PART One

Introduction to Advising Ultra-Affluent Clients and Family Offices

CHAPTER 1

Who Are the Ultra-Affluent?

I don't believe in a law to prevent a man from getting rich; it would do more harm than good.

—Abraham Lincoln

Despite the downdraft in the financial markets that began in 2008, which has dealt a blow to the portfolios of many ultra-affluent clients, an explosion in wealth has occurred in the world in the last 25 years. Global equity markets have performed exceptionally well since the recession of the early 1980s, albeit with periods of volatility like the one we have seen recently, and that performance has created large numbers of ultra-affluent individuals and families across the globe. In addition, a flood of money into private equity over that time has created valuable new companies and helped existing companies grow to become even more valuable. For advisers, this activity has created a wide and vast pool of potential clients who need help on a variety of fronts. What an exciting time to be in the financial advisory business.

Seldom is opportunity without challenge. The complexities of managing wealth have never been greater. Advisers to wealthy families have had to improve their skills in order to serve their clients. Family members who are involved in managing their wealth have needed to educate themselves on topics that go well beyond investment management. There are multiple layers of activities to manage simultaneously. Ultra-affluent clients and family offices are now acting like institutions, starting with governance policies that guide the activities of the family. Figure 1.1 shows the integrated complexities advisers and families alike face.

If an adviser considers himself qualified to advise ultra-affluent clients (hereafter UACs), he needs to have a deep and broad skill set. As you will learn throughout this book, managing wealth is about developing a

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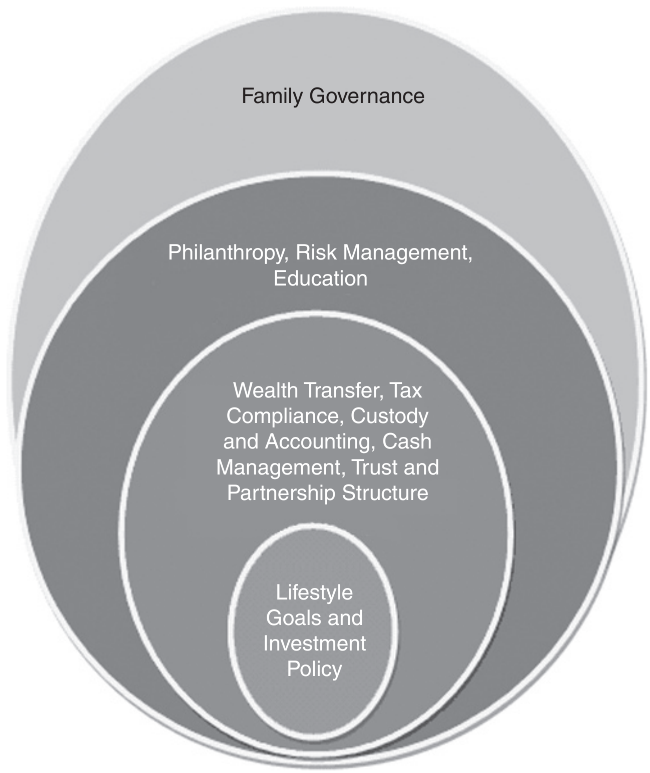

FIGURE 1.1 Multilayered Complexities of Managing Wealth

process, and only those advisers who understand both key investment and noninvestment issues—and know that they can't do it all themselves—will succeed. Advisers with the skill sets to manage vast wealth *properly* and without conflicts will be the advisers of choice in the future. But fret not! This chapter is intended to get you fired up! If you are reading this book, you are preparing yourself to serve clients in a dynamic segment of the financial services industry. Serving ultra-affluent clients and family offices is a fantastic business opportunity with lots of upside potential.

Many financial families, particularly those not involved in running a business day-to-day, are becoming more sophisticated in their understanding of investment and noninvestment issues, and are fostering new attitudes and perspectives that challenge advisers to be at their best. These clients from around the world are in command of the language they need so they can decipher complex wealth management concepts. This is partly driven

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by the proliferation of financial and nonfinancial news, data, and analyses available. This information is provided not only by public news agencies but also through UAC networking groups, by fund managers, and by sophisticated legal and tax professionals who target UACs directly. In the process of selling services to potential clients, they also provide education about sophisticated strategies. The result is that ultra-affluent clients are sometimes better informed than the people who pretend to have the skills to advise them! Clearly, this is not a good situation to be in if you are holding yourself out as an adviser to UACs.

