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Generation Private – Family Office Survey Australia, Hong Kong, New Zealand and Singapore

Adapted from a KPMG and The Table Club Report, "Wealth in Transition – Family Offices in Plain View", October 2021

By way of introduction, we have summarised the recent Family Office Survey conducted by KPMG and The Table Club. The report provides some valuable insights from an Australian and Asia Pac perspective of the Family Office environment.

We have provided an executive summary here with more detail provided in the back section of this article.

Executive Summary

The Family Office (FO) is professionalising

The FO is now being recognised as a preferred structure for family wealth management and seen as a business to be managed like any other.

Mission and purpose matter to the next generation

Next generation family members are increasingly involved in the design of their FO with a focus on governance, renewal of mission and purpose, and merging tradition with innovation. They want a reason for the Office to exist beyond accumulating money for its own sake.

Risk management is idiosyncratic

Less than half of FOs have 'broad diversification' as a strategy for managing risk or have formal investment committees. More are appointing independent non-executive directors to their boards.

The wealthy are ready for risk

FOs are expecting to increase their exposure to risk assets in the next 12 months and continue to benefit from supportive Australian Government monetary policies.

There is a risk mismatch

Whilst 'risk allocations' may be increasing, 'risk tolerance' may not. There is a likelihood of some misalignment between individual family members as the next generation take over from founders.

COVID-19 has not slowed the FO

FOs anticipated the shock to asset prices brought on by the initial stages of COVID-19 and were well placed to capture opportunities that arose.

Succession stresses are universal

The issue of who will lead and how can be just as complex in the FO as in a family enterprise. While it is an issue that cannot be ignored, many are not prepared. FO founders are concerned with what the impact of

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'dilution' of ownership and control will have on the future of the FO. FO inheritors are concerned about having clear expectations and understanding what the role will require.

Philanthropy is now strategic

Wealthy families now approach philanthropy in the nature of 'problem solving', through a strategic lens. Rather than giving a 'gift', their aim is to help build capacity and scale for a more significant impact.

Conscious capitalism counts for the next generation

There is an increasing focus on ESG concerns in investment portfolio construction. Impact Investing is also being actively considered by many FOs, with education a key area of interest.

Technology is enabling the FO to self-serve

While some FOs are struggling to understand how technology can increase their back-office efficiencies, others are embracing new software to drive powerful data and analytics for decision making.

Cyber risk is on the rise

As threat actors rise, so do the cyber security risks for FO operations, with security incidents increasing locally and globally. While risk management needs to be proactively managed, FOs are more reactive and may underestimate the likelihood and impact of risks beyond investment risks.

Read on for a more detailed analysis of the report.

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Survey Background

Survey responses and interviews were received from 80 participants with over 75% of respondents being FOs, and the balance being individuals in control of significant private wealth. Australian FO representatives made up 76% of respondents, with 36% based in Sydney and 19% in Melbourne. Other responses were received from Hong Kong, Singapore, Taiwan, Indonesia, and New Zealand.

The two main sources of the original family wealth in over half of the respondents were Real Estate and Financial Services & Investment with another 10% reporting their wealth was created from Technology investment.

While less than half the respondents were from the first generation of wealth owners, 85% were from generation one or two suggesting that the transition of ownership and control from one generation to the next is underway. However, the responses indicated that there is little uniformity about managing this transition process. This may be due to either the relative immaturity of this sector or simply that every family is different.

While some FOs may be created due to demands from second generation family members, it is more often that they are being set up by the wealth originators, aware of the importance of having structure to support the management and subsequent transmission of wealth.

Mission and Purpose First

FOs have increasingly recognised the importance of defining a 'mission and purpose' to underpin the FO, providing a reason for existence and motivation to the members.

There are several reasons for this:

- The broader adoption of business processes in the FO is leading to enterprise-style practices – such as having a clear purpose.
- To ensure the longevity of the FOs ability to serve the needs of at least two or three generations, a purpose gives everyone the drive to keep it growing, where there are already funds to support the next generation.
- Purpose, once defined, provides a guide for future generations to follow.
- Events such as the COVID-19 pandemic highlight the power of wealth to make a difference, thus driving 'wealth consciousness' in families and FOs.
- Social media shines a spotlight on the choices made by the world's wealthy, showing that with wealth comes responsibility and scrutiny. Reputations matter and having a 'purpose' helps demonstrate good citizenship.

