

Starting a Family Office

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Part 1: Ready, Set, Whoa!

If you're considering starting a family office, the odds are that you already have one, an informal one, any way. A family office typically evolves from humble beginnings. You probably use some of your business employees for personal matters. Perhaps your assistant books personal travel. Your in-house bookkeeper maintains some personal records and works with your outside CPA to get your tax returns prepared.

As you become more successful, the family grows and the kids get older, the needs become more complex. Outside advisors are expensive, so you hire some additional people and, before you know it, they coalesce into a family office.

What is a family office? The definition clearly is in the eye of the beholder. Family offices run the spectrum from the humble beginnings I just described to those having dozens of people capable of highly sophisticated investing, reporting and other functions.

Wherever you might be on this spectrum, you should take some time to reflect on where your family office might head and, more importantly, what you want it to look like in the future.

Of course, there is the obvious approach. Determine what services you and your family need and/or want

now and over the next 5 - 10 years. Then, go hire people to fulfill those needs. More on this later, but first, there is a more important...

Threshold Question

It's not an easy one, so I'll state it bluntly. Will a family office deprive family members of potentially important life experiences? What??!! you exclaim. That question sure came out of left field! Ross, are you playing shrink again?

Not really. I'm just concerned about your family's well being. So, let me explain.

It's fine for an experienced family member like you to hire people to handle your non-business affairs. You've already learned how to manage people and make tough financial and personal decisions. YOU want someone to take care of YOUR problems because YOU'RE busy and YOU'VE earned the privilege. More power to you!

But, by indulging your needs, do you potentially create problems for your descendants or other family members? The family office's mission typically becomes one of relieving family members of many of life's responsibilities and burdens. Competent family office personnel will treat family members as clients and will seek ways to care for family members needs.

The family office becomes the easy place for a family

member to turn if some need arises. Need a new house? Call the family office and have them arrange financing and deal with that messy paperwork. Need a will? Let the family office interact with the family lawyer to handle that complicated stuff. Need to fire the maid? The family office can handle that distasteful task. Don't want to plan your own budget or try to understand investment principles? Give me a call.

Just like raising little kids, if the office does everything for them, family members may never learn to do things for themselves or to supervise those they might hire to do things for them. If you provide a way for your kids to avoid life's difficult and unpleasant experiences, they will.

Certainly, wealth and success bring privilege. How much privilege is appropriate? Assuming the answer is something less than unlimited, you will need to impose constraints. Both family office personnel and family members must understand those constraints.

Perhaps some services should be offered only to senior generation family members. However, there is a risk. As some younger generation members move up in the business and family hierarchy, they may feel entitled to step into the perks previously offered only to their elders. That can breed resentment among the have-nots - those members not in positions of authority or esteem.

Ask and Tell

Assuming a less-than-unlimited budget, should the family office be expected to satisfy all family member service requests? Family members typically have little awareness, much less understanding of the cost involved in the services they receive from their family offices. That can't be healthy in the long-term. But the client-service-oriented family office can't bear to say no to a request for help.

With senior generation belt-tightening over the past several years of economic downturn, many family offices are seeking additional revenue sources to support themselves. Some are thinking about billing family members for certain services, but they fear the family will be appalled at the cost. Some have gone full circle and are trying to cut back on services

that the office considers unprofitable. Unfortunately, those often are the high-touch services most desired by family members who have grown accustomed to the pampering.

It is indeed interesting to watch longstanding family offices start to apply basic business principles to their operations. This subtle change foreshadows many important lessons that your budding family office might learn from the mature ones.

I recommend a reverse-Clinton policy: Ask and Tell. Family members must be trained to ask the cost of a service before they approve it and office personnel must be trained not to be shy about telling family members about the resources (cost) required to fulfill a request.

Unless someone is willing to provide unlimited resources to the office, there must be some accountability. Perhaps the best approach is to require family members to pay for the services they use.

There are some additional unseemly and unpleasant considerations to address before you launch a family office. The next decision is whether to relieve your needs via an in-house or outhouse experience.

Part 2: Unearthing the Hidden Costs

Ok, so you've gotten past my concern that a family office may deprive family members of important life experiences. You agree with my Ask and Tell policy, which requires cost discussion before the office fulfills a family member's service request.

Now, can I go ahead and hire some people to handle all my non-business distractions? you ask. Sorry, no. Darn! Now what?

Well, as attractive as in-house family office employees might seem, you really need to decide whether you'd do better relieving your needs, yes, I'll say it, outhouse. Should some or all of the services be outsourced?

