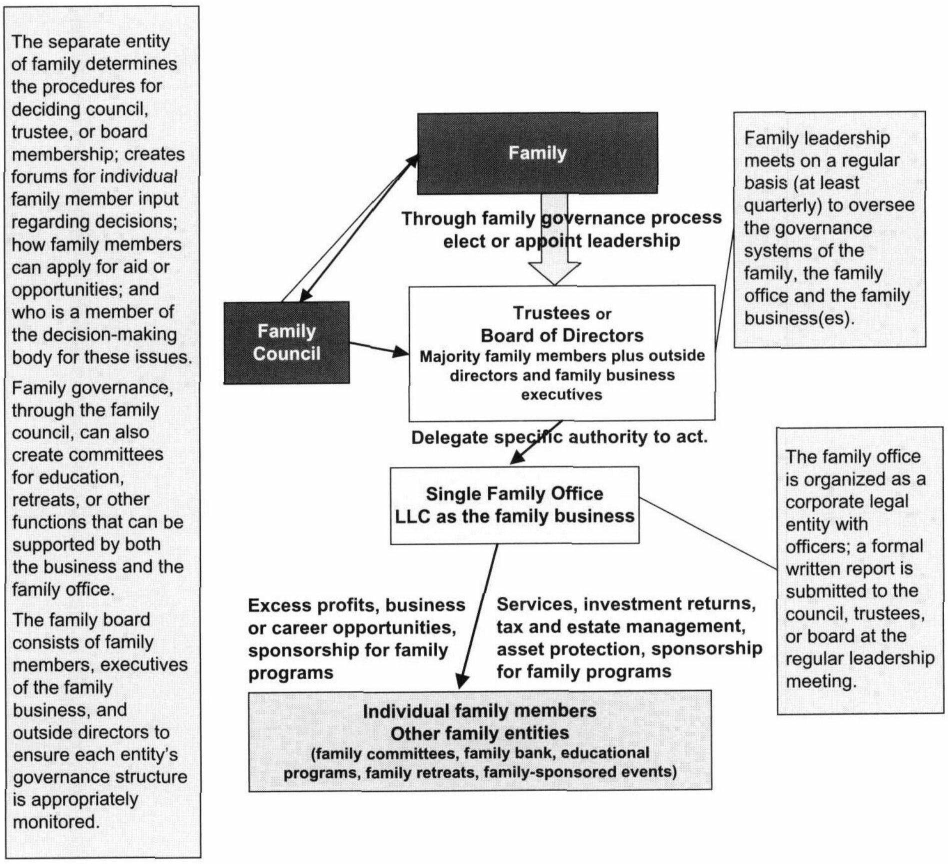
the entity of family is larger than the individual family members, the concept of governance necessarily becomes larger to enable the successful integration of all three governance systems and the ultimate support of family goals, which include goals for the business as well as the family. As noted earlier, the function of the family office is to serve the family and house the tools that foster the family wealth, such as investment management, tax and legal planning, estate planning, and/or personal family services to support the growth of human, intellectual, social, and financial capacities.

In Exhibit 7, we again see how the three governance structures work together, conceptually integrating the governance systems of each of the three entities so that decisions are made appropriately for each entity, then viewed comprehensively for the benefit of the whole. The family either votes or appoints delegates from the family and the family business to the family board. Outside directors may also be appointed as well as the family office executive. Representatives from the two primary entities, the family and the family business, serve on the board, and representatives from the family office are appointed at the family's discretion, based on the family office structure. Thus, the family board is the collection of family representatives chosen by the family to guard their interests and to make decisions that will both protect the family wealth and foster its development.

Exhibits 7 and 8 are a more robust illustration than Exhibit 2 of the implementation of governance with the family office positioned to appoint positions of authority between the family services performed, the people and advisors performing them, and the family members themselves as well as family entities, such as the