Advising ultra-affluent clients is about much more than getting an extra 20 basis points return on a portfolio or creating the most efficient estate plan. It's equally—or potentially even more—about soft issues such as family governance and philanthropy. These issues are taking an equal footing with investment issues for today's UACs. Advisers with the ability to bring the client a wide array of resources that serve the wide variety of needs will be successful. This book can help not only advisers wishing to take their advisory practice to the next level, but also UACs wishing to broaden their knowledge of key issues they face when managing their own wealth and dealing with the advisers who serve them. Before we jump into advisory topics, it's important that we define what we mean by a UAC. There are a number of ways to potentially define this type of client, and we need to have a common understanding of the types of clients that can benefit from the broad range of topics I cover in this book.

DEFINING THE ULTRA-AFFLUENT

If you ask 20 advisers of wealthy clients how they define ultra-affluent, you will likely get 20 different answers to the question. For the purpose of this book, however, it is important that we put some parameters around what we are to consider *ultra-affluent* as distinguished from *mass-affluent,* or what I call *intermediate-affluent.* There are numerous factors that could be considered to define ultra-affluent, which I discuss in the next section. But first, let's establish a baseline definition.

In researching various definitions of ultra-affluent, I found that PricewaterhouseCoopers's (PWC) categorization of affluent investors is as good as any that I've seen; it will be modified somewhat, however, for our purposes. Figure 1.2 shows five categories of affluent individuals, along with three definitions that are used throughout the book. The five PWC categories are: Affluent ($100,000 to $500,000); Wealthy ($500,000 to $1 million) High Net Worth ($1 million to $5 million); Very High Net Worth ($5 million to $50 million) and Ultra High Net Worth ($50 million and more).[1] Although I

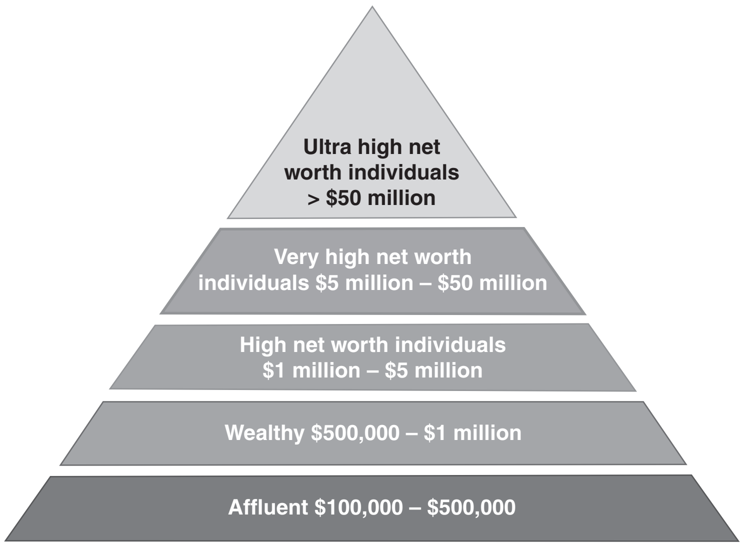

FIGURE 1.2 Categories of Affluent Investors
Source: PricewaterhouseCoopers.

do think this is an excellent breakdown, I prefer to further simplify these categories into these three: mass-affluent (MA), intermediate-affluent (IA), and ultra-affluent (UA). MA describes individuals with $100,000 to $5 million; IA, $5 million to $50 million; and UA, $50 million and more. As a general rule, for the purpose of this book, I regard a client with $50 million and more to be UA. But that definition may dip below $50 million for some conceptual applications and rise above $50 million for others. Regarding family offices, and the levels of wealth associated with them, please see Chapter 14.

You may be asking, "Why $50 million?" There are numerous factors that could be considered to define ultra-affluent. Three key factors are discussed next: complexity of needs, investment access, and service model.

