STONEHAGE FLEMING

KNOW HOW BULLETIN

TOTAL WEALTH MANAGEMENT FOR BUSINESS OWNERS AND ENTREPRENEURS

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SUCCESSFULLY NAVIGATING A CONFLICT OF PHILOSOPHIES

The term 'wealth management' implies more than just the management of an investment portfolio, and most wealth managers claim to add value across the whole spectrum of their clients' affairs. Comprehensive understanding of an individual's total wealth may be plausible for clients whose affairs are relatively straightforward, and who have the bulk of their assets in cash and marketable investments. However, this becomes more complex and challenging when a substantial proportion of an individual or family's wealth is tied up in a family business and perhaps a number of other directly held investments.

It is not uncommon for a founding entrepreneur to have amassed a significant portfolio of specialist investments aside from their core business. These active, self-directed investors, who have been heavily reliant on their own knowledge and expertise, may invest for many years largely without the need for a conventional investment manager.

Typically, this type of entrepreneur only begins to consider professional investment advisers when they start thinking about succession, especially where their children or other successors simply do not have their specialist knowledge, influence and contacts, or do not share their interest in business.

Often, an entrepreneur will only then seek an investment adviser who can help manage the transition to the next generation:

- To provide expert support to the family in managing the legacy investments
- Probably to exit at least some of these investments and re-invest in a more balanced portfolio

Finding such a manager or adviser is, however, no easy matter:

- Most investment managers are trained to manage wealth within a process and framework that does not match the mind-set of the successful entrepreneur
- In particular, entrepreneurs have an approach to risk management that sometimes differs quite fundamentally from that of a professional investment manager
- The impact of this is that the portfolio is likely to be confined to one or two sectors, far from the well spread portfolio advocated by investment professionals

- Many entrepreneurs do not readily place their trust in investment professionals
- These doubts have been compounded by the events of the last decade, which have substantially reduced trust in the financial services industry

DIFFERENT PERCEPTIONS OF RISK

The professional investment manager reduces risk through diversification across the whole spectrum of asset classes, whereas the entrepreneur tends to invest only in sectors which he understands and with people whom he knows, often resulting in a very concentrated portfolio. Risk is highly subjective and neither view is either right or wrong: they are just fundamentally different, and these differences have to be reconciled to begin developing a coherent investment strategy.

A multi-asset investment manager will typically espouse the benefits of diversification, built from the tenets of Modern Portfolio Theory and the work of a generation of Nobel prize-winning academics. In practice this means investing in a range of investments across asset classes, such that the overall portfolio sits at the required point of the risk/reward trade off.

The entrepreneur's view is often far more personal than the investment manager's because, rather than taking a holistic view, starting with analysis of the global marketplace, the entrepreneur sees risk and opportunity through the prism of his own practical experience. He or she has built a business relying on their own hard work and judgment, and has considerable belief in his or her ability to judge a business proposition.

In the early stages of the business venture, the priority is survival rather than the management of an asset. After a period, the successful business begins to provide a comfortable living, and eventually acquires significant capital value.

At the stage where there is significant value in the business, the theorist would argue the case for diversification, but the entrepreneur sees a growing business with increasing market share and decreasing risk of failure. As surplus cash is generated, some entrepreneurs may indeed seek to diversify by investing in a professionally managed portfolio. Others however, perhaps fuelled by the self-belief that is central to their own success, are more inclined to back their own judgment than hand money over to professional investment managers. An entrepreneur will often back individuals whose abilities he respects, as a result of first-hand knowledge, especially from past business relationships.

With the exception of property, which is a special case, most entrepreneurs do not invest outside their range of perceived expertise and are not often inclined to trust the ability of people with whom they have no direct experience.

The validity of this approach to risk management can be debated, and it can be argued that successful entrepreneurs may sometimes underestimate the risks in applying their undoubted business skills to investments in other ventures which they do not control. Their self-belief can be reinforced by mixing with other similarly successful businessmen, who have all generated much better returns over many years, than professional investment managers.

Often it is only when the core business matures, and/or when the entrepreneur begins to contemplate retirement and succession, that a more devolved form of investment management becomes an attractive option. For the reasons touched upon above, such individuals are likely to need convincing that a wealth manager possesses competencies which can genuinely add value. The wealth manager has no hope of gaining their trust unless he or she addresses and reconciles the fundamental differences of perspective in the management of risk.

