Wealth Preservation Tips from the Leading Families

Studying diverse cases of families' wealth creation and wealth preservation (or destruction) is fascinating! Evidence shows that families create wealth by concentration, but KEEP it through effective diversification. Preserving wealth proves to be as, or even more challenging, as creating wealth. The leading families are not only able to create vast wealth during the "concentration" stage, but more importantly, they are able to maintain, grow and transfer their wealth over generations. As such, they are able to leave a legacy.

In this Thinking Man, we identify a few of the shared Best Practices of the leading families from all over the world. We base our findings on our research of case studies from families, of success stories and of failure stories. We also base it from our experience of being (or trying to be) the "*Consiglieri*" of our family clients.

We find that Family Unity and wealth preservation are the two dominant objectives of families. While there is no one single model or magic formula to achieve Family Unity and wealth preservation, there are Best Practices amongst leading families, which we summarize into:

1. They have a structured approach to managing their wealth and foment Family Unity, frequently organized in the form of a family office or an investment partnership.
2. Regarding investment management and strategy:
    a. They generally allocate large parts of their wealth to Illiquid Investments like Private Equity and Real Estate;
    b. They are well diversified;
    c. They focus on Co-Investments (with other partners they collaborate as part of their long-term strategy)

1. A structured approach to managing wealth

Having a clearly defined Family strategy, and investing time and energy in its implementation, is fundamental to achieve the goals of wealth preservation and family unity across generations. The leading families "institutionalize" their practice of wealth management, utilizing vehicles like an investment partnership or a family office. No doubt that one key best practice is to run the family money like a business" and separate it from the operational businesses. As a family moves through generations, we can view it as a system that must function in two very different realms—the realm of family relationships, and the realm of finance and business, or the Business of the Family and the Business of Wealth.

The Thinking Man's Approach

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As the proverb goes, families face some laws like "Shirtsleeves to shirtsleeves in 3 generations". Preserving wealth proved to be even more challenging than creating wealth. The leading families are able to create but more importantly maintain, grow and transfer their wealth over generations. As such they are able to leave a LEGACY. "What can we learn from them?" is the main focus of this paper. We discuss having a structured approach to managing wealth, allocation to illiquid investments, and the importance of diversification, as well as co-investing with like-minded investors (with whom they share a value system). We also highlight various case studies of families to learn from their diverse experiences.

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Each area demands different skills, capabilities and rules, and must contain clear structures, agreements, policies and activities. In regards to the Business of Wealth, there are objective criteria to choose the most appropriate wealth management set-up and Family Governance. In general, a **Family Office**, whether dedicated (or Single Family Office) or shared (Multi-Family Office) is a better solution for ultra-high net worth families. ***Quilvest***, the Family Office of the Bemberg family, with over 100-year history, held for seven generations is a good example. Their activities extend beyond just investment management; their focus is on **Wealth Stewardship**, defined as the dedication to discipline, intellectual integrity and alignment of interests necessary to facilitate the transfer of a legacy from one generation to the other. Family Stewardship is the ethic that embodies the responsible planning and management of the family's resources. For this, the key is a **Family Governance** structure that include rules and policies for Shareholding (transfer policy, dividend policy, share transfer restrictions and more); Decision making (voting policy, involvement in the Board); Conflict resolution process; Right to work for a company owned by the family.