For many years, the mission and purpose of a FO was often defined as being to 'preserve wealth'. However, with the reasons listed above in mind, this is no longer satisfactory. There is benefit of scale in keeping family wealth together in a FO, rather than divested amongst family members. Therefore, an underpinning mission and purpose adds to the ability to achieve this. To work, it needs to be identified by the family, stakeholders, managers and employees and considered relevant.

Managing Investments

Governance and Decision Making

Translating business success into investment management success is notoriously difficult.

Due to the differences in skill set, ***several FOs have opted to invest in familiar territory. While they are more familiar with the specific risks faced, a potential problem is that they may have little or no diversification away from that specific asset class*.**

Committee types and members

Considering the different skills required to invest successfully, it was therefore striking that less than half of those surveyed had a formal investment committee in place, with the balance choosing to meet on an ad hoc basis without a formal committee. Half of the respondents said family members, executives and independent advisers sat on their investment committee or were responsible for making investment decisions. ***All of those surveyed had at least one family member involved in making investment decisions, while one fifth did not have any non-family representatives***.

Generally, the complexity of the family's governance of the investment management process correlated with both an increase in the family's wealth and the number of generations involved.

More professionals

Generally, an increase in the number of investment professionals engaged by FOs, as either employees, or on the boards of investment committees, has been observed ***and this trend is expected to continue as FOs transition ownership and control, and the complexity of the FO's portfolio becomes greater***.

The trend toward independent directors

Best practice among FOs is to formally establish a board of directors for the Investment Committee to provide guidance and oversight.

The key rationale for appointing an independent director to an Investment Committee includes the following:

- Bring experience and expertise to assist in establishing investment guidelines and policies
- Implementing investment strategies
- Broaden the investment opportunities through their networks
- Provide objectivity and accountability in the face of family dynamics
- Provide advice on contentious issues such as board appointments, succession planning and remuneration.
- Contribute to the business development of the FO

- Opportunity to extend the FOs areas of expertise to foster more critical insights and better decision making

Setting goals and objectives

The dominant goal, for nearly two thirds of respondents, was to grow capital by a certain target percentage.

Investment beliefs

Part of setting goals stems from having 'investment beliefs', which are a set of ideas that form the basis for decision making about an investment portfolio's strategy and objectives. For example, these might pertain to risk and return expectations, or the nature of investments preferred.

Usually, such beliefs would form part of a defined policy of intent***. Creating an Investment Policy Statement (IPS) can be the basis for a supportive conversation across the family.***

Return expectations

Respondents indicated that return expectations and targets are widely set.

The majority were targeting total returns on the portfolio of between 6-10% per annum, with around 70% of respondents expecting to earn 10% or less per annum for the next five years.

Potential misalignment on risk

It is possible that there is some disconnect between what respondents stated was their mission and purpose and their key goals in managing capital. This raises the question of whether the 'risk profile' of the family, as a collection of individuals, is properly reflected in their FO's investment strategy.

Implementation

When FOs are created, their function is to manage the family's financial wealth. This function was recognised by respondents as the primary purpose of their FOs.

But how has this purpose been translated into the structure and implementation of the FO's investment strategy?

This question has two components:

1. How has capital been allocated by these offices?
2. How have they structured the management of their investment function?

From the responses to the second part of the question, ***approximately 20% 'wholly' managed their investments in-house (insourcing), with a further 50% managing investments 'predominantly' in-house (suggesting the remaining portion was outsourced).***

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Insourcing versus outsourcing management

It is common for FOs with suitable internal resourcing to manage 'traditional' asset classes in-house, such as Cash & Fixed Income, Listed Equities (Australian) and Domestic Property. The extent to which Real Estate is managed in-house by the Australian FO (around 60%) is notably higher than FOs globally.

There was a significant proportion of respondents indicating that they managed their Private Equity portfolio in house. This hints at an increasing sophistication of the FO given the increased resourcing required to take an active role in sourcing, acquiring, and managing the portfolio.

It is reasonable to expect that FOs will 'buy' rather than 'build' expertise in areas which require high levels of skill and experience. ***It is not unusual, therefore, to see the extent to which equity portfolios, both locally and globally, are outsourced to specialist management***.

It is likely that an in-house resource will manage a series of external asset managers dedicated to different areas of investment. Where direct equity portfolios are managed in-house, the investment capability would typically be acquired rather than home grown.

