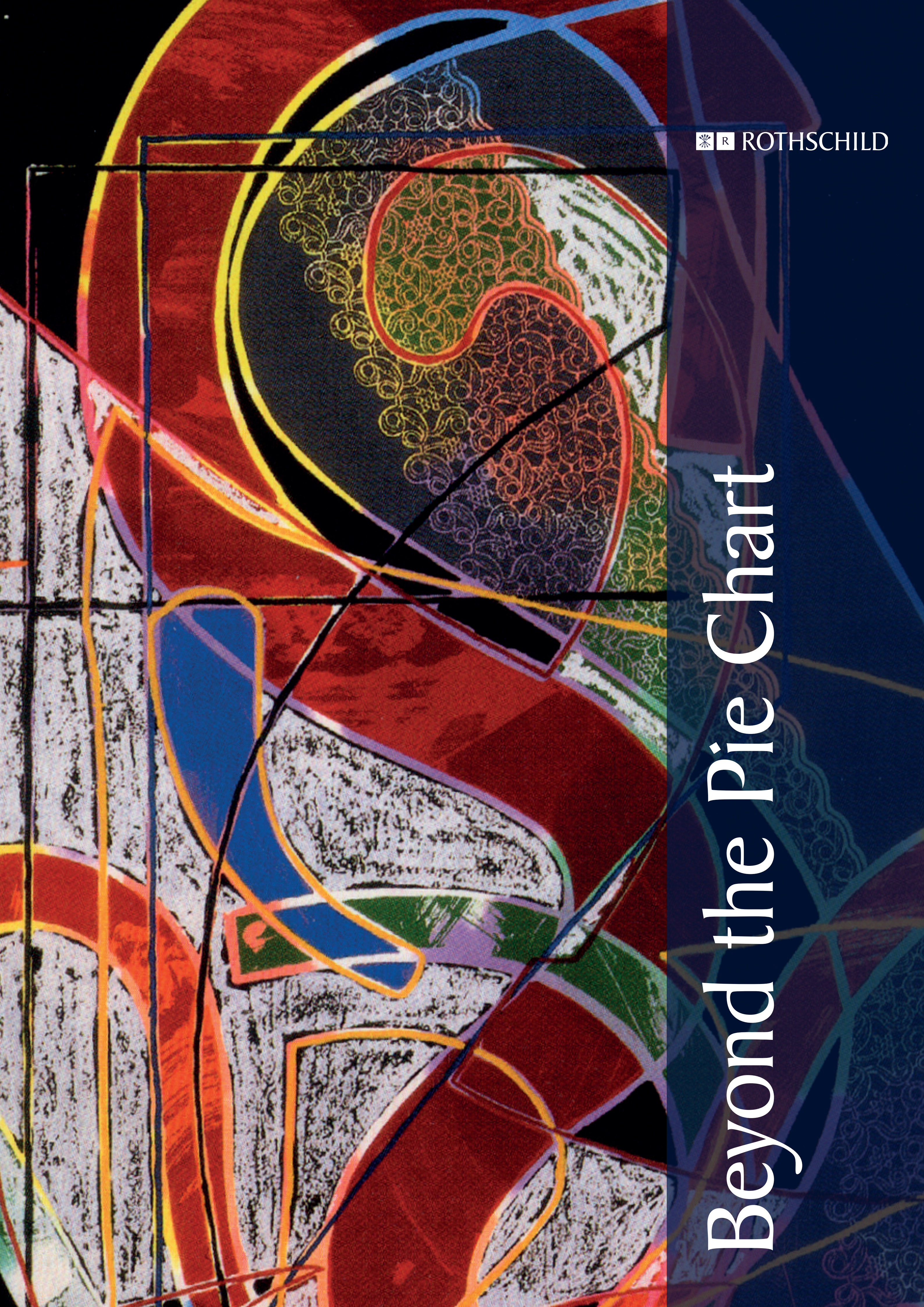

ROTHSCHILD
Beyond the Pie Chart

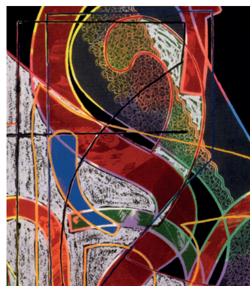
foreword

A quick game of word association can reveal a great deal. Say the phrase 'asset allocation' to a private client adviser, and most will think of simulations on spreadsheets, risk expressed as a number, and pie charts dominated by equities, bonds and cash.