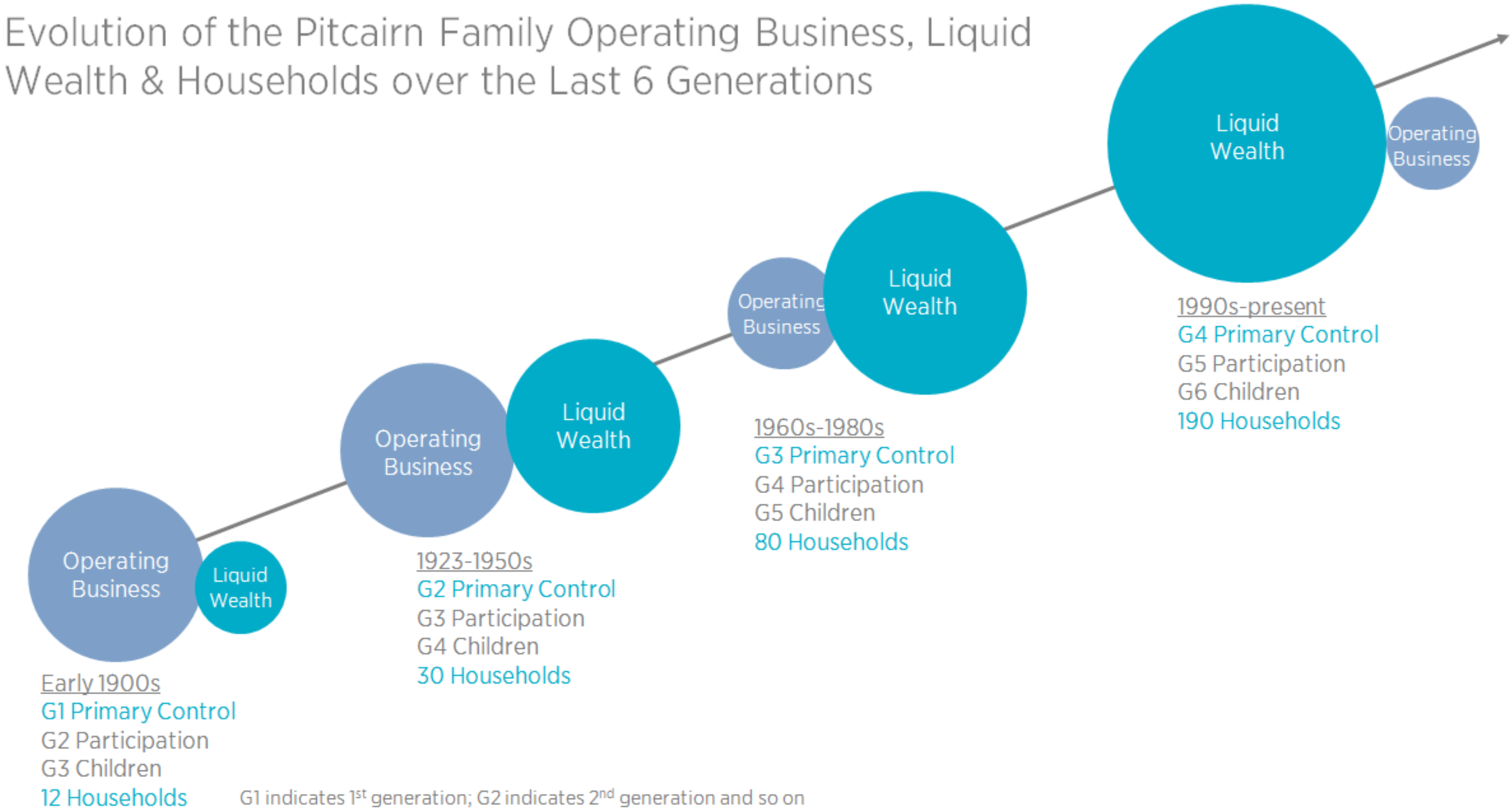
In this last regard, for example, the ***Phipps*** family, owner of Bessemer Trust (created In 1907 as a family office, to manage the proceeds from the sale of Carnegie Steel), have decided decades ago that no family member could participate in the bank's management. Their participation is solely through the board.

A wave of family offices will be transformed into registered investment companies over the next decade in the face of increased regulatory scrutiny and a growing culture of professionalism. Significant effort goes into the establishment of these structures to achieve tax, legal and financial advantages. Moreover, the **human capital** aspects of the family are also key.

