
Passing the Baton: Advising on Family Succession Planning

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This article is based on a guest speaker talk given at Berkeley Research Group by Konstantin Graf von Schweinitz, a nonexecutive director and advisor to family offices, private equity companies, hedge funds and banks. He writes in a personal capacity.

Family office thesis

Family offices behave completely differently than institutional investors, and this brings unique challenges to dealing with them and in particular with respect to succession planning.

Institutional investor constraints

It is illustrative to begin by describing institutional investor behavior. If you are a pension fund trustee, a finance committee member of a charity or a director of an endowment oversight board, your role in looking after the investment funds is in practice quite constrained by the fiduciary and regulatory obligations you will have.

These are twofold: first, capital preservation (i.e., do not lose what you have already). Second, in the overused words of the market, “generate superior risk-adjusted returns”. What does this mean in practice? It means that you are typically required to appoint an advisor to define the appropriate asset portfolio, taking into account the liabilities of the fund (pension fund payments, planned charity disbursements and endowment commitments). This sometimes requires complex modelling and a particular regard to the liquidity profile of the assets. Once the asset profile has been defined, the fund has to select and appoint managers to allocate the assets to. This also requires minimum hurdles to be met. The fund manager needs to have a track record for at least three to five years, minimum assets under management of a certain size and have undergone extensive due diligence checks.

All of the above inevitably result in a classic asset allocation model which has dominated financial literature for decades. The typical portfolio would have a range between 40% and 70% in public-listed global equities and between 20% and 40% in global fixed-income securities, such as investment grade corporate and government bonds. This leaves between 10% and 20% in “alternative or other” assets which are variously defined but may include real estate, infrastructure assets, private equity and hedge funds.

Family office approach to investing

If you approach a family office and suggest the tried and tested approach of such institutional investors, their reaction is typically the following: they are not much interested in public-listed equities (risky), government bonds (no return) or hedge funds (expensive). Rather, they would like to invest in “special interesting opportunities”, particularly in private equity and venture capital. Even in private equity, they would prefer to invest in individual companies (co-investments) rather than funds (too expensive and without an industry focus).

What is the reason for this differing view? Typically, family offices’ sources of wealth come from a single large asset, a family company that the family owned at one time, still owns or has at least a large shareholding in. This asset was built by an entrepreneurial culture and through concentrated risk-taking, with the value creation coming from focusing on specific ideas and innovations rather than from diversification of risk.

Family office setup

It is in the first instance therefore critical to understand the history of the current family office setup. This will reflect the interest and motivation of the principals of the family. For example, the original purpose of the family office may have been to preserve and secure the original source of wealth (i.e., the family company). Or it may have been to build a portfolio of private equity and venture capital investments along an original principal asset. Or it may have been to create a family trust structure that assured steady cash flows for family members who had no personal interest or inclination for family office investing. It could be a combination of all of the above to varying degrees.

What is important to recognise is that the skill base required for each of the above activities can be quite different.

For the preservation of a principal asset, a family member would be either an active employee in the company or more likely a nonexecutive member of the company board. In that role, an understanding of corporate governance is very important. How does a board communicate with the executive about the strategic direction of the firm? How are decisions made? What happens if there is disagreement between the board and the management? How are managers aligned, incentivised and rewarded? How do you evaluate the long-term success of the company, etc.? These are all important questions and require a particular aptitude and skill base, especially in personal communication and conduct of a board.

If the purpose of the family office is more focused on private and venture capital investments, a skill base similar to what private equity companies require is necessary. This is an ability to source interesting transactions from a network of good industry contacts, to be capable of conducting in-depth due diligence prior to purchase and finally knowledge of how to structure transactions properly with aligned interest with management and partners.

If the principal purpose is to provide regular income to a number of family members, then a skill base around diversified investing across multiple asset classes similar to institutional investors is more important. This requires experience in asset allocation and risk management and an interest in markets and portfolio construction.

In practice, an existing family office may have multiple and sometimes conflicting goals conditioned by the source of wealth, the history of the family office and the current interests and beliefs of the incumbent principals. Just like many individuals who have to make a will, they may focus only on how their assets will be divided on death but not on how they will be managed thereafter.

Steps to consensus

How then can the complexities of a family office be managed so that succession is smooth and transparent? For the family office, a continuous process of financial education and learning is key. So, for example, it is advisable to establish a “family board” that meets regularly to review all investments and discuss new proposals and changes to the portfolio.

This requires an element of formal processes and reporting to be effective. An independent family board advisor/director with requisite knowledge would be an advantage. Reviewing the performance of the portfolio and understanding the reasons for over- and underperformance are critical elements of learning about intelligent investing. In this context, the correct benchmarking of all investments in the portfolio is an important component where independent advisors can add value. Nowadays, virtually all assets, even very illiquid ones, can be benchmarked (there are more indices than stocks in the US). When a family office sees, for example, that a private equity fund’s performance is so much better than the sum of the individual private co-investments made, it can lead to good discussions about an honest assessment of the investing performance.

Top-class reporting of assets including proper classification, benchmarks, performance and risk metrics is actually quite difficult, and few market providers offer a good service here. It requires a lot of thought about how information should be presented and formatted so that key risks are highlighted. As an example, the ability to isolate currency effects from underlying investment portfolio effects is difficult even for some of the more sophisticated institutional investors.

Final thought

The journey towards an agreed objective, good governance and professional process of a family office will need time, patience and goodwill from all family members, independent advisors and employees. It should not be rushed. It should be openly addressed as a topic of ultimate importance to the long-term success of a family office.

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