Striking the balance

As FOs mature, and subsequent generations take control, it will be interesting to see whether internal investment management functions evolve, or alternatively become more focused on outsourcing to third-party managers. These insource/outsource decisions are driven either by the ability of the FO to carry the cost of hiring investment teams in house, or the ability to raise external capital to spread costs across the investor base. The decision may be dictated by the level of talent available in the market, and whether there is the ability to 'buy' the expertise necessary to execute effectively on desired investment strategies.

Capital Allocation

The period of data collection, December 2020 to January 2021, was one of abnormality due to COVID-19, within which traditional market assumptions were tested. Central bank intervention and massive fiscal stimulus turned a global economic shutdown into one of the strongest bull runs of the 21st century.

Going forward, investors are faced with new challenges as we enter untested economic waters, threats of inflation, and account deficits that must be unwound. With an unprecedented amount of capital in markets, there has been a diminishing reward for taking risk, which, paired with increasing uncertainty around future economic conditions, has made the job of the capital allocator harder, and more important.

Perhaps reflecting the market's uncertainty or reflecting the opportunistic nature of a FO's capital allocation, is ***the fact that less than 40% of the respondents have a formal asset allocation policy in place***. Therefore, it is difficult to dissect what the standard 'strategic asset allocation' of FOs was in the early COVID-19 period, but some interesting observations are possible.

Risk is pursued

Despite the returns on risk diminishing, nearly 70% of respondents expected to increase their exposure to risk assets in the next 12 months.

Tailored investment opportunities

As FO have become more visible, the number of investment opportunities that are presented to them has increased significantly. Many propositions are being described as built solely with FO in mind.

FOs have also become more discerning in their approach to sourcing investment opportunities. Areas of interest to the survey respondents were Manufacturing and Consumer Goods, Property & Infrastructure, Healthcare/BioTech/MedTech and Innovation (technology & data).

Many FO's don't have the expertise to properly assess these investments and have (or are contemplating) engaging an external consultant to properly assess these opportunities having regard to the defined Investment Policy Statement.

Managing money on behalf of UHNWs

Multi FOs (MFO) are professional services businesses that have been created to serve the needs of the UHNW marketplace.

Traditionally, MFOs were seen to serve the needs of families that may not have sufficient wealth to set up their own FO. However, based on the reported level of capital that these MFO's were responsible to manage, this is not necessarily the case, with average client funds under management comfortably exceeding that which would make a Single FO economically viable. Instead, the MFO model, bolstered by the improvements in technology that allows ease of access to funds and reporting, is becoming increasingly attractive to substantial families.

The rigour that is applied to the investment processes of MFOs may also be attractive to multi-generational families over an in-house solution. A MFO could help to avoid conflicts as the profiles of family members diverge, or the number of branches of the family served by the FO increases.

There is now a move towards an integration of aligned families into 'buying blocks' – therefore increasing the availability of unique institutional grade investment opportunities.

How is COVID-19 impacting FOs?

From an economic perspective, the pandemic had negatively impacted the performance of investment portfolios in less than 20% of respondents, with the remainder reporting no change (~30%) and the reminder observing increased performance.

By and large, FOs did not suffer liquidity issues during the initial COVID-19 lockdowns in Australia in 2020, but instead had already anticipated a market correction prior to March 2020.

Operational challenges

At an operational level, the management of FOs was most impacted by COVID-19 by having to adjust for staffing and work conditions.

Separately, FO landlords reported the need to have rent negotiations with tenants as a major impact. Nearly half reported needing to review budgets and forecasts.

Factors that helped in responding to the pandemic and sought to prove the benefit of families working together jointly, showed that the nature of the dynamics of family ownership was a strong contributor to being able to manage the crisis effectively. Having effective communication forums helped, as well as a good governance framework.

How the future FO is forming

As generational changes occur, the influence of future owners of capital is becoming more prominent inside FOs.

Discussion of succession inside the FO can be complex. Principals need to consider how their succession process should work, the expectations around how succession should occur, and the composition of the FO for the subsequent generations.

Encouraging the next generation

Almost all FOs said that they encouraged family members to participate in the FO if they had relevant experience; or it was for the individuals to determine participation themselves. Participation may also relate to the size of the FO where the number of family members served by the FO was higher, the greater extent to which suggestions of 'conflict of interest' could be made.

A complexity revealed by the survey was how to properly remunerate family members working for the FO.