## Exhibit 7

**Governance Delegation of Authority**

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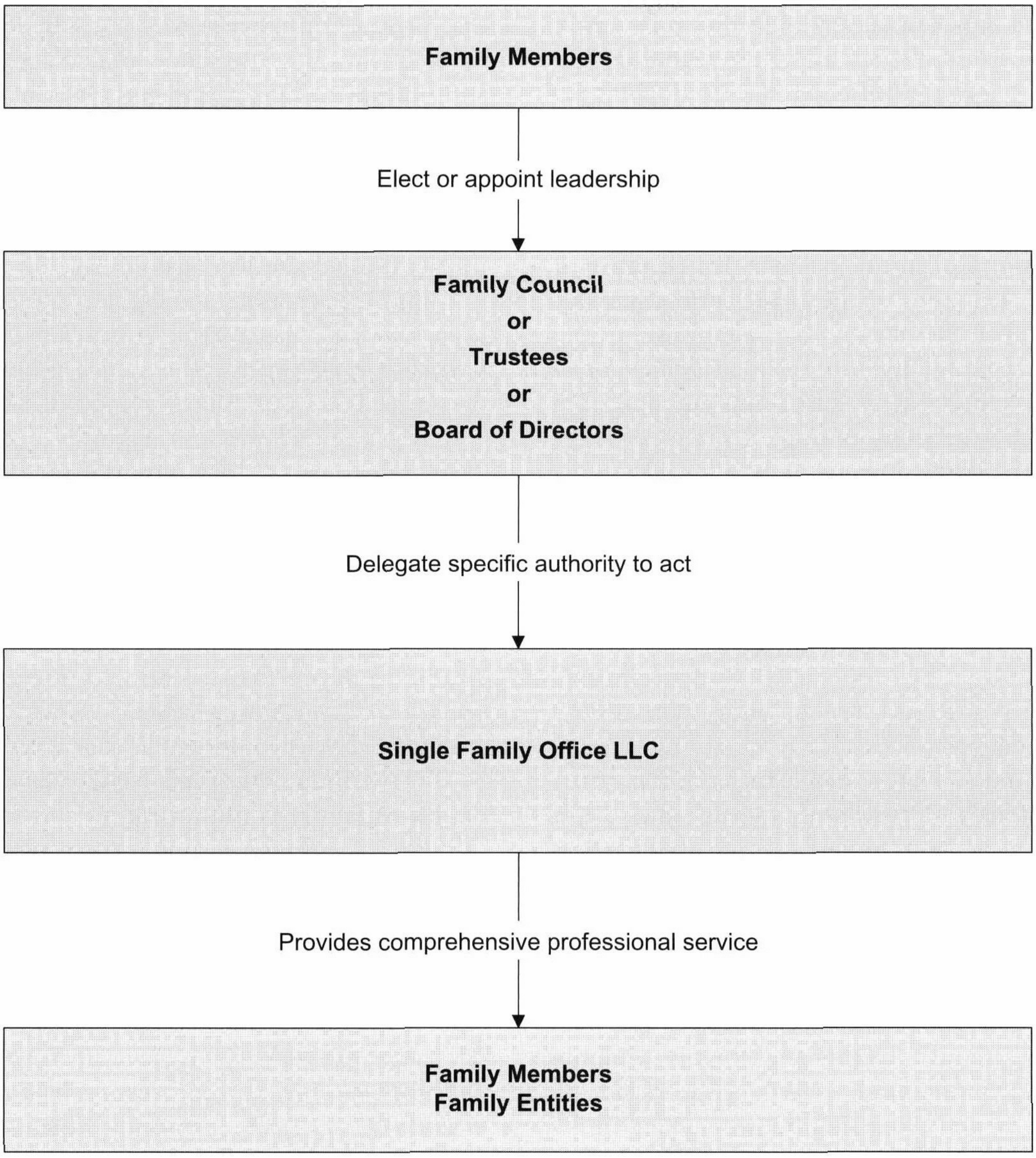
## Exhibit 8
**Family Office Flow of Authority and Services**






family-operating business. It shows how the various sub-entities work together for the benefit of the other two primary entities of the family and the family business. Although the chart shows the trustees hiring the family office entity to provide support services, the trustees themselves—as well as all other family advisors—are, in some form or fashion, under the governance of the family. A trust protector may be hired to ensure trustees are indeed fulfilling their duties and should have the power to replace a trustee if that becomes necessary. Although the family office is the conduit through which multiple advisors work with the family, the unique nature of family office service includes the possibility that the family may not take the advice of its advisors. Such a decision ultimately may be to the detriment of the family, but it is, nevertheless, the family's prerogative and any resulting mistakes fall under the accountability of the family.[12] The family office has the responsibility to help the family understand possible ramifications of such a decision, but *all advisors—either in house or outsourced—as well as family office executives and staff are deemed to be in the service of the family.*

As the number of family members and family entities grows, the demands of the family office become more complex. Families may wish to establish a private trust company to better organize the management of all their concerns. Hundreds of trusts, multiple operating businesses and partnerships, multiple trustees, advisors of all types, and multiple investment pools need coordination and monitoring if the proper service level to the family and its entities is to be maintained.

## THE OVERRIDING ELEMENT OF FAMILY OFFICE GOVERNANCE

The family office is a unique entity with a duty to implement best practices, while remaining attuned to the family and flexible enough to serve them in a manner consistent with the family's goals. The role of family governance relative to the family office is to select the services needed by the family, select the staff and advisors qualified to provide them, allow those advisors and service providers to do their best work within the guidelines the family has set forth, and to replace them if the family collectively feels they are not performing as they should. In the best situations, family governance and family office governance work side by side, with overlap and direct family involvement in the areas deemed most appropriate. The right staff and advisors who sign on with such an arrangement take on very fulfilling professions, because they are enabled to serve at the highest level.