Complexity of Needs

Perhaps the most intuitive definition of ultra-affluent has to do with the complexity of the needs of the client rather than an absolute dollar amount. UACs have complicated lives, and advisers who work with these types of clients must be aware of a vast array of issues, many of which are serviced by specialists (internal or external to the advisers' firms) such as CPAs, attorneys, philanthropy advisers, and so on. Figure 1.3 shows the complex needs of the UAC.

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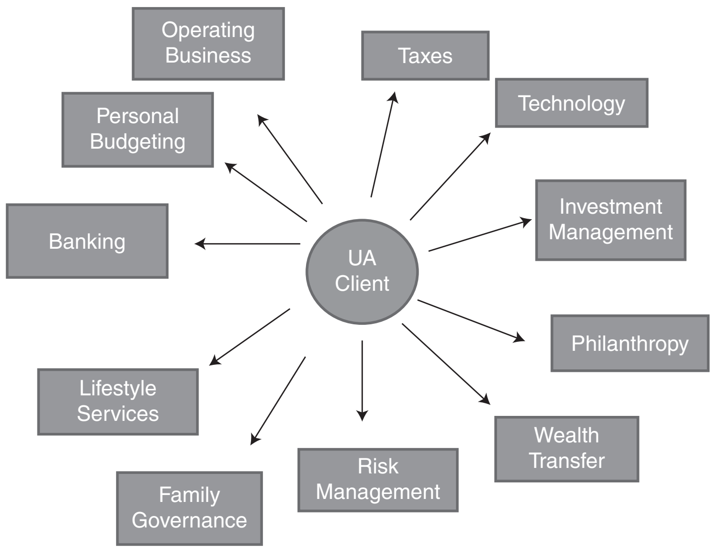

FIGURE 1.3 Needs of Ultra-Affluent Clients

Needs such as tax compliance, philanthropy, and investments, among others, are typically handled by a team of professionals. These professionals must work together, either across different firms or within the same firm, to service the client. MA or IA clients may not need or be willing to pay for services that are demanded by UACs—but some IA clients may have these complex needs while other UACs may not. Table 1.1 shows the types of services demanded by UACs compared to those that may be demanded by MA and IA clients.

Investment Access

In my daily work providing investment consulting services to UACs and family offices, my definition of ultra-affluence is actually higher than $50 million. I consider UACs to be those who have $100 million or more. Because the primary service my firm offers is investment advice, this definition has more to do with the type of investment program the client can undertake than an absolute wealth level or the complexity of the family's needs. For example, when considering alternative investments generally, and hedge funds, private equity, and private real assets in particular, I consider a client to be UA if she has the ability to directly invest in these funds or through the highest quality fund of funds. Naturally, this dollar amount is open to a significant amount

TABLE 1.1 Services Demanded across the Spectrum of Affluent Clients

Type of Service	Mass-Affluent	Intermediate-Affluent	Ultra-Affluent
Investment Advice Providers	Self-directed, brokerage, banks and financial planners	Private banks and multifamily offices (MFOs)	Investment consultants, multi- and single-family offices (SFOs)
Philanthropy	None or commingled vehicle	Commingled or family foundation	Professional philanthropy
Tax Preparation	Self or CPA	CPA or integrated with investment provider	MFO, SFO, or sophisticated CPA firm
Investment Access	Modest	Good	Great
Life Insurance	Local agent or broker	Higher-end provider integrated with estate plan	Intergenerational insurance planning by many specialists
Estate Planning	Local attorney	Regional or national firm	Integrated insurance, investments and tax plan by many specialists
Lifestyle/Concierge Services	None	Modest	Extensive

of debate. Yes, there are some investors who have $50 million or $75 million and are well-connected enough in the investment world that accessing the best managers at lower minimums is not an issue. And yes, there are some who might argue that $100 million is too low because the best managers in the world require a minimum of $5 million—and how could a proper portfolio be created with one or more managers taking up five percent of the total portfolio? In my experience, creating an outstanding portfolio of alternative and traditional managers is certainly doable with $100 million.*

Nonetheless, investors with $25 million to $50 million have substantial buying power and could in some circles be considered UA.