Unchartered waters

Whether the succession involves the transition of ownership, management and control of an operating business, or the running of a FO, there remains a tendency to defer action until forced. Some FO are engaging an independent CEO or Chair to run or oversee the FO operations and investment activity.

When dealing with the transition of family wealth to the next generation of the family, the biggest concerns were different aspirations amongst the next generation, followed by getting the right advice, complexity of the process, lack of entrepreneurship and dilution amongst the next generation.

Ready for control

For younger family members, their concern when considering inheriting control and ownership of the family's financial resources, was whether they will be allowed the freedom to make their own decisions. Also of concern was having a clear understanding of the purpose and objective of the role, having confidence in their own capacity and whether the family was confident in their capacity.

Impact of the FO on wealth succession

How to manage succession varies from family to family. The process of transitioning ownership and control of family wealth becomes more structured where a FO has been created. For an open-minded family, participation in a Family Council, provides the chance to learn from each other as to how succession may best enable family members to continue working together.

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Enhancing the family's social capital

Private Ancillary Funds (PAFs) had a profound impact on the nature of philanthropy by incentivising wealth holders to create their own foundations in their lifetime.

Family philanthropy has evolved to become more strategic and purposeful, and families are developing new ways of thinking about how to make an impact financially, socially, and environmentally.

The majority of FO's actively thinking about their 'legacy' and more than a third felt that a legacy related to the family's capacity to have 'social impact'.

Legacy and impact

Rather than giving a 'gift', the aim of many FOs is now to build ongoing capacity and scale. For many, this approach is a natural extension of their business careers. It has also meant that 'measurement' of impact is now key.

Fostering family engagement

Looking outward to help is important, but for several respondents this started with looking inward to the family. For them, the more strategic approach to philanthropy has not removed its role as the 'glue' that can bind a family across generations.

Teaming up

The capacity for FOs to learn from each other and identify best practice is now common across many aspects of what a FO does, including in achieving philanthropic objectives. Such collaborations could have a positive focus and the potential to have a profound impact on social and environmental needs.

Positive influence

A family's capital is said to be comprised of several elements, not just its financial capital. One of these elements is a family's capacity to exercise influence and support its community, and, in so doing, enhance its own reputation and standing. Significant wealth owners now see philanthropy as being of prime importance to them and how their wealth is applied.

Conscious capitalism

The survey revealed that FOs have absorbed a great deal of the next generation's concerns surrounding how investor funds are applied, particularly when it comes to having 'conscious capital'.

This means having an awareness of how investment actions may have social and environmental consequences and adjusting them accordingly. They also know that their actions are being keenly observed by the public and are keen to maintain a positive reputation.

ESG evolution

A significant investment theme globally has been the rise in ESG factors in portfolio construction. In line with a greater focus on conscious capital, the respondents showed an increased influence in awareness and actions regarding ESG issues.

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While integration of ESG principals into portfolio construction decision making is on the rise, there is very little universality in the manner or speed with which these policies are being integrated. The high level of interest in 'impact' investing suggests that the prevalence of ESG and specifically Climate Change considerations in portfolio construction will increase over time.

Impact Investments

The extent to which FOs had crossed the boundary from being conscious in their investment decision making, to being more deliberate in the outcomes they sought to achieve, was reflected by the percentage of respondents who reported having made several 'Impact Investments'.

Impact Investments are typically made by family foundations and endowments investing a quantity of their foundation as a direct expression of their philanthropic purpose. An Impact Investment may not sit within the family's main pool of investments and could even be managed by a family member rather than the investment team.

Specific areas of investment interest included renewable energy and sustainable eco-systems. Within renewable energy, there has been a trend of FOs using their perpetual time horizons to back emerging technologies that are at, or near the cusp of, commercialisation, such as hydrogen storage.

Running the FO

As families and their FOs become more financially sophisticated and professional, it is important to understand the impact this has had on the operation of the office and administration of their family's wealth.

Within the FO, the most significant costs related to the running of the investments are salary and remuneration, technology and IT infrastructure, and third-party investment management fees. Other administration costs, such as asset custody, have decreased because of new technologies.

In most FOs, there are also costs related to the management of non-income producing assets such as yachts. Managing these costs requires confirming exactly whose responsibility it is for their maintenance and costs and formalising that process.