"You want the brightest and best from the industry who have the service heart required to work with families in a close relationship and who really want to make a difference on a private basis rather than working in a public company, accounting firm, or law firm. You have to really understand the nature of the family office business and the interrelationship between family issues and business issues," explains Rankin.[13]

Hughes [2004] notes that the core addition to a family's suite of services by affording its own office is having people who are committed to the principle that in everything they do, they will seek to educate family members on their roles in that part of the family's administration and government. One surprising result of the survey conducted by Williams and Preisser [2003] was that much greater time was devoted by family members in setting up estate-planning documents than in educating their progeny to effectively manage the impact those documents would have on their lives.

Indeed, according to Hughes, "*Unless the educational component is the raison d'être for the office in the first place, there is no reason to have a family office* as opposed to using outsourced services. Outsourcing will always be more cost effective and efficient, basically because the hard costs will be less. More importantly, the family will have no soft cost of its time given to the management of the office. Family offices' only reason for existence other than the hubris of saying you have one is if they are the educational antidote of the form and function paradox."[14]

This means that the primary focus of the family office is *qualitative*, not *quantitative*. I would add to Hughes' statement above by noting that education simply cannot be effective unless the family has developed a solid foundation of family communication and trust on which to build. The family respondents in the Williams and Preisser survey [2003] attributed 60% of the fulfilment rate of the Proverb to a lack of communication and trust among family members and 25% to heirs' lack of clarity regarding their roles and the responsibilities that accompany them. *Therefore, everything we have discussed in this section up to this point is completely moot if an overriding concern of supporting the trust-level communication and educational roles of the family governance system are not foremost in the minds of family office personnel.*

This turns the dynamic of the family office completely on its head. Rather than thinking of the family office as simply a place to house trustees and advisors to manage the family's financial assets, it becomes a critical support system for the communication and educational roles of family governance. Since the support of those roles becomes the very reason for the family office's existence, it also places the family office squarely in its most proper role of serving the family in its effort to achieve its goals. Even if the family office becomes another business of the family, the service element remains. Within this new dynamic, an added dimension for hiring family office personnel emerges: *Personnes de confiance* should be hired for the key qualitative positions and *Personnes d'affaire* should be hired for the supportive quantitative functions.[15]

Examples of qualitative positions include, but are not limited to

- education of younger generations on how family systems and organisms work and their roles in making them work;[16]
- family meeting support (communication, mission statements, family constitution);
- coordination and monitoring of family advisors;
- estate planning and wealth transfer structure design;
- family bank process design.

Examples of quantitative positions include, but are not limited to

- operations and business processes;
- investment management and trustee functions;
- office management and compliance issues;
- tax management;
- family foundation management;
- personal services management.

Conversely, a virtual office structure—one that employs outsourcing as a total solution—by its very nature cannot effectively support either the communication or educational role of the family governance system. The support of these roles comprises the soft costs of the family office. The virtual structure is designed primarily with efficiency in mind and soft costs are not part of the equation. Therefore, if a family cannot afford the luxury of a family office focused on supporting the communication and educational functions of the family governance system, the family governance structure itself will have to develop and support those programs and outsource the hard-cost functions in the most efficient manner possible.

Now, if we go back over the entire article with these new elements in mind, we see how the three forms of governance—family governance, family business governance, and family office governance—truly complement each other toward achieving the ultimate goals of the family entity. As noted in part I, "Any form of family governance is designed to provide a means for the higher functioning of the joint decision-making process—no more and no less." The paradox of many governance systems today is that families are so concerned with getting a form of governance in place that the functions of governance are often overlooked, causing the governance systems to fail, the family goals to go unachieved, and the family wealth to be diminished.

## RELATIONSHIPS BETWEEN THE THREE FORMS OF GOVERNANCE

Separating the governance components makes it much easier for families to address their needs and to identify sources for support in achieving their goals. Monitoring the family, the family business, and the family office for possible issues becomes much easier through a three-faceted system. Imagine a family who spends the time, effort, and money to develop a governance system for the family and sets up the family office after the family governance system is in place rather than the other way around. What better insight into their authentic needs might they have! What greater knowledge of the types of advisors they need, of the services they need to provide in-house, which can be outsourced and what will be expected of each advisor, executive, or staff member. Think of the time and money saved and the higher quality of service the family will experience as a result.

Throughout the discussion of governance of the various family entities, the common denominator has been the empowerment of family members as dynamic stakeholder owners. The ability of the family to act together for the benefit of the family in making decisions, especially difficult ones, inspires the family spirit, re-creates the family identity, and makes the family a stalwart entity.