*It should also be noted that clients of my firm have the ability to invest in volume, as we gain access to top managers at reduced minimums by placing large sums with the managers we work with. Any client with $100 million has the ability to hire a consulting firm like mine.

Service Model

As already mentioned, UACs have more complex needs than MA clients. They must, therefore, be serviced differently. Generally speaking, as wealth level increases, the complexity of needs increases. As an MA client passes through the stages of the investor life cycle, he or she can usually be serviced by the same firm or even the same individual adviser throughout all of these stages. For example, as a client moves from the initial phases of accumulation, to managing wealth, to wealth planning, to wealth transfer, a single source such as a full-service private bank may be sufficient.

As clients move into intermediate wealth, they may find commercial family offices to be their best options. A commercial family office is usually a large investment firm that offers a high level of personal assistance and a wide offering of services such as financial, estate and tax planning, asset allocation, and manager selection. It may offer its own products, however, and may not provide some services of the traditional family office like bill paying, financial reporting, and tax compliance. The UAC with $50 million or more typically has needs beyond what can be delivered by a full-service private banking firm or commercial family office. Figure 1.4 shows the complexity of needs as wealth level increases.

A multifamily office (MFO) or single-family office (SFO) is generally the best option for UACs. The MFO and SFO typically provide objective advice (that is, they only receive fees from clients and not from investment managers) and can service all of the intergenerational needs I have already

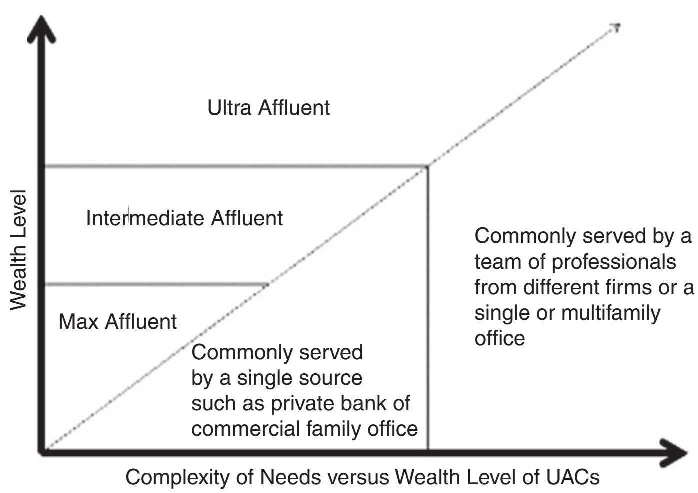

FIGURE 1.4 Complexity of Needs versus Wealth Level of UACs

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touched on. I review in great detail later in the book the services that a family office offers and what level of wealth is appropriate for creating a family office. For now, I have established a baseline definition of the UAC: A $50 million client with complex, intergenerational wealth management needs. So now that you have this definition, I can turn to some numbers and trends involving UACs. As you will see, the UA market is growing, and those advisers who can service these clients are positioned well for the future.

QUANTIFYING ULTRA-AFFLUENCE AMONG TOTAL GLOBAL WEALTH

Although the number of UACs in the world is debatable, one thing is clear: the number is growing. Sources of information about the number of UACs are limited because there is no central database of ultra-wealthy households like there is for other classes of investors such as colleges, foundations, or pension funds. There is one widely accepted source, however, from which we can get some idea of the number of UACs worldwide: the annual Capgemini/Merrill Lynch survey. Although this survey is focused mainly on MA clients with five million dollars or less in net worth, there is a good amount of analysis done on UACs. The cutoff for UA in this survey is $30 million. Granted, this number is smaller than the $50 million figure I am using, but you can still gain some good insight into UAC trends from these data.

Figure 1.5 shows the number of Capgemini/Merrill Lynch–defined Ultra-High Net Worth (UHNW) individuals in the world. In the 2006 survey, the latest information at the time this book was written, the number of UNHW individuals, or people with net assets of at least $30 million, was 94,970 worldwide. This number had risen by 11.3 percent since 2005 and the group's aggregate wealth increased 16.8 percent to $13.1 trillion. Of these individuals, nearly 50 percent are in North America—and although the survey doesn't break down the numbers by country, it may fairly be concluded that the vast majority of the 40,000 or more North American UACs are in the United States.[2] Are you surprised by that number? Consider this: Even if all 40,000 of those families had only $30 million each, that's an aggregate amount of $1.2 trillion, which is approximately the gross domestic product of Spain![3]

Perhaps the most exciting part of the financial advisory business at the upper end of the wealth scale is the sheer volume of clients that are available to be serviced—not only now but into the future.

