CHAPTER 1

George Titan III and His Catastrophic Mistake

PREPARATION AND USE

George Titan III was the third child and only son of George Titan Jr. and his wife, Mary (see Chapter 1). George had a difficult career at Titan Industries, and was let go by Smythson Brothers following its acquisition of Titan. However, when his father died George became the patriarch of that branch of the family and inherited responsibility for its investment portfolio. His sister, Grace, would probably have been a better choice, but in those days it was assumed that the males in the family would handle business and investment matters.

And this is an important point. In some families in the early and mid-twentieth century, the brains of the family happened to fall mainly on the female side. But decision-making responsibilities continued to lie in the male line, right up until fairly recently. This meant that those families were fielding second-string players instead of their best, and sometimes that situation would come back to bite them. As we will see, such was the case with the George Titan III branch of the family.

HOW NOT TO MANAGE YOUR FAMILY'S MONEY

For decades, the capital of the children of George Titan Jr. had been managed by a local Pittsburgh trust company, the one selected by George Titan Jr. years earlier. But shortly after World War II the trust company was acquired by a local bank, and over the years that bank decided it wanted to become a world-class investment manager and to compete globally for investment business.

Up to that point, the family's portfolio had been managed very cautiously, with half the capital always invested in bonds. But as time went by, and as their bank advisor developed many new products, they sold those products to George III, convincing him to invest more and more aggressively.

QUICK NOTE

This episode illustrates the danger of a family behaving too passively in the face of industry changes. The acquisition of the trust company by a bank completely changed the identity and nature of George Titan's advisor, but he went along with it without, apparently, realizing how consequential the change was.

Note that there is nothing wrong with investing aggressively. Many families have done it with great success for many years. But aggressive investing leaves precious little margin for error. If you're driving your car at 40 miles per hour, a lot of bad things can happen on the road and you'll still have plenty of time to adjust. But at 80 miles per hour, you'd better be on high alert at all times. George III thought of himself as a far-above-average investor, but as we will see, he was confusing brilliance with a bull market.

The American Stock Market Turns Sour

The late 1960s had seen strong equity markets in the United States, but the year is now 1974 and it is mid-July. George III is 70 years old and has been overseeing the family investment portfolio from his office at Lawburn (the Titan family office) for many years.

George III considered himself to be an astute investor, and both under the local trust company and, later, under the bank, George believed that the family's capital had been well-managed. Following the Allied victory in World War II, the United States had become the world's most powerful country. It's main competitors at the time—Germany, Japan, and Britain—had all been devastated in the war and the U.S. economy expanded rapidly.

The American stock market had kept pace with this growth, so that even net of the family's rather heavy spending—about 5% of the capital's value every year—the portfolio had continued to grow in both nominal and real terms. Basically, since the end of World War II the U.S. stock market had been on a consistent upward march. During the decade of the 1950s, for example, the Dow rose from just over 200 to over 600. The surge slowed a bit in the 1960s, but even so the Dow rose to 800 during that decade, and there were several official bull markets late in the decade (1962–1966 and 1967–1968).

In 1972, the Dow Jones Industrial Average had gained 15%, and most investors believed that the good times would continue. The 1970s would be at least as good as the 1960s, and maybe as good as the 1950s. *Time* magazine, for example, in early January 1973, predicted that 1973 was "shaping up as a gilt-edged year."[1]

But the prognosticators were badly off-target. On January 11, 1973, the Dow began a dive that would result in one of the worst bear markets in history. Over the following 699 days, through December 1974, the Dow dropped 45%. Making matters worse, inflation, which had been just over 3% in 1972, jumped to 12.3% in 1974. In other words, in inflation-adjusted terms the losses were even greater. And while the market was crashing, so was the U.S. economy, where GDP growth dropped from +7.2% in 1972 to −2.1% in 1974. (Matters were even worse elsewhere. The London FT 30 Index, a predecessor of today's FT 100 Index, dropped 73% during the bear market.)