Successful families ensure that their **purpose** and **values** carry through into the governance of the structures they establish that connect and integrate their family, business and community objectives. A good family governance structure helps to tackle the Human behavioral risk factors. The new field of Behavioral Economics and Behavioral Finance, has made great progress in studying the effects of psychological and emotional factors on individuals' economic decisions, like:

- i. Lifestyle expense inflation and Over-spending
- ii. Lack of portfolio strategy (so client acts emotionally and "buys high and sells low")
- iii. Family Conflicts (divorces, siblings conflicts and other)
- iv. Excessive use of leverage (on illiquid investments)

A great example is the first Family Office on record from 1923: the ***Pitcairn*** Family Office. It managed the wealth of the founders of Pittsburgh Plate Glass Company (1883), which in 1968 changed its name to PPG Industries, Inc. The "Pitcairns" are a family that has beaten the ominous shirtsleeves proverb by preserving wealth for six generations, growing from initially 12 households to 190 households today. It's interesting how successful single family offices naturally evolve into successful multi-family offices. The below graphic depicts the increasing importance of the Pitcairn's liquid wealth over the generations.



Last but not least, a critical role of the family office is to develop the family's **human and intellectual capital**, investing in **education**, preparing the next generation members, supporting entrepreneurship and communicating and discussing the family history, values, mission and culture.

2a. Private Equity, Real Estate and other illiquid investments

In terms of asset allocation, the leading families have a similar asset allocation to Sovereign Wealth Funds and University Endowment funds. Private Equity, Real Estate, Natural Resources (metals & mining, timber, oil & gas) and Hedge Funds are together generally asset classes with over 50% allocation.

The *Harvard Business Review* from February 2015 notes that David Swensen, the CIO of the Yale University Endowment Fund, has a 31% allocation to Private Equity and over half in Alternative/Illiquid investments. Why? Swensen notes that the difference in performance between the best and the worst managers within an asset class, is key to determine how much alpha or value can be created within that asset class. For US fixed-income managers the gap between the top quartile and the bottom quartile was 0.7% per year. For US Large Cap stocks, that gap between the 25th and 75th percentiles managers was 1.6% per annum. This gap widened quite significantly in less liquid assets: 5.8% for hedge funds, 14.4% for US buy-outs, 16.4% for natural resources, 16.6% for Real Estate, and 19.8% for US Venture Capital.

Clearly, illiquidity premiums exist, but you also need to be with the top quartile managers. Incremental returns were possible with superior managers in non-public markets characterized by incomplete information and illiquidity. The Yale Endowment fund returned 13.9% per annum over the last 20 years, but lost one quarter of its value in 2008. Swensen notes it's a long-term game.

Let's look at the case of arguably the best investors of our time, ***Warren Buffet*** and *Charlie Munger*, who hold around 2/3 of the $340B market value of Berkshire Hathaway in a **private equity portfolio**. This private equity portfolio generates around 70% of BRK's earnings, while only 30% come from the publicly traded equity portfolio. As we note in our Thinking Man #16, Berkshire's great absolute performance is not so much as a stock-picker than someone with ability to acquire and manage private components. Also, we note he makes good **tactical bets** from adjusting **leverage** and varying **public/private weights over time**.

2b. Diversification (by industry and/ or away from home country risk)

The risk of diversifying away from local country risk is especially importantfor Emerging Markets based families.

We prepared a presentation to a prospective Brazilian billionaire client with over 90% of his assets in "Brazil risk" (both operational businesses and financial assets). Comparing his total portfolio with a globally diversified balanced portfolio (Gp), we found that long-term returns were similar, but Gp risk is much lower. Gp is a proxy for the Global Market Portfolio.

We pointed out to our prospective client that Brazilian Real Estate is around a 0.3% of the Global Real Estate Market Cap - and he has 25% of his total wealth in that asset class. We also note that the Brazilian stock market is around 0.4% of the Global Equity Market Cap – and he has 25% of his total wealth in Brazilian stocks. Most of the other 50% of the portfolio has currency and interest rate exposure in Brazil! We measured risk in terms of volatility (6% for Gp vs 23% for the highly concentrated Brazilian portfolio). More importantly, Gp has a much lower probability of permanent capital loss and probability of negative returns in any year (11% vs 34% Brazil only). Thus, Gp has an Improved Sharpe Ratio (1.2 vs. 0.4 Brazil only). This has huge implications for managing the family's wealth.