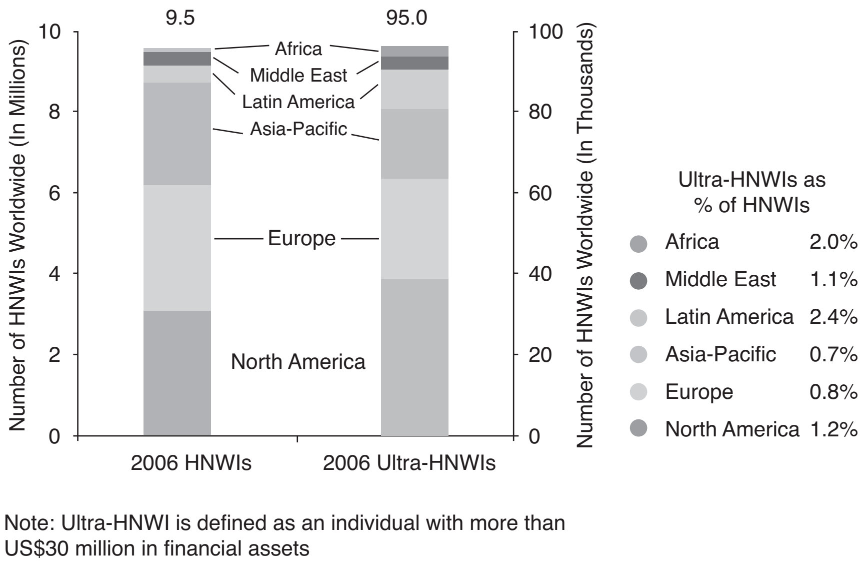

FIGURE 1.5 Number of Ultra-Affluent Clients Worldwide as of 2006
Source:

LOOKING TO THE FUTURE

There are several macroeconomic trends in place that point to a robust market for those who serve UACs globally, both in developed markets and developing countries. I next discuss two major trends: wealth accumulation in developing countries, and aging business ownership in developed countries.

Wealth Accumulation in Developing Markets

Wealth creation is moving beyond developed markets and slowly but surely seeping into developing markets. This trend is expected to increase rapidly as we move into the twenty-first century. Jeremy Siegel, of the Wharton School of Business, estimates that by 2050 developing countries should account for 75 percent of the world's gross domestic product (GDP), up from 25 percent today. "The population of India and China, among the countries with the fastest economic growth, will be eight times that of the U.S. Those huge populations will make the products that the U.S. will stop producing, and consume those that the U.S. will continue to provide."[4]

This growth in developing countries will fuel a boom in wealth creation. Developing countries today are creating large numbers of millionaires and UA individuals at a much faster rate than developed countries. Although the number of UACs worldwide is dominated by North America (especially the United States) and Europe, nearly 40 percent of UACs are outside these two geographies.[5] In Figure 1.5, Capgemini shows the percentages of UACs in 2007. Note that the developing countries had much higher growth rates of UACs compared to the United States and Europe.

Asia and the BRIC Countries As shown in Figure 1.6, the number of millionaires in the world jumped significantly between 2004 and 2006, led by growth in emerging markets like Brazil, Russia, India, and China (BRIC). The BRIC nations are playing increasingly important roles in the global economy, as demonstrated by the 53 percent increase in the MSCI's BRIC Index in 2006. Two of these four countries made their way onto the list of the 10 fastest-growing High Net Worth Individual (HNWI) populations in 2006.[6] GDP in China, for example, has grown by an average of about nine percent per year for the past decade.[7] China's HNWI population grew by almost eight percent in 2006.[8] Singapore and India are seeing high growth in the number of millionaires as well. Japan, despite being home to the second-largest HNWI population in the world, has showed sluggish growth for many years; wealth is not being dramatically created there.[9]