All this stunned George III who, as noted earlier, had presided over two decades of excellent returns and who had forgotten that those returns were driven mainly by strong market conditions and not by his excellent investment judgment. As the markets continued to sink throughout 1973 and into 1974, George began to raise hell with his bank investment managers.

But those advisors believed that investors should think long term. Sure, the market was currently in a bear phase, their thinking went, but that wasn't a permanent condition. Sooner or later, the market would turn up again, and when it did, families like the Titans needed to be heavily exposed to stocks in order to take advantage of the rebound.

But the result of this thinking was that the bank was continually "averaging down," as George indignantly put it, selling good bonds to buy bad stocks. Whatever the bank bought, it promptly went down.

QUICK NOTE

Here is a case of the family's advisor giving them reasonably good advice, but not couching it in terms the family could accept. Quarter-after-quarter of "averaging down" convinced George Titan that the bank didn't know what it was doing, that it was just operating on automatic pilot.

By the first quarter of 1974, George was getting questions from his wife and (adult) children about what was going on in the portfolio. They were naturally concerned that, as the value of their capital plummeted, their spending might have to be cut. In an effort to keep the pressure off, George III didn't cut the family's spending, but as a result, that spending grew and grew as a percentage of the capital that supported it.

As noted earlier, at the end of the 1960s the George III branch of the family had been spending 5% of its capital every year. This was too high, but George III was analogizing his family to the endowments of the nonprofit organizations on whose boards he served, most of which spent about 5% per year. But George had forgotten that nonprofit endowments don't pay taxes and that, typically, they are large enough to pay much lower investment management fees than families pay. Moreover, endowed institutions have a fallback in the event of poor outcomes: they can go out and raise more money. Try *that* as a family.

George's family should have been spending more like 3% of their capital each year, even in good times. But as the value of the portfolio plummeted throughout 1973 and 1974, and as the family's spending remained constant, the percentage they were spending grew and grew, causing the capital to decline even faster. By early summer of 1974, the George III branch of the Titan family was spending more than 8% of the portfolio's value.

The family's account managers at the bank were alarmed by the high spending, and they would sometimes (very gently) raise the issue with George III. But the patriarch's view was that it was none of the bank's business how much the family spent, and so the conversation went nowhere.

George III Makes a Fateful Decision

As his family's losses deepened, George III found himself losing sleep. He became difficult to live with, snapping at Mary and avoiding his friends. Finally, at the end of June 1974, George III took a room at the Rolling Rock Club, locked his door, and spent the better part of three days reviewing the performance of the family's portfolio under his management—going all the way back to World War II.

As he worked his way forward from the war years to the present day, George noticed something he'd never focused on before. As mentioned above, immediately after the war everything went America's way. But this was because our competitors in Europe and Japan had been flattened in the war while America was hardly touched.

By the 1960s, while things still looked good in America and while the market was still moving up, albeit not so sharply, it was obvious to George that looks were deceiving. Europe and Japan were recovering rapidly, thanks in many cases to generous help from America, and competition from those quarters was beginning to bite. Already steel from Germany and Japan was beginning to show up in the United States, and it was not only cheaper than our own steel, it was in many cases of better quality.

American investors, lulled into somnolence by two decades of easy money, had been asleep at the switch. But in the early 1970s those investors woke up and realized that America had fallen behind Europe and Japan, to say nothing of a resurgent Soviet Union. Suddenly, no one wanted to own stocks.

George returned to his office and scheduled a family meeting for mid-July. That meeting would also be held at the Rolling Rock Club, a tony country club founded by Pittsburgh's Mellon family. George had reserved a secluded meeting room behind the Card Room, most easily accessed by a secret door through the bookcases. George wanted to be sure no one would hear what he had to say except his own family. His advisors at the bank weren't invited, and only one young lawyer from the family's law firm would be there to take notes.

When the family was assembled and drinks had been served, George rose to his feet and made a long and impassioned speech. That speech clocked in at 37 minutes, but we'll look at an edited version of it here. The essence of the matter was that, the very next day, George planned to instruct the bank to sell every stock in the family portfolio. Because some of the positions were large and thinly traded, it would be the end of August before the family was completely out of stocks, but after that the family would own not a single equity security.