MANAGING THE TRANSITION

As an entrepreneur approaches retirement, the need for succession planning becomes more immediate. Where there are family members ready and able to take over, there may be no need for a fundamental change of approach. However, in many circumstances the next generation do not have the desire or expertise of the founder, thus necessitating either significant changes in strategy, or bringing on board external expertise. Ideally there will be a transition period during which the founder will gradually hand over control, but this process is far from easy.

After forty or more years of taking all the decisions in successfully building up a valuable core business and a variety of other assets, the difficulties involved in a transfer of authority must be obvious:

- The sheer habit of independent decision making is ingrained
- A long track record of success has convinced the individual that their judgment is usually best
- There is inevitably a strong emotional commitment to the core business and possibly other investments
- There may be a need to 'own up to' some past failures
- If a fundamental change of investment philosophy is required, there will be a serious conflict with the founder's entrenched instincts, which can rarely be resolved overnight
- There are usually family complications which add to the difficulty of decision making

The first and most obvious decision is whether the core business should continue under family ownership and management. This is a massive decision, which requires extensive planning, preferably over many years. It is the subject of a separate paper by Stonehage Fleming (Selling the Family Business).

As stated above, many successful entrepreneurs approaching retirement have invested in a variety of businesses, operating in similar sectors to the core business. In addition, there may be other substantial holdings including property, leisure assets and increasingly, valuable art collections. Unless the next generation is ready and willing to step into the founder's shoes in each of these areas, the eventual loss of his knowledge, expertise, contacts and business skills may make some of these investments vulnerable.

It is highly unlikely that any founding entrepreneur will dispose of all such assets overnight and re-invest in the sort of balanced portfolio favoured by the investment industry. It will typically be a process in which the entrepreneur begins to adapt gradually to a new approach, and will need to be convinced every step of the way of the merits of the new philosophy. He or she will also need to be convinced of the ability of prospective advisers to add value in eventually stepping into his or her shoes, and providing the support and understanding they want for their family after they have gone.

The requirement therefore is to develop a transition plan which probably includes:

1. Exit strategy for investments which depend too heavily on the founder's knowledge and influence
2. Phased reduction in exposure to concentrated sectors
3. Some level of constraint on further investment in specialist, entrepreneur-led opportunities
4. Full risk management strategy across the entire asset base, which will include mitigation of sector specific risks and illiquidity during the transition
5. Clear protocols for handing over decision making and consulting other family members (family governance)
6. Definition of role of advisers / wealth managers in implementing the transition and in supporting the family, both during the process and thereafter

The plan must of course have a clear timetable with milestones, which will act as an important discipline and will only be modified with good reason, in the light of changing circumstances. It therefore goes without saying that the prospective wealth manager must have experience and capabilities which extend across the whole of the asset base, as it stands at the start of the process.

The 'legacy' positions present two particular challenges to new advisers.

The first is to 'get under the bonnet' of each company, understand its business model, and assess the strengths and weaknesses. The second is to negotiate an exit strategy, which can be an emotive process because of the long relationship between the client and the investment. It is key to the adviser's role to understand these nuances, and provide an exit program that makes sense from both a personal and portfolio perspective.

Even the most astute entrepreneurs can be unfamiliar with the complexities of negotiating the exit of a position that may not have obvious market comparables. Consideration should be given to the length of time required to dispose of the position, whether it is tradable in the market, the degree of influence or voting rights in decision making, whether there are any lock-up periods and the relative importance of the investment to the entrepreneur personally (friends, partners or family who are involved in the business may be affected).

While legacy assets can be considered a hindrance from an adviser's perspective, the client may be reluctant to dispose of them for very valid personal reasons.

RESPECTING THE CLIENT PERSPECTIVE, WHILE DISCHARGING ADVISORY AND FIDUCIARY RESPONSIBILITIES

Just as it is vital for the potential adviser to understand the client, it is equally important for the client to understand the constraints within which the adviser operates:

1. The circumstances and portfolio of assets described above are far removed from anything that a typical wealth manager would normally recommend
2. The adviser has a clear obligation to express his or her opinion, recommend a course of action, and ensure that the client fully understands and accepts the risks involved in taking a different course
3. The adviser may have responsibilities to other parties including family members, trustees or beneficiaries

This type of client needs an adviser who can provide conventional asset management of the highest quality, but also has the capability, experience, insight and flexibility to deal constructively with the existing portfolio of specialist investments. The adviser needs to be challenging, but able to compromise and to take account of client views, without undermining his objectivity and frankness. Such an adviser will recognise the need for a transition period, where he is effectively operating as co-pilot, alongside the client.