I know that the whole reason that you want to create a family office is because you aren't getting desired services from outside or, more likely, you think you're paying too much for them. But, before you bulk up on people, let's do some business-like analysis.

First, there is the basic cost consideration. Determine what services you and your family need and/or want now and over the next 5 - 10 years. Then, investigate the costs of obtaining these services by hiring people or by outsourcing.

Don't forget the full range of costs of having employees: office space, secretarial support, computers and specialized software, employee benefits, continuing education, research services, annual raises and bonuses, etc. Employees must be managed, so be sure to factor in your time and potential hassle.

Hidden Costs

Unfortunately, it gets worse. You probably need more people than you think. The reason centers on the fact that it is hard to find multi-talented people who can or are willing to do diverse things.

Consider the person you hire to prepare family tax returns. Will he have the skills to deal with the complex tax and other issues associated with that new real estate investment deal you're contemplating? Conversely, if you hire a high-powered person who can handle complex matters, will she be willing to do mundane things, like keep books and fill out household employee W-2 forms? I doubt it. Either you'll need more types of people or you'll have to continue outsourcing part of what you planned to bring in house.

It takes a rather large critical mass of wealth to justify hiring all of the skill sets that you'll need over time. The obvious compromise answer is to staff for core needs and outsource functions that are more specialized.

Can you reasonably expect to attract and retain high caliber people? What career path can you offer? Exceptional people crave challenge and complexity. If you don't provide it, they'll create it (or they'll leave). That complexity and resulting activity will swell the employee ranks. Of course, retaining great people requires rapidly escalating compensation packages.

Most family offices are cost centers, big-time cost centers. That does not make them bad. In fact, a family office can save money and provide valuable services for family members. But, you might pay a very substantial price in the form of hard-to-quantify.

Opportunity Costs

Ross! Why are you making this so difficult? You ask in agony. All I want to do is make our lives easier and cut down on those darn legal and accounting fees. Fine. But, my two-plus decades of experience with family offices reveals a dark underbelly.

Family office personnel inevitably adopt this key mission with a vengeance: **HOLD DOWN OUTSIDE COSTS!!** That is a major justification for the office in the first place. But, even if the family never enunciates or validates the mission, the family office will do it any way to justify its existence.

There are some major risks to this cost-reduction mission:

- If you staff your office with less-than-high-caliber people, they might not have the insight to identify when external advice is in fact needed. For example, an employee skilled at selecting domestic equities managers can be dangerous in the world of selecting and monitoring hedge fund managers. Will he admit his deficiency and spend your money on a hedge fund advisor, or will he try to wing it, thereby subjecting you to potentially devastating risk?
- Advisors relegated to handling specific issues will not have sufficient exposure to you and your family to identify issues or opportunities beyond the discrete matter presented to them. You should not assume that family office personnel have the experience to fill this self-imposed vacuum.

Speaking of vacuums, family office personnel also try to prove their value by acting as intermediaries. Filtering your needs, objectives and concerns through your office personnel inevitably reduces your outside advisors ability to understand your needs. Conversely, filtering advisors thoughts through family office personnel reduces the interaction necessary to tailor the advice to your specific needs.

In private, outside advisors often call family office personnel gate keepers. It is a derogatory term reflecting advisors routinely experienced frustration when family office personnel block the principal's access to their advice. Allow this gate keeping at your potentially severe peril.

The key is for you, your family members and your family office personnel to recognize the family office's limitations. The trick is recognizing when you need help from outside sources.

Help and Alternatives

Did you know that there is a whole new breed of consultants out there chomping on the bit to help you create or enhance your family office? They can identify family office best practices, find employees and fulfill complex software needs. Search family office on the web and you'll get a sense for the resources (both good and bad) out there. Anyone with something to sell can help with at least part of your family office needs.

If that gets a bit too mind-boggling, you can outsource all or part of your family office functions to other family offices. Indeed, there is a fledgling industry coalescing around the term multi-family office, in which a few to several dozen families are served by an office that has the critical mass of personnel to serve the wide range of client families needs. However, beware that this attractive concept has attracted the attention of major investment banks, investment advisory firms and even

some accounting firms, who now masquerade their traditional services behind the multi-family office label.

Please don't misunderstand. I am very much in favor of avoiding the use of family business personnel to handle non-business needs. A separate and distinct family office is superior to using business resources to handle personal matters. Separating these functions reduces employees confusion over their priorities. It also eliminates the family distractions that can hurt employee morale and productivity.

You probably don't think of your proposed family office as a for-profit business. However, it justifies the same or even more thought than you would give to starting a new business. Running a business with unrelated customers can be easy relative to running one that serves you and your family members! Think about it.

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