Data driven FOs

In today's data-driven environment, there are numerous options available to FOs to help collect data, analyse it, and share that information in a meaningful way. Often these providers do not take ownership of assets in any way. Instead, they aggregate data from several sources and then present that information back to the FO through customised reporting.

Legacy technology

Despite their interest in new technology solutions, many FOs are currently relying on legacy technology to support reporting capability. ***Over 40% of FOs reported they were collating data manually to build their own reports in Excel, with another 16% used Excel in conjunction with other reporting software.***

It was also found that several FOs have not invested time to become familiar with technology that could enable deeper and more insightful sharing of information with family members. The majority used email

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for communication which does not enable the rich data reporting that some specialist software can provide, and it could also expose the FO to cyber security risks.

Cyber security risks

When it comes to cyber security threats, the research found that over half of the respondents had received several threats to their security. ***Just over one quarter (26%) had experienced a cyber-attack. Close to 60% were actively considering how to manage cyber security risks as part of their risk management process.***

FOs now need to be more vigilant in the management of risks in general – not just investment risks.

Staffing – recruitment and retention

As a family's financial affairs become more diverse, there is often an increase in the number of staff employed by the FO.

Within the FO itself, role descriptions and responsibilities can typically be unclear. The Chief Financial Officer may double as the Chief Risk Officer, with an overlap in managing regulation and compliance with the Chief Investment Officer.

Consequently, benchmarking a market rate of remuneration is not straightforward. Likewise, it can be complex to set specific performance goals from which a discretionary bonus may be paid.

Whilst some may find a lack of formal structure disorientating, FOs are becoming increasingly attractive places to work, competing with larger institutions for quality staff. FO employees often have influence, a broader remit, and greater control of outcomes.

Globally, the demand for experienced FO staff is being met with an increase in recruitment dedicated to the FO market.

Performance assessment

When asked how the performance of the FO was measured, and the most significant measurement was the movement in the value of financial assets year-on-year (over 90%).

It follows that in assessing individual staff performance, the movement in the value of financial assets remains a key measure. ***The study suggests that individual performance is measured as a combination of 'qualitative and quantitative' factors***.

With FOs generally not offering long term equity incentives, the incentive of co-investing alongside the family represents a compromise.

Most FOs prefer to exercise discretion when rewarding executives by way of bonus. However, increasingly, FOs are looking to benchmark FO roles and understand how others are structuring rewards.

The future of the FO

This survey has shown that FOs are on the rise in Australia. They are continuing to professionalise, to refine their mission and purpose, and are looking to the next generation for influence on how they can make an impact beyond their own building of wealth.

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They are increasingly aware that the way they invest is scrutinised and their reputations are always at risk.

As a source of funding for private enterprise they have never been as active. Their influence, particularly, in funding early-stage venture capital and innovation, is becoming more strategic. As a lure for professional skills and talent they are increasingly attractive.

Some issues for the FO to consider include:

- How to work closely together to avoid fragmentation of wealth and loss of influence by clearly defining their own expectations of the FO.
- A shift in the dynamics of running and operating a FO towards a more efficient approach embracing technology.
- Building and demonstrating effective tax and corporate governance, to enable effective decision making focused on the family's long-term vision.
- Reviewing the family's mission and purpose and its alignment across generations.
- Educating family members of cyber security risks and being able to respond to any risk issues effectively.

FOs are cognisant of the challenges that lay ahead and the changes they must manage.

The following will be emerging trends for the FO as a sector into the next decade:

- As financial markets transition from unprecedented central bank and government stimulus, achieving return targets will be more challenging. There is likely to be a greater focus on having appropriate policies in place as well as having experienced investment committee members (experienced family members and independents) on board to guide the FO through volatility.
- The rate at which new FOs are created in Australia will increase as equity and real estate asset values remain supported and inflate.
- The increasing size and depth of the sector in Australia and across South East Asia means that FOs will continue to attract skills, talent and resources from the financial services sector and from commerce more generally. This will result in an increase in the costs of hiring for and managing FOs as salary and wage costs compete for talent.
- FOs will need to benchmark their performance, culture, and purpose as a basis for competing for talent.
- Third-party technology platforms able to collate data efficiently and accurately will continue to be more easily accessible and drive down administration costs.

Adapted from: **WEALTH IN TRANSITION - Family offices in plain view.** Research into the Family Office Market in Australia, Hong Kong, New Zealand and Singapore. KPMG and The Table Club, October 2021.