There were a few gasps around the table when George announced this decision, but the patriarch held up his hand for silence.

"I want to be quite clear about this," he said. "All across the world investors are dumping their stocks because of the bear market. But that's not what's driving my decision. No one likes to lose money, of course, and no one especially likes to lose money month in and month out for eighteen months.

"But long-term investors know that bear markets come and go, just as bull markets come and go. To pull out of the stock market just because stocks are going down is a very foolish thing to do. And that's not what I'm doing.

"If I continued to have confidence in American industry—indeed, in America itself—I would simply hold on, knowing that sooner or later the markets will turn and we will be making money again. But—and I say this in sadness and regret—I've lost that confidence."

George went on to describe how American businesses had thrived after the war, and how they appeared to be continuing to thrive during the 1960s. But that was just surface momentum and investor hardheadedness. In fact, it was in the 1960s that America began to lose its way.

"I don't have to remind you what was happening on our college campuses in the Sixties," George said, glancing pointedly at his grandchildren. "Hippies everywhere, antiwar activists blowing up buildings, administrators who should know better throwing in the towel and capitulating to the demonstrators.

"And you all know what happened to us in Vietnam. America had never lost a war before, but in Southeast Asia we cut and ran. The American public has no stomach for war anymore, and keep in mind that that's when Rome began to decline, too.

"How many of you in this room have waited in a long line to buy gas?" Hands went up. "Do you know why? Because America allowed itself to become dependent on oil from the Middle East, that's why. When we backed Israel in the Yom Kippur War, the Arabs embargoed our oil and forced us to our knees. We made Israel back down because we were desperate for oil, for oil at any price! We used to pay about three dollars a barrel for oil, but now it's twelve dollars and no end in sight.

"And what about what's going on in the White House? I voted for Nixon, and I'm sure—I *hope* I'm sure—that many of you did, too. But God knows what he thinks he's been doing down there in Washington. I hear he could resign any day. Imagine that! A president of the United States forced out of office for possible criminal activities! It's unbelievable!" (In fact, President Nixon resigned less than a month after George III spoke, on August 9, 1974.)

George took a long swallow of his martini, shook his head in disbelief at what had happened to his country, and then continued.

"The worst of it all is what's happened to American industry. When my grandfather—your great-grandfather and great-great-grandfather—came to America, he came because we were the greatest country in the world, a country full of opportunity. American companies were the most competitive anywhere.

"When the United States Steel Company was organized right here in Pittsburgh just after the turn of the century, it was the largest and most powerful firm in the world. Imagine! The United States of America, barely a century old, had outdone all the countries of Europe and Asia.

"But look at U.S. Steel today—it's a pathetic shell of its former self. Sure, they've built themselves a fine new building, but they're not half as good at making steel as they are at building fancy headquarters.

"In fact," George continued, really warming to his message now, "I wouldn't even call it a company. It's more like a bureaucracy, like something you'd find in the government. There are so many layers of management at U.S. Steel they can never get anything done. No one can make a decision, and in the rare cases when a decision gets made it's impossible to know who was responsible for it.

"All U.S. Steel's management cares about is preserving labor peace, and they've bought it by selling out to the unions. Do you know that a young steelworker who's willing to work overtime can earn almost fifty thousand dollars a year? Do you know what a young lawyer, straight out of Harvard, makes a year?"

George looked around the room, but no one seemed to know the answer.

"Well, I'll tell you: twelve thousand. Yes! A Harvard-trained lawyer in Pittsburgh makes twelve thousand dollars a year, while an uneducated steelworker makes fifty thousand! How long do you think that's going to last? I predict the American steel industry'll be dead in twenty years, if not sooner. And where the steel industry goes, so goes the rest of American industry."

George looked around the room. Everyone was riveted, staring at him. He nodded his head at them and continued.