Yet if you ask the clients how they allocate their assets and categorise their wealth, the conversation will be very different. Wealth owners will talk about operating businesses, commercial properties, capital invested in start-ups, nest-egg investment portfolios, art collections, forests and farmland as well as first, second, third and fourth homes.

These contrasting associations should, at the very least, prompt some re-thinking. If advisers are to help clients plan and manage all of their wealth, they must look beyond liquid and financial assets. For successful families and entrepreneurs, their overall wealth is usually a complex knot, with important interactions between many different strands.

On the following pages, we present a model we use when planning with our clients. In presenting it here, our hope is that it offers a fresh perspective on the allocation of wealth, helping wealth owners in planning for the overall management and structuring of their liquidity and capital.



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Rothschild Trust
Zollikerstrasse 181
8034 Zurich
Switzerland
Telephone +41 44 384 7111

www.rothschildtrust.com

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Beyond the pie chart

Our wealth allocation model is a practical planning tool for entrepreneurs, families and their advisers. It helps bring clarity to the overall financial situation, highlights interdependencies that are often hidden, and can guide decisions on how wealth should be used in families.

There are four main things a wealth owner can do with their money: retain it, spend it, invest it, or give it away. These four categories provide the structure for our wealth allocation model.

Retain it

We start with the operating business as the source of wealth creation. In the foundation and early-growth stages, an entrepreneur's assets and liquidity are usually closely tied to their business; growth is the focus and diversification tends to be low. However, as the business flourishes and matures, the entrepreneur will have the opportunity to take money out of the company and will therefore need to decide how much to retain for day-to-day business needs and unexpected demands.

Given the level of uncertainty that surrounds most businesses, particularly those that are young or growing rapidly, retained cash balances are often high, and sometimes much higher than they need to be. Here, entrepreneurs should consider investments that are more productive than cash and offer real diversification, and yet which can still be easily accessed if needed to meet unexpected business demands.

This is also a natural point at which to address business governance issues. Common needs include formal shareholder agreements, consolidation of holding companies, and the separation and ring-fencing of business and private assets.

Looking to the long term, if an entrepreneur wants his or her family to continue creating wealth across generations, most will need to retain ownership of their operating business, investing in high-performing products and divisions while pruning out weak areas.

Families who have sold, or don't have, an operating business are likely to be at a very different stage in the cycle. Wealth preservation will be a more realistic objective than multiplying wealth and, without dividends from a business, the family's income and spending needs may depend heavily on their invested assets.

Spend it

Our second category, for lifestyle assets and spending, is a drain on wealth. It includes both the ongoing cost of living as well as assets that have been purchased mainly to be used and enjoyed. Some of these assets depreciate in value over time (yachts and aircraft), some may appreciate (a villa in Tuscany) and all cost money to own, run, maintain and insure.

For wealthy individuals, there is usually an international component to their lifestyle, which brings its own burden. When real estate or bank accounts are in more than one jurisdiction, compliance and administration become demanding and succession planning gets a great deal more complex. How are the related needs being met?

In our experience, every wealth owner has some kind of family office function, whether they know it or not. This covers both business and private assets and life.

The set-up could be as simple as a corporate employee who takes care of payments and managing a property, or as complex as a formal institution employing dozens of people, ranging from senior managers and investors to personal assistants and administrators.