Russia's market capitalization has accelerated since the beginning of 2000, on the heels of IPOs and the liberalization of the country's banking sector.[10] Shares of Russian banks have led the way to wealth creation. Brazil's commodity-based economy has also created significant wealth. In 2006, the total number of HNWIs in Brazil increased by 10.1 percent. India continued its strong expansion, with real GDP growth of 8.8 percent in 2006, and a HNWI population increase of 20.5 percent in 2006.[11]

Latin America, the Middle East, and Africa Latin America continues to add to its HNWI population, with Argentina, Brazil, Peru, and Chile leading the way. Real GDP is healthy, reflecting China's growing demand for local commodities as well as its mounting foreign direct investments in the region. Latin America's HNWI population is growing faster than the global average; in 2006, it expanded by 10.2 percent, up from 9.7 percent in 2005.

The Middle East benefits from high oil prices and developed nations' heavy dependence on fossil fuels, creating staggering amounts of wealth. The Gulf Cooperation Council (GCC) countries (Bahrain, Kuwait, Oman,

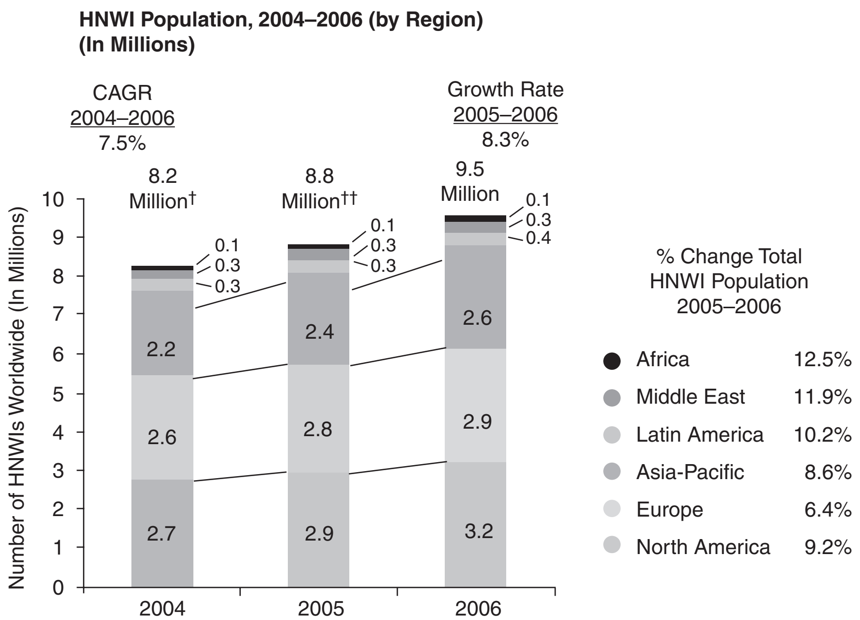

FIGURE 1.6 Growth Trends among Global High Net Worth Individuals
Source: © 2007, Merrill Lynch and Capgemini. All rights reserved.

Qatar, Saudi Arabia, and the United Arab Emirates) continue to drive wealth creation throughout the region.[12] The following excerpt, taken from the Capgemini/Merrill Lynch Global Wealth Report, discusses Africa and Latin America.

> *On the back of high commodity prices worldwide, Africa's real GDP rose 5.1 percent in 2006. This surge in turn led to increased interest in foreign direct investment, particularly in the mining and exploration sectors. Much of this interest has centered on South Africa and its gold-mining activities. China has been an active player in Africa, as in Latin America, investing heavily in various sectors and showing particular interest in mining.[13] Taken together, these factors bolstered the continent's HNWI population, helping it grow by 12.5 percent in 2006, and increasing its wealth by 14.0 percent.[14]*

For those advisers with a global scope, there are ample business opportunities. Figure 1.7 summarizes growth in HNWI populations.

FIGURE 1.7 Highest Growth Rates in HNWI Population Globally
Source: © 2007, Merrill Lynch and Capgemini. All rights reserved.