"If I had confidence in America, in American business, I wouldn't be selling stocks. No, I'd be a *buyer* at these prices! I'm not selling out because of the bear market, I'm selling out because the American Century is over. We've had our day in the sun, but just like every other great civilization, we rose and now we've fallen. Some of you might remember that Russian Premier Khrushchev told us way back in 1959, 'We will bury you!' Well, the Russians *have* buried us, not by beating us in war, but by beating us in peace. And Germany and Japan have beaten us, too.

"I don't say any of this out of anything but sadness, deep and abiding sadness for the country I love, for the *city* I love. But it's my family I have to think of first. We've lost a lot of money over the past year and a half—nearly forty percent of our capital, in fact. But we're still rich and I want to be sure we stay that way. By the end of next month we'll be entirely out of stocks. Our wealth will be secure. Thank you."

George set down and drained the rest of his martini, then ordered another. For a long moment there was silence around the table, but then someone started to clap. Others took up the applause and soon George Titan III was being given a standing ovation by his family.

QUICK NOTE

One important thing to note here is that George Titan stated that he wasn't exiting the stock market because he was in a panic over his losses. Instead, he couched his decision in broader terms. But note that when a family panics during a bear market, there will almost always be "broader terms." Often, the broader terms will have to do with not wanting the family's asset base to drop below a certain, usually arbitrary, point.

The Aftermath of George's Decision

The extraordinary thing about this episode in the Titan family is this: George III was right—or nearly right—about almost everything he said. And yet, the decision to sell all the family's stocks proved to be an utter debacle, destroying his family's capital almost entirely in one generation.

How could this be? The main problem was that George Titan III failed to consider the resilience of the American economy and the American people. He was correct that conditions were dire in the mid-1970s in America—a few years later, in 1979, President Carter would give his famous "malaise" speech in which he opined that Americans were suffering from a "crisis of confidence."

But Americans had faced far worse challenges over the prior 200 years: fighting for their freedom against Great Britain, then the most powerful country in the world; engaging in one of the most destructive civil wars in human history; entering World War I barely in time to turn the tide; surviving the Great Depression; leading the fight in World War II, where Americans were forced to battle powerful foes on two fronts thousands of miles away. George should have been able to put the current malaise in perspective, but he didn't.

Even as George was addressing his family at the Rolling Rock Club, the bear market was coming to an end. Stock prices would continue to jump around until December 1974, but looking back it's clear that the terrible downdrafts ended in August, a few weeks after George spoke to his family.

The Dow eventually settled near 578 on December 4, 1974, but in 1975 and 1976, the stock markets snapped back, as they usually do after a bear market, closing just above 1,000 at the end of 1976. By the end of 1980 the Dow was back where it had been at its peak in 1972.

But none of this mattered to George III's branch of the Titan family, because they were no longer invested in stocks. The family had ridden the bear market all the way to the bottom, then sold out (immortalizing their losses), paid heavy capital gains taxes, and then failed to reinvest.

Missing the 1975–1976 recovery was bad enough, but most of the family remained invested entirely in bonds throughout the 1980s and 1990s. George Titan III died in 1981, but he had run the family's capital entirely on his own for a very long time, and as a result no one else had any experience investing money. If bonds were good enough for their father, bonds were good enough for them. Besides, their spending needs were very great and stocks yielded very little.

The bank that was advising them had made a few timid suggestions to the effect that it might be a good idea to get back into the stock market, but it never happened. Stocks made the family uncomfortable, and the family patriarch had made it clear before his death that owning stocks was a fool's errand.

QUICK NOTE

Once it became clear that George Titan was not just exiting the stock market, which was bad enough, but that he planned to stay out indefinitely, query whether the bank shouldn't have resigned as his advisor. Note that if a lawyer's client refuses to take his advice, the lawyer may be required by the Code of Professional Responsibility to resign. A wealth advisor's ethical compass should be at least as sensitive.

In 1982, one of the great bull markets in history began, running almost uninterrupted until 1999, when investor enthusiasm slammed into the "tech bust" and prices collapsed. During those 17 years, many investors built large fortunes in the markets, but, again, the George Titan III family missed out on all of it.