The function should be cost-effective and suitable for the wealth owner's needs, and it will need to adapt over time, as the volume and pattern of wealth changes. Some needs will be best met in-house, through a de facto or formal family office; others are best outsourced, to a multi-family office or specialist providers. There is no single right approach and a lot will depend on the individual wealth owner's preferences and capabilities.

Even those with very sophisticated family offices will still need outside advice. This could be in a technical area such as global tax planning or to address something strategic, such as business succession or an M&A transaction. It might also relate to family governance: as employees, family office staff often struggle to tackle sensitive issues that affect relationships within the client family.

Beyond the pie chart

"Lack of order will turn a millionaire into a beggar." Mayer Amschel Rothschild (1744–1812)

Invest it

Investing is the area of the model in which we expect to see the most change over the next decade, with big shifts in demand and allocations. Within investing, the need for an overall strategy, a solid governance structure, and clear reporting are often neglected.

Without a good strategy, wealth owners easily accumulate 'magpie' portfolios, collecting shiny investments in private equity and property, with little thought as to how the parts fit together. In doing so, they can overlook their need for a sustainable income as well as for a 'nest egg' portfolio that can be drawn on to meet unexpected or emergency business and family needs.

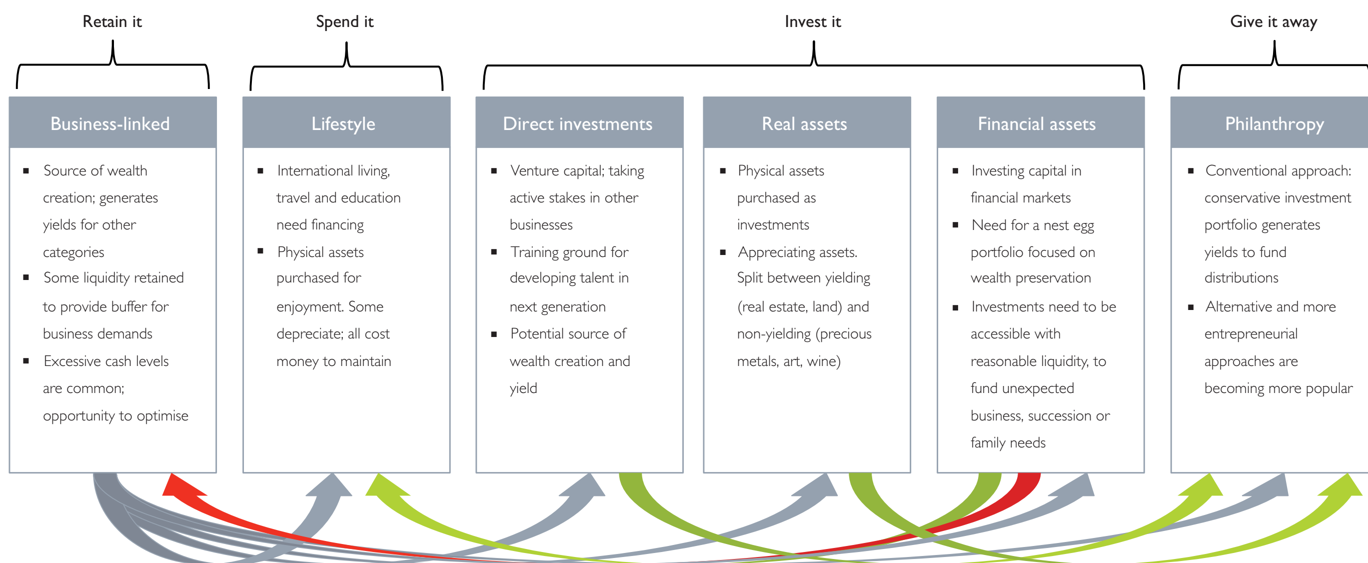
Turning to governance, best practice for invested assets involves checks and balances. This includes defining who can take decisions about how assets are invested, and whether capital and income can be spent. If the overall strategy is to have any value, then controls are needed to ensure investment allocations and activity are aligned with the strategic objectives, and remain aligned over time.