The separation of governance structures also enables a family to manage its emotional connection to the business in a more beneficial way. It allows a founder to see that the identity to which he is so closely tied will always be there for him, regardless of a decision to sell the business. What he built for the family will always distinguish the family. It will live on through the stories that are told, the history of generations past told by the generations who are living, and it will continue to add meaning to the lives of generations who follow.

The separate treatment of governance structures also serves as an effective checks and balances system to keep the flexibility the family needs as it experiences inevitable growth and change. This yields a win for the family; a win for the business of the family; and a win for those serving the family through the family office.

## ENDNOTES

[1]The Family Governance Triangle$^{SM}$ is a service mark owned by graymatter Strategies LLC.

[2]Carroll, Jon, CPA, president and CEO, Family Office Metrics, LLC, personal interview, January 2007.

[3]Strouse, J., *Morgan: American Financier,* New York, NY: Random House, 1999, p. 206.

[4]Hughes places the minimum asset level at $60 million in his book, *Family Wealth: Keeping It in the Family*, [2004, p. 147].

[5]Duncan, John P.C., principal of the law firm Duncan Associates and Counselors, P.C., places the exhibit between $100 million and $250 million. Personal interview, February 2007.

[6]Hughes, [2004, pp. 150–151].

[7]Rankin, M.J., president, the Rankin Group, personal interview, November 2006.

[8]Pearl, Natasha, founder of Aston Pearl, personal interview, December 2006.

[9]Hughes, Jr., James E. Personal interview, October 2007. The term "differentness" in reference to the family entity is used with permission.

[10]Carroll, Jon, CPA, president and CEO, Family Office Metrics, LLC, personal interview, January 2007.

[11]Duncan, John P.C., principal of the law firm Duncan Associates Attorneys and Counselors, P.C., personal interview, February 2007.

[12]Handler, Thomas J., J.D., P.C., Handler, Thayer & Duggan, September 2006.

[13]Rankin, M.J., president, the Rankin Group, personal interview, November 2006.

[14]Hughes, Jr., James E., personal e-mail exchange, March 14, 2007.

[15]Hughes, personal e-mail exchange, March 14, 2007.

[16]Hughes, personal e-mail exchange, March 14, 2007.

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Hughes, Jr., J.E. *Family Wealth: Keeping It in the Family.* New York, NY: Bloomberg Press, 2004, p. 152.

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# Wealth Management



Private wealth management is the investment management specialization focused on high-net-worth individuals and families. Portfolio design and investment solutions in private wealth management are customized to reflect the complexities of the investor's unique circumstances. This literature review reflects the current best thinking on private wealth management.



This article is the third part in a series adapted from the book, *Generational Wealth Management*, the first part of which was initially published in the Fall 2007 issue of *The Journal of Wealth Management*. Part I noted the importance of the hierarchy of the three forms of governance: family governance is the most critical structure governing the three entities. Part II (Fall 2008) positioned the family business in its proper role as the instrument by which the founding generation's authentic wealth was materialized and explored its ongoing roles and responsibilities as the materializing instrument of the wealth. This third and final offering on family office governance brings together the three forms of governance discussion, showing how all three forms work together to support the family's optimal achievement of the goals it sets, whether those goals are investment, personal, or business related.



The authors propose an incremental step toward combining the insights of modern portfolio theory with some of the propensities documented in the literature on behavioral finance. They develop a goals-based wealth management approach that finds a specific subportfolio to address each of an investor's goals and then derive the least-cost solution. They relate the closed-form solution for the one-period, two-asset problem to the mean–variance efficient frontier. Consistent with the "lockbox separation" concept proposed by Sharpe, they demonstrate that a multiperiod goal, such as a retirement plan, can be viewed as a collection of single-period problems. Next, they extend their result to a market with many assets, where portfolios are exogenously given. Finally, they illustrate the approach with a case study with multiple asset classes and multiperiod goals.



The goal of wealth generation demands a different investing strategy than the goal of wealth preservation. This article attempts to understand the impact of portfolio diversification on the ability of an investor to move up the wealth spectrum. While modern portfolio theory systematically eliminates idiosyncratic risk to create an optimal diversified portfolio, the authors' conclusion is that upward wealth mobility is unlikely without the assumption of idiosyncratic risk. The authors use simple quantitative arguments to demonstrate that if an investment portfolio were limited to well-diversified portfolios lying along the efficient frontier, it would take close to a century to materially change the investor's relative (wealth) position in society. A variety of data sources, including the *Survey of Consumer Finances*, the Forbes list of wealthiest individuals, and historical market returns are used to support those conclusions.



After two serious declines in asset markets in less than 10 years, wealth managers today must contend with increasingly concerned clients amidst increasingly volatile markets.