Business Transition in Developed Markets

During the next two decades, trillions of dollars in wealth in established private businesses are expected to change hands and become liquid in the developed world, particularly in the United States and Europe. With the number of private businesses at an all-time high and an increase in the number of aging business owners that are either passing away or planning to retire, a surplus of businesses will be up for sale or transition in the United States and Europe in the upcoming years. The implication of this trend is that the need for UA advisers will increase significantly in the coming years because the number of UACs is likely to double or even triple by 2020. Those advisers, who can adequately prepare themselves on both domestic and international fronts, will have a very strong business opportunity to capitalize on in the future.

United States Given current trends, the demand for UA advisers will remain very strong in the United States. Why? Steady growth in private business in the United States over the past several decades is going to have a significant impact on the amount of private business wealth available to be transferred or sold in the next decade. Most of the private businesses started in the 1980s and early 1990s are owned by people 50 years old and older.[15] Just as the Baby Boomer demographic bulge threatens the solvency of the Social Security system as boomers approach retirement, the private business owner demographic bulge will seriously strain and possibly overwhelm the available supply of buyers and the support infrastructure for business transition and transactions as these owners approach retirement. Some industry observers have dubbed this activity the *Business Transition Tidal Wave.*[16]

More than four out of five U.S. family businesses are still controlled by their founders, and the coming wave of change will likely catch many business owners and their families off guard because they have not taken the time or made the effort to put ownership succession plans in place.[17] According to the Family Firm Institute, about 40 percent of family businesses expected the leadership of their companies to change by 2008; well over half of family businesses expect a leadership change by 2013.[18] This activity presents abundant opportunities for those in the right position to become trusted advisers by helping to bring resources to this problem. Ownership succession planning is the one subject that the family or the family's professional advisers should be thinking about.

As of 2007, the number of established private businesses in the United States was about 12 million, with an estimated value of $10 trillion. Not only has the number of private companies significantly increased, but the rate at which private business owners are transferring or selling their companies has increased as well. In 2001, 50,000 business owners in the United States planned to retire, while in 2005, 350,000 business owners planned to retire.[19] As shown in Figure 1.8, nearly 60 percent of business owners are 55 years or older and 30 percent of business owners are 65 years or older.

After a private business is created and has experienced a period of growth and success, the next natural stage in the business cycle is the transfer of ownership. When business owners retire, they face four possible courses: usually one third will sell the business to an external buyer, one third will sell the business to a family member, and one third will either sell the business to current employees or close the business.[20] This means that over two thirds of businesses will have new owners, either within the family or not.

For the purpose of this analysis, I am assuming that over the next 10 years, 25 percent of owners aged 55 to 65 will relinquish ownership and that 75 percent will do the same among owners aged 66 and older. With the estimates of CEO age, transition assumptions, and the prediction that two thirds of businesses will have new owners, we can roughly calculate that approximately $1.5 trillion dollars will change hands in the next 10 years due to current business owners currently aged 55 to 65. With regard to business owners aged 65 and older, approximately $2.25 trillion will change hands in the next 10 years. This totals $3.75 trillion that is estimated to be changing hands in the United States during the next 10 years. This estimation is generally consistent with some long-run forecasts on private business transition made by various researchers. The Austin Family Business program

AGE OF MAJORITY SHAREHOLDER

18 to 34	1.2%
35 to 44	8.9%
45 to 54	31.3%
55 to 64	28.5%
Older than 65	30.1%
Total	100%