On reporting, wealth owners need a clear and consolidated overview of their assets and positioning. They often lack the control and insight they would like and have to manually piece together data and reports from multiple sources in a variety of formats, making it hard to see the big picture. This extends beyond just investing. For example, to plan cash and expenditure management well, a wealth owner may need complete and up-to-date information on rental income from properties, dividends from businesses, yields on balanced portfolios and running costs for a yacht.

Categorising investments

Financial assets such as equities and bonds are central and will remain important, but we see these financial assets as just one of three investment types, alongside real assets and direct investments.

Categories for allocating capital and liquidity



Note

Arrows represent example distributions, highlighting interdependence. Grey = primary flows. Green = subsequent flows. Red = emergency flows.

Beyond the pie chart

Real assets, financial assets, and direct investments are very different from each other; managing and administering them requires specialist skills.

- **Direct investments**

This label covers private stakes in other businesses, taken actively with involvement in the company's strategy and management, or passively at arm's length.

These investments are both a source of diversification and a potential source of wealth creation and yield. Active direct investments can also act as a training ground. Succession is one of the biggest challenges for entrepreneurs and their 'next generation' might be unproven children or longstanding employees. An active stake in another business can be a low-risk way to test future leaders, while giving those future leaders opportunities to develop.

Turning to the practicalities, the investment process for direct investments begins with finding and evaluating opportunities. Due diligence is labour intensive and requires specialist valuation and legal skills. Once an entrepreneur has decided to invest, they need help facilitating and structuring transactions, structuring and holding assets in custody, and with ongoing administration and cash management.

More broadly, we see emerging and latent demand for a more collaborative approach to this type of investment, something that goes beyond the conventional, passive, private equity model. Entrepreneurs are seeking to invest more actively in business they know, to deploy both their skills and their capital, and to be involved in sourcing and selecting opportunities before co-investing alongside like-minded peers.

This demand is particularly evident among entrepreneurs who have sold their operating business. They are often too young to retire or unsuited to retirement; direct investments give them hands-on opportunities to work on new ventures, putting their skills and experience to good use.

- **Real assets**

Under this heading we place all physical assets purchased primarily as investments. This includes real estate, land, precious metals, wine and art plus trophies such as classic cars, diamonds and jewellery. These real assets have intrinsic value, are tangible, often communicate status and wealth, and come with little or no reliance on financial institutions.

For many wealth owners, real assets provide a complement or alternative to the public markets. The financial crisis in 2008 did lasting damage to perceptions of finance and since then the Libor scandal, the rigging of FX rates, the growth of dark pools and high-frequency trading all suggest the playing field isn't level. Add in the volatility and randomness of markets, highly-correlated asset classes, the burden of debt and unprecedented monetary experiments and it should not be surprising that there is growing interest in physical assets as a source of wealth preservation and growth.

A recent Insead study of Asian family offices provides an interesting snapshot of demand in this area, recording an average allocation to real estate of 40%, with some family offices allocating up to 80% of their investable assets to property.

For these real assets, the support wealth owners need is very different from that associated with a portfolio of cash and securities. Transaction fees are higher, liquidity is lower, and therefore the time horizon of holdings tends to be much longer. The cost of storage, maintenance and insurance can be significant and related borrowing should be planned carefully, to avoid excessive leverage. Cash management also needs to be planned, for both yielding and non-yielding assets.

- **Financial assets**

We now return to our pie chart, and to capital that is invested in public markets.

Wealth owners need a good sparring partner for their financial assets, someone who can lead them through an initial design phase, with discussions and guidance on investment philosophy, risk tolerance, return objectives, time horizon, income and liquidity needs.

Only after the design phase is complete should attention turn to identifying and appointing wealth managers, asset managers, banks and hedge funds to invest on the wealth owner's behalf.