Eventually, the combination of no portfolio growth and high spending made it clear even to the most unsophisticated family members that matters couldn't long continue. But by then a new generation of Titans had come along, and, while *per capita* spending did decline, *absolute* spending increased.

The end result was highly predictable: by the late 1990s, the George III branch of the family was no longer wealthy. From the end of World War II through the 1970s, that branch of the family had been one of Pittsburgh's most prominent. George III and his wife, Mary, sat on all the important boards in town and were members of all the right clubs. Everyone knew who they were and their opinions mattered. But by the end of the 1990s, the Titans were a middle-class family, struggling to avoid falling even further. No one knew who they were or cared. They had become the "poor" Titans.

THE MISTAKES GEORGE MADE

When a family's wealth is devastated through investment errors, there is usually more than one mistake in the picture. Let's walk through some of the mistakes George Titan III made in managing his family's money.

Failing to Learn and Grow

Although George Titan III had managed his family's portfolio for more than three decades, he knew very little more about the investment process in 1974 than he'd known in 1938. If we'd asked George about this, he would have dismissed the question—after all, George had advisors whose job it was to understand these sorts of things, and he paid them high fees to do so.

George would have viewed investment advice as similar to any other kind of advice or service he might need. For example, George knew very little about how his furnaces worked, but so what? He had a contractor who handled that sort of thing. Similarly, George saw no reason to learn about investing, because he had advisors who handled that sort of thing.

What George forgot was the difference in the *consequences* of failure. If his furnace failed, the only consequence was that George needed to buy a new one. This might be a serious annoyance if the furnace happened to fail in January, but it would hardly be a catastrophe.

But if George's portfolio failed, that would be a family tragedy that would haunt the George Titan III family members for generations. There are big differences between furnace failures and portfolio failures, but George never picked up on this important point.

What George should have done was to learn enough about the investment process at least to be a thoughtful client, a prudent overseer of his family's wealth. He could have achieved this objective by requiring his advisors to help teach him about the investment process. He could also have attended conferences and seminars at which investment issues are discussed. He could have read books on investing or he could have joined the local Pittsburgh affinity group of family offices, which offered regular investment seminars, as well as contacts with other family offices.

Unfortunately, George did none of this. He relied as heavily on his financial advisors as he did on his furnace contractor, and the results were very unfortunate.

Working with the Wrong Advisor

When the trust company that had managed the Titan portfolio was acquired by a bank, the nature of George Titan III's financial advisor changed radically. The bank was a very fundamentally different creature from the trust company and the chance that it would just happen to be appropriate for the family was very low. But George simply went along passively with the change. It's true, of course, that the trust company had been acquired by a Pittsburgh-based bank that George was somewhat familiar with and that many people he knew banked with. But George knew nothing about the bank's (rapidly evolving) money management capabilities.

As noted, the bank had decided to get into the investment business in a big way and had begun buying up money management firms and hiring scores of investment professionals. Today, in 2015, that bank manages billions of dollars for pension funds and individuals. But along the way the bank went through many difficult periods.

Building a global money management business almost from scratch is a huge undertaking. Many of the firms the bank acquired promptly produced dismal performance numbers. The investment professionals who had built those firms had just cashed out on the sale and no longer much cared about the hard work of managing money.

But since George knew nothing about the investment management business, it never occurred to him that, behind the scenes, things were not well at the bank. And since the bank was reporting on its own performance, it was usually able to sweep poor results under the rug. Those results were in the account statements somewhere, but George wasn't likely to find them on his own, and the bank had no incentive to point them out.

Being Sold Instead of Buying

Over the decades, the bank's advisory personnel managed to sell George just about every hot new product they could dream up. Some of these products were actually useful and appropriate for the Titans, but many were not. Inside the bank, George was notorious for his willingness to buy just about anything the bank had to sell.

But a family that hopes to do well in the investment of its capital should never, ever be *sold* anything. The family should, instead, be an active, knowledgeable and proactive *buyer* of investment services and products.