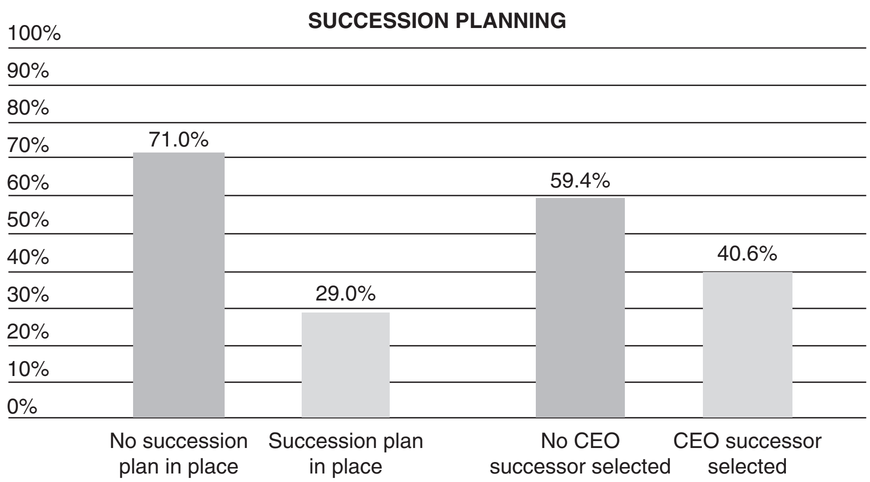

FIGURE 1.8 Trends in Succession Plans for Private Family Businesses
Source: © Laird Norton Tyee Family Business Survey, 2007.

estimated in 1999 that $4.8 trillion of net worth will be transferred in the United States by 2020 and by 2040, $10.4 trillion will be transferred. By 2052, $41 trillion will be transferred.[21]

Europe Europe is also providing robust opportunities for UA advisers. In fact, a number of U.S.-based multifamily offices have recently announced plans for expansion in Europe.[22] The reasons for this opportunity in Europe are similar to those in the U.S. For example, the European Commission has reported two recent trends concerning European private businesses that point to accelerated business transitions in the next decade. First, entrepreneurs are more often relinquishing their ownership rights before the typical retirement age so they may enjoy those years earlier. Second, entrepreneurs are attempting to diversify their life experiences by staying with one venture for shorter periods of time, rather than staying in the same enterprise for their entire careers.[23]

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TABLE 1.2 Estimated Value of Business Transition by 2017

Country	Value of Private Business (50% is private) – (GDP/2)	Percent that Will Transition	Value of Transition
Italy	$900 billion	40	$360 billion
Austria	$155 billion	23	$36 billion
United Kingdom	$1.2 trillion	33	$396 billion
France	$1.1 trillion	33 (approx)	$363 billion
Sweden	$185 billion	33 (approx)	$61 billion
Germany	$1.5 trillion	33 (approx)	$495 billion
Total			$1.4 trillion

Source: European Commission, *Transfer of Businesses—Continuity through a New Beginning,* MAP 2002 Project, Final Report, 2006.

In Europe, family businesses account for 55 to 65 percent of the Gross National Product and 70 percent of employment.[24] Expectations of ownership transfer over the next 10 years are increasing. In 2002, it was estimated that 610,000 small- and medium-sized companies in Europe would change ownership every year.[25] By 2006, the estimate increased to 690,000 ownership transfers.[26] These data imply that over 10 years, up to 6.9 million enterprises, representing one third of all European entrepreneurs, will be transferred or sold to new owners.[27]

Ownership transfer in Europe can be broken down into individual countries. Forty percent of all Italian companies, 23 percent of all Austrian companies, and one-third of all companies in the United Kingdom are expected to change hands in the next 10 years. Six hundred thousand French companies and 45,000 to 50,000 Swedish companies will transfer ownership in the next decade. In Germany, 354,000 companies' owners are expected to withdraw in the next five years.[28] In these countries alone, approximately $1.4 trillion will be transferred in the next 10 years as calculated in Table 1.2.

A WORLD OF OPPORTUNITIES FOR ADVISERS

Successful succession requires clear strategic planning. Although a massive ownership transfer is expected to occur, many business owners have not begun to prepare. In the United States, fewer than half of the owners who plan to retire in the next five years have selected successors. For those expecting to retire in the next 6 to 11 years, fewer than one third have selected successors.[29] A similar situation exists in Europe. One and a half million European owners plan to retire in the next decade, but many have not selected successors.[30]

One effect of this phenomenon will be the increase in demand for professionals with transition experience and wealth management expertise. Ownership transfer requires accountants, lawyers, valuation advisers, and insurance professionals. With these transitions comes liquid wealth—and with liquid wealth comes significant demand for investment advisers to manage this wealth. Although all professionals will profit from the increased demand, if the supply of these professionals is too low, their resources will be stretched and the quality of their work could potentially deteriorate. We need to prepare for the coming onslaught! With the Baby Boomers in the United States transitioning into retirement and the large European population aging, the next decade will be a turning point in the amount of private business wealth that will be transferred or sold.