Jorge Paulo Lemann, ranked as the 26th richest person in the world by Bloomberg Billionaire Index, with an estimated net worth of US$25 billion as of February 2015, is Brazil's richest man and Switzerland's second richest. In 1971, Lemann, Carlos Alberto Sicupira and Marcel Herrmann Telles founded the Brazilian investment banking firm Banco Garantia, which they sold to Credit Suisse in 1998. In the last 18 years, Lemann has been acting through his partnerships GP Investimentos and then forming 3G Capital, a global investment firm, founded in 2004 by the same partners originally from Banco Garantia. Lemann quietly created wealth by diversifying out of the "Brazil risk" by buying Brahma in 1989 and from there has been growing the sector from a regional to global firm. He was carefully planning his moves on high profile targets in the US and Europe like Anheuser Busch in 2008 and more recently Heinz in 2013, Burger King in 2014 and Kraft and Sab Miller in 2015. It was the success of the *Santo Domingo* family and other regional brewing dynasties like the *Bemberg* family in Argentina and the *Mendoza* family in Venezuela, who inspired Lemann to get into the brewing business. Today the combination of the world's two biggest brewers would be the third-largest takeover in history. *Forbes* says he is doing what may sound strange to many Americans, who for a long time have been used to seeing US corporations buy up foreign firms, and not the opposite.

The ***Santo Domingo*** family: In addition to being very strategic, these successful families are opportunistic. When the economic situation became very good in Latin America, this family started selling a significant amount of assets and going abroad. Thus, they were less exposed as the entrepreneurs with high concentration in a country and in one region (Latin America). The merger of Anheuser-Busch Inbev NV and SABMiller Plc created the ultimate King of Beers, while the wealthiest family in Colombia, the *Santo Domingo* clan, led by 38-year-old Alejandro Santo Domingo, saw its fortune swell by $2.2 billion to $15 billion (according to the Bloomberg Billionaires Index). Their secret to success was geographic diversification and "globalization". The Santo Domingos' biggest move was the 2005 sale of Bavaria brewery, then Colombia's biggest, to SABMiller in exchange for stock. The deal transformed the family from majority ownership of a regional brewing powerhouse to the second-largest shareholder -- with 14% of the equity and two seats on the board -- in the world's second largest beer maker. Mr. Santo Domingo manages the family fortune out of Quadrant Capital Advisory, alongside his cousin, *Carlos Alejandro Pérez Dávila*, a former Goldman Sachs investment banker who sits with Alejandro on SAB's board. Today, the Santo Domingo Group has investments in real estate, banking, broadcasting and service companies. In one deal last year, the family-owned Terranum Group teamed up with billionaire *Sam Zell's* Equity International to buy the Decameron chain of resorts across Latin America.

2c. Co-Investments or "Club of Investors" concept

Another great example of a well-diversified approach to wealth management is from ***Bill and Melinda Gates***. They manage their wealth through Bill and Melinda Gates Investments (BMGI), run by chief investment officer Michael Larson. Bill Gates hired Larson 22 years ago to take over the investment of his personal wealth, which was about $5bn at the time. Since then Gates's fortune has grown to around $80bn (of which he has given away around half to **philanthropic** causes) after Larson diversified the funds out of Microsoft, Gates's software company, and into a broad range of investments. BMGI is an organization that manages the portfolios of Cascade, the Bill & Melinda Gates Foundation Trust and other entities, but again it does not label itself as a family office. Cascade is not a family office in the traditional sense as it does not handle logistics, payroll or expenses for the foundation and is purely an asset management firm that invests Gates's personal wealth.

One interesting observation is how these leading families co-invest alongside each other. Gates' BMGI owns 4% of Berkshire Hathaway. Most recently, in July 2015, 3G Capital partnered with Berkshire Hathaway to complete the combination of H.J. Heinz Company and Kraft Foods Group, forming the Kraft Heinz Company, following 3G and Berkshire's acquisition of Heinz in June 2013. Also, the deal between Inbev and Sab Miller, the 4th largest in history, was closed by a conversation between Lemann and Santo Domingo. The two billionaires know each other well since the Santo Domingos are investors with 3G Capital.