The way the process should work is that a family looks at the risk and return profile of its portfolio and decides that (let's say) it needs to reduce its risk but, hopefully, without reducing its returns by a similar amount. The family will then look around for ways to accomplish this and might (for example) decide to replace some of its long equity managers with long/short hedge fund managers. The family will look for the best long/short managers in the business and engage one or two of them.

But that's not how it worked with George Titan III. Instead, George would show up at a meeting with his advisors and find that they had a new idea for him. The bank had recently purchased a hedge fund, and the advisors thought the find would be a useful addition to the family's portfolio. The advisors would walk George through reams of data showing how terrific the hedge fund's returns had been, and eventually, with George lost in the details, he would tell the advisors, sure, let's give it a try.

Maybe the family's portfolio needed a hedge fund and maybe it didn't. George would never know. Maybe this was the best hedge fund for the family and maybe it wasn't (in fact, the odds were huge that it wasn't), but, again, George would never know.

Abandoning the Equity Markets

The biggest error George Titan III made was his decision to abandon the equity markets. A wealthy family, like it or not, is in the business of managing capital, and it's a tough business to be in. Families pay taxes, they pay investment management fees, they spend money from the portfolio, and, of course, inflation constantly eats away at the value of the capital. And as if all that weren't enough, families tend to compound faster than capital does, so that even successful families will likely see their *per capita* wealth drop across the generations.

Given all these headwinds, it's essential that family portfolios be growth-oriented, and that means owning stocks. George's rationale for selling equities may have resonated at the time, but longer term it was a calamitous, utterly destructive act. When George sold out, the family's portfolio had already declined by about 40%. Selling immortalized those losses. Then, with no growth assets in the portfolio, it was impossible for the family to recoup.

As noted previously, if George had simply held on for a few more months, the stock markets would have resumed their upward trend. The strong markets of 1975 and 1976 wouldn't have restored the family to its former wealth, but it would have been a nice start. Then, when the big bull market started in 1982, the family would have enjoyed 17 long years of mainly very strong markets. They would have been much wealthier in 1999 than they'd been in 1972, before the 1973–1974 bear markets.

But it wasn't to be. George Titan III's investment mistakes, and especially the devastating decision to abandon equities, destroyed his family's wealth.

WHAT A GOOD ADVISOR COULD HAVE DONE FOR THE TITANS

For advisors to wealthy families, there are many lessons here, but perhaps the main one is this: a successful wealth advisor must grapple with much more than capital markets. Let's examine some of the ways George Titan III's advisors might have helped prevent the very unfortunate outcome described earlier.

Putting the Client First

Advisors shouldn't even think about working with wealthy families unless they are willing to place the clients' interests above their own. This should be true of any financial advisor, but unfortunately the Securities and Exchange

Commission (SEC) has seen fit to allow most advisors to put their own interests first.

The first words on the SEC's website are these: "The mission of the U.S. Securities and Exchange Commission is to protect investors."[2] In fact, it would be more accurate to say, "The mission of the SEC is to protect large brokerage firms." The brokerage industry has lobbied the SEC hard to avoid having to put their clients' interests ahead of their own, and so far they have always succeeded.

As we'll see in the next chapter, some advisors are fiduciaries, meaning that, as a matter of law, they must elevate their clients' interests above their own. Mainly, these are so-called RIAs (registered investment advisors). But most financial advisors, including the ones George Titan III used, are *not* fiduciaries.

These other advisors, constituting the vast majority of financial advisory professionals, operate under a loosey-goosey rule known as the *suitability standard*. In other words, so long as an investment is "suitable" for the client, non-fiduciary advisors are free of any further obligations to their clients.

In the case of George Titan III, every investment product the bank's advisory professionals sold George was suitable. Since the Titans were a wealthy family, it's almost impossible to imagine an investment that would be *prima facie un*suitable. Yet many of those products were very expensive, poorly performing, tax-inefficient, and had no business being in George's portfolio. But under the SEC definition, they were certainly suitable.