He will also be building his relationship with the next generation and needs to be ready to support, advise and possibly challenge them, should they have both the will and the aptitude to continue the tradition of direct investment, at least for an element of their wealth.

The adviser must be accountable for all outcomes and ensure that his responsibilities are clearly defined, so that he puts up a robust and well informed challenge when required. Some advisers will find this type of relationship very difficult to handle, and will immediately recommend formal 'text book' family governance with decision making by committees. However this dilutes the control of the founder entrepreneur, and it is often wiser to recognise that most founding entrepreneurs find it very difficult to let go of the reins, so it sometimes has to be a gradual process.

The solution will lie in finding a balance, but decision making responsibilities need to be very carefully documented and transparent to all relevant parties, including trustees and beneficiaries.

CONCLUSIONS

The financial services industry builds scalability and cost efficiency by selling commoditised products, which are designed for 'typical clients'. Wealth managers tend to be rather more flexible, but in most cases their business model relies on a relatively standardised approach which meets the needs of their chosen target market. The flip side is that such a model often cannot economically address the requirements of exceptional clients, whose affairs are particularly complex and who have built their wealth by backing their own judgment and making their own decisions.

Wealth management for entrepreneurs and business owners demands a model that is based on listening to each client and delivering genuinely bespoke services, especially in managing the transition to the next generation. It requires significant skill, broadly based knowledge and well defined responsibilities.

The adviser must have the breadth of experience to add value across the entire asset base and to challenge the entrepreneur, even within his or her own areas of expertise. Many entrepreneurs are strong personalities, and questioning their judgement can require courage.

It is not a job for the faint hearted!

On the 15th January 2015 Stonehage Group Holdings Limited completed a merger with Fleming Family & Partners Limited ('FF&P'), a London-based Multi-Family Office. The combined company is called Stonehage Fleming Family & Partners Limited ('Stonehage Fleming') and is the leading independently-owned multi-family office in Europe, Middle East and Africa. Its advisory division provides corporate finance and direct investment advisory services as part of a holistic approach to advising wealthy families.

FOR MORE INFORMATION

Steven Kettle
Partner - Head of Client Management

Steven is Head of Client Management for Stonehage Fleming Investment Management. For over 15 years Steven has worked with families of substantial international wealth advising them on investment governance, investment strategy and underlying portfolio investments. He chairs several Investment Committees and also acts as Key Adviser to a number of client families within the Group. Steven is Chairman of Stonehage Fleming Art Management.

Prior to joining the Group in 2000, Steve previously worked for Ernst & Young in New York after qualifying as a Chartered Accountant at Ernst & Young in Cape Town. He holds a Bachelor of Commerce degree and a Post Graduate Diploma in Accounting from the University of Cape Town.

Richard Hill
Partner

Richard heads Stonehage Fleming Advisory, he advises clients on a wide range of advisory, investment and capital raising mandates in various sectors, including financial services, real estate, technology and natural resources.

Prior to joining the Group in 2002 where he helped establish the advisory business, Richard worked at JP Morgan, he previously qualified as a Chartered Accountant with PwC and then joined the investment banking business of Robert Fleming.

Caspar Helmore
Senior Associate - Client Management

Caspar is a Senior Associate within Stonehage Fleming Investment Management.

Prior to joining the Group Caspar worked at Thurleigh, a boutique asset management firm, where he spent four years as a Portfolio Manager focussed on investment research and managing client accounts. He has an Honours degree in Modern Languages and is a CFA Charterholder. Caspar is on the Board of Governors at a school in London, where he chairs the Finance Committee.

Justin Roberts
Senior Associate - Stonehage Fleming Advisory

Justin is a Senior Associate within Stonehage Fleming Investment Management. He has advised a variety of corporates, financial institutions, governments, central banks and public sector institutions on a wide range of mandates, including strategy, M&A, capital raising, public liability management, creditor committee advisory, asset management and recovery procedures. Justin has broad sector experience in technology, real estate, financial services and business services sectors.

Prior to joining the Group in 2014, Justin worked in Houlihan Loukey's Financial Advisory Services team and before that at Quayle Munro's Corporate Finance team focussing on TMT. Justin gained his Chartered Financial Analyst (CFA) certification at Poole, Carbone & Eckbert in the USA.

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