Co-investments are a focus at our company, as we believe we can successfully co-invest with great families which we **share values** and through vehicles where we have our **interests aligned**. We call this "Club of Investors". These deals allow us to collaborate with other family offices or investment partnerships. We have done this in Real Estate, Private Equity, Venture Capital and Real Estate investments. Through **collaboration** we can improve the quality of our access to deal flow. We think this is another Best Practice from leading families.

Some case studies of Wealth destruction

1. Coming back to Latin American brewing dynasties: contrast the difference in success in the last decade between the Santo Domingos, and other regional brewing dynasties like the *Mendozas* in Venezuela, who missed the opportunity to sell Polar (their local king beer company) to a multi-national. They missed the opportunity to be part of a global brand and own shares in a global brewing king. Error: not diversifying away country risk.

2. The Case of the *Zambrano family* of Mexico's Cemex. In its heyday one of the world's top three cement companies, which almost went bankrupt after it

embarked on a US and European buying spree just before housing markets plunged in 2008. We think this case relates to **Human Behavior** of over ambition, excessive debt and bad timing.

3. Lastly, an Asian case study. Perhaps this case brings the biggest lesson as it comes from the "oldest money" – defined as the family where <u>wealth transferred over more generations</u>. The case of the *Kongō Gumi* Family, who had a construction company headquartered in Osaka, Japan which was in operation for more than 1,400 years. It was founded in the year 578 and was a family company for 40 generations until it was sold in 2006 (considered oldest family business on record). They were heavily invested in Japan and wanted to diversify their portfolio in the 1980s. To diversify they invested in real estate but only Japanese Real Estate. After the boom and bust of the Japanese economy and real estate market the company was loaded with debt and limited revenues. To maintain a sliver of the wealth, the family was forced to sell the company in 2006. The 40 generation dynasty came to an end because of their **concentration of risk** (in this case by both industry and country).

Conclusion

We find that Family Unity and wealth preservation are the two dominant objectives of families. There is no one single model or magic formula to achieve family unity and wealth preservation. But there are **Best Practices** amongst leading families that allow them to successfully **manage** the main **risk factors** they face. These include:

1. **Concentration** in a single asset (in one industry/ sector risk and technological changes);

2. **Geographical** concentration (country risk, regional risks and FX risks);

3. Those related to "**physical or scientific laws**" (*) like Taxation and family proliferation**. Death** and **taxes** are life guarantees. The mere fact that **families grow in time**, creates the reality that family wealth must grow at fast enough rates – most often impossible.

4. Those related to **Human Behavior** like:
    a. Lifestyle expense inflation and over-spending
    b. Lack of portfolio strategy (so client acts emotionally and "buys high and sells low")
    c. Family Conflicts (divorces, siblings conflicts and other)
    d. Excessive use of leverage (on illiquid investments)

Having a fiduciary mindset and creating a **Family Governance** structure that educates and empowers current and future generations to make decisions as one unit. The family governance structure should include rules and policies for Shareholding, Decision making, Conflict resolution process; Right to work for a company owned by the family. The "family governance structure", which varies from family to family, should help develop the family's human and intellectual capital, investing in education, preparing the next generation members, supporting entrepreneurship and communicating and discussing the family history, values, mission and culture. A good family governance structure helps to tackle the risk factors facing families, including those related to Human behavior. The new field of Behavioral Economics and Behavioral Finance, has made great progress in studying the effects of psychological and emotional factors on an individuals' economic decisions.

If a family has a solid Governance structure, a structured approach to managing wealth, a well-diversified investment portfolio with a healthy allocation to illiquid investments, and collaborates with other successful families and institutional investors through co-investments, they are well positioned for wealth preservation and family unity.

(*) Physical or scientific laws are typically conclusions based on repeated scientific observations over many years and which have become accepted universally.

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