Ideally, every advisor to a wealthy family would be, legally, a fiduciary. But if advisors are working in environments where they aren't technically fiduciaries, they should always *act* as though they are. Thus, stockbrokers, insurance agents, and advisors working inside banks should put aside the suitability standard and provide advice that would meet any fiduciary standard.

But that's not what happened with the Titan III family. The bank's advisors sold George everything they could think of to sell him. This made the bank a lot of money, but it also made a mockery of the idea that the bank's professionals were *advisors* in any useful sense of the word.

Educating the Client

The goal of every wealth advisor should be to ensure that the client is more knowledgeable about the investment process every year of the engagement. This means that in every interaction with the client the advisor needs to be sure the client understands what is being discussed. At every client meeting, opportunities for education should be seized. At least once a year, time should be set aside at meetings for both the client and the advisor to become better informed about some aspect of the investment process. This can be done by using guest speakers, for example.

But George Titan III's advisors wasted none of their time trying to educate George about the investment world—after all, an ignorant client was a much more profitable client. If George had clearly understood the investment process, for example, he would have clearly understood how full of conflicts of interest his bank advisors were. That in turn may have led George to terminate his relationship with the bank. Hence, why educate George?

One dire consequence of George's lack of understanding of capital markets was that he was able to convince himself that America and its industries were in a terminal state of decline. George didn't grasp the way capitalism works: when companies get fat and lazy, they become easy targets for people who want to turn them into lean competitors again, and a lot of money can be made doing this.

Beginning with the Reagan tax cuts and the deregulatory activity of the 1980s, the leveraged buyout (LBO) industry was born. Firms like Kolberg Kravis & Roberts would raise capital, leverage that capital with borrowings from banks, then buy up units of companies or even whole companies. They would then strip out redundant layers of management, eliminate excess employment, bring in new management, and provide strong incentives for those managers to deliver on profit targets.

As the value of the now-competitive companies rose, the LBO firm would take the companies public again (or sell them to larger firms) at much higher price multiples than they had originally paid. Add on the effect of leverage and the LBO firms—and their limited partner investors—made huge sums of money.

Thousands of uncompetitive firms were transformed in this manner, and thousands of other firms, observing that they were in the crosshairs of the LBO artists, transformed *themselves* rather than being taken out. By the 1990s, American industry, which had been moribund in the 1970s, had become fearsome, so much so that every developed country in the world had to respond or be crushed.

George, unfortunately, understood none of this. He saw American businesses becoming increasingly uncompetitive and he assumed that trend would go on forever. It was a deadly error.

Focusing on Spending

Many families overspend, and the George Titan III family was no exception. A driving force behind overspending is almost always a lack of appreciation by the family of the *consequences* of spending too much.

George III's advisors did, tentatively, raise the issue of spending on one or two occasions, but George shut them down and they never raised it again.

What the advisors could have done was to have prepared analyses showing the *impact* on the family's wealth of spending at various levels.

Consider, for example (this is a very simplified analysis), a family that spends 5% of the value of its capital every year, as the George Titan III family was doing even before the bear market hit. It doesn't take a rocket scientist to run through a simple calculation like this:

Expected *after-tax* return on the portfolio: 6%

Investment fees: (1%)

Inflation: (3%)

Portfolio growth before spending: 2%

Spending: 5%

Net portfolio growth: (3%)

George Titan III may not have been the best steward of his family's capital, but a chart like that, showing that over the three decades of his oversight the portfolio would decline very significantly or even disappear altogether, might well have gotten his attention.

Taking Private Capital Seriously

The bank that was advising the George Titan III family certainly took the *business* of advising private capital seriously. It spent lavishly to build its investment management business and also spent heavily to market it. For a bank, a large wealth management business offers important advantages.

The problem for banks is that lending is sometimes a good business and sometimes a bad business, depending on interest rate and economic conditions. Investors don't like earnings volatility, so a bank that generates its earnings mainly from its credit activities will sell at a relatively low price/earnings ratio.