Beyond the pie chart

Because each category of wealth interacts with others, planning and structuring need to be comprehensive.

As well as helping to identify strong providers and to negotiate fees, the sparring partner should encourage their clients to think critically about how many counterparties to work with. For example, while diversification in investing is usually the best course of action, in the area of custodianship it may be more sensible to work with just one leading global custodian, as this usually comes with benefits including a single point of contact, greater operational efficiency and enhanced oversight on wealth.

On an ongoing basis, wealth owners need help actively monitoring and benchmarking performance and controlling costs and risks. Consolidated reporting is valuable, but providers typically struggle to give a clear and timely overview of wealth and asset positioning across asset classes and managers.

In addition, both advice and reporting must be appropriate to the wealth owner's tax and regulatory situation. For example, if an investment is subject to a 30% withholding tax, it probably doesn't matter how good the performance is: the returns the investor actually experiences will almost certainly be much lower than a tax-efficient alternative.

Give it away

There are many and varied approaches to philanthropy. The conventional model involves creating a conservative investment portfolio that generates yields to fund distributions to charities and good causes. However, there is lots of scope to develop alternative, more active and more entrepreneurial approaches to giving, in areas such as social entrepreneurship and impact investing.

One of the key things a wealth owner must decide is whether to establish their own charity or to support other existing charities with their funds. In our experience, most people underestimate the level of work involved with establishing a charity of their own. It requires initial and ongoing commitments in areas of strategy, organisation, recruitment, governance and investments, both related to the charity itself and in the creation, sourcing and evaluation of projects to support. Funding other existing charities can be more efficient, and it is certainly less complex and time-consuming: the emphasis is on finding suitable organisations working in the right areas, and then performing due diligence on them.

Whichever route is chosen, charitable giving provides opportunities to enhance relationships and develop shared interests within a family. Compared with an operating business, there is much greater scope to involve all family members in philanthropy, whatever their age, interests and expertise.

Categories interact

In presenting this framework for allocating assets and liquidity, our aim is to stimulate thinking with a practical planning tool.

One of the main points we want to stress is the interdependence of categories and the related need of wealth owners for an overall, top-down, strategic plan. Consider the following scenarios, with flows between categories that are both voluntary and forced:

- An operating business suffers a permanent downturn in fortunes; what was an asset becomes a liability that needs financing. Without appropriate checks or limits, the family's invested capital can be depleted or destroyed.
- Financial markets crash. The family's income strategy fails, leading to a badly-timed liquidation of a commercial property investment to meet a 'cash crunch'.
- An entrepreneur dies, leaving two adult daughters. To meet the inheritance law requirement for equal treatment of siblings, the operating business needs to be refinanced to buy out the daughter who is not involved with the firm.
- A family fails to formally separate capital from their operating business. When their business is nationalised following a shock change of government, they are left with a fraction of their former total assets.
- A family's property portfolio is heavily leveraged. When interest rates spike, they have to cancel their philanthropy programme and liquidate an investment portfolio to meet their mortgage commitments.

Beyond the pie chart

Understanding wealth overall, and in its constituent parts.

Against that backdrop, we believe entrepreneurs and wealth-owning families need integrated planning and ongoing advice that addresses the business and personal, wealth and relationships, the physical and financial, the liquid and illiquid. This is true across the developed and emerging markets and for clients with all family office types, from the de facto and informal to the established and mature.

Flowing from that, this model can also help wealth owners think through their legacy, giving an opportunity to discuss the purpose of the wealth overall as well as in its constituent parts. If the legacy is to flourish across generations, there needs to be clarity on how wealth can be used, with an equilibrium between creating, preserving, diversifying, investing, spending and giving away.

Notes

At Rothschild Trust, we help entrepreneurs and families to safeguard their assets and create their own legacy. As world leaders in wealth and succession planning, we look beyond narrow legal and technical issues, to help clients strengthen their business and family relationships.

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