A healthy wealth management business, on the other hand, provides a bank with an annuity-like stream of revenue and earnings, which investors prize. Such a bank will sell at a higher multiple of earnings. Therefore, for the bank's senior management, building a strong wealth management business made a lot of sense.

The problem was that the bank didn't take private capital *itself* seriously. The bank and its advisors viewed wealthy families essentially as prey. The idea was to hunt these families down, get them to engage the bank as their advisor, and then sell them everything they could sell and charge fees as high as they could get away with.

This lack of respect for private capital virtually ensured that any client of the bank that began to go off the rails would continue to go off the rails. The bank simply failed to understand the nature of private capital and the crucial role it plays in the American economy and way of life.

I've discussed this point in depth elsewhere, but here is the essence of the matter:

> *Private capital is critically important because it is the progenitor of all other forms of capital. Governments possess capital, but only because they tax it away from private individuals. Corporations possess capital, but only because individuals have voluntarily invested their capital in corporate stocks and bonds. Colleges and universities and charitable foundations and nonprofit groups of all kinds possess capital (in the form of endowments and operating funds), but only because private individuals have donated that capital.*[3]

Just to take one simple example, wealthier families pay roughly 80% of all federal income taxes. If all private capital went the way of the capital of the George Titan III family, taxes on middle-income people would have to skyrocket. More broadly, almost everything that makes America unique would cease to exist, and in terms of our economic, cultural, military, and financial characteristics we would look more like, say, the peripheral countries of Europe.

But no one at the bank ever thought about these matters. When the George Titan III family's capital disappeared, it was a catastrophe for the family, but it was no more than a minor annoyance to the bank. The family's capital was completely gone while the bank had merely lost a small portion of its annual revenue.

It's a dirty little secret in the wealth advisory business that many wealth advisors quietly despise their own clients. If we could have injected the bank's advisors with truth serum, we would have found that many of them resented George's wealth and his privileged status in the community. After all, they would have said, George III didn't make the money. Even George's father, George Titan Jr., didn't make it. The family fortune was made by George III's *grandfather*.

Let's face it, George Titan III wasn't a very sympathetic character. But so what? There are plenty of middle-income people who aren't very sympathetic, either, but that doesn't cause us to despise the middle class.

George III's advisors were making the mistake of confusing the importance of the *owner* of the capital with the importance of the *capital itself*. Private capital is what distinguishes America from other societies that are superficially similar, and it is what is largely responsible for American exceptionalism: the extraordinary success America has experienced versus its international competitors for more than 200 years.[4]

Advisors who allow their personal biases to color the quality of their advisory work simply shouldn't be in the business. Unfortunately, this describes all too many of the so-called professionals in the wealth advisory business today.

SUMMARY

The main point in this chapter is that advisors who aspire to work with wealthy families have an obligation to understand much more than capital markets. The kinds of mistakes families can make range from the trivial and easily rectified to the catastrophic. A competent wealth advisor needs to help families navigate these treacherous waters every step of the way.

In order to be successful, wealth advisors must first and foremost understand the important role private capital plays in America, and, therefore, the important role wealth advisors play. Private capital is enormously hard to create and, once created, it needs to persist for many generations if it is to do its work on America's behalf.

Beyond that, wealth advisors must put their clients' interests ahead of their own. Whatever platform advisors are working from, they need to conduct themselves as though they were fiduciaries, even if, technically, they are not.

Successful wealth advisors need to help their clients become better investors and help them understand the consequences of overspending and overpaying. Advisors who fall short of these goals are shortchanging their clients, of course, but they are also shortchanging themselves, their firms, and the reputation of the financial advisory business.

NOTES

1. Issue of January 8, 1973.
2. http://www.sec.gov/about/whatwedo.shtml#.VMggLcaIcqw.
3. Gregory Curtis, *The Stewardship of Wealth: Successful Private Wealth Management for Investors and Their Advisors* (Hoboken, NJ: John Wiley & Sons, 2013), 42 ff.
4. I discuss this important issue at great length in Part One of *The Stewardship of Wealth*, op. cit., note 3, pages 1–50.