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Preserving the Family Fortune: If you think accumulating a king's ransom is difficult, try holding onto one

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"Any fool can make a fortune. It takes a man of brains to hold on to it."

— Cornelius Vanderbilt

The Internet and publications of various kinds are littered with stories about the difficulties wealthy families face in keeping their fortunes intact over time. Apparently, it is a losing battle. The oft-repeated statistics are grim — 70 percent lose their wealth by the second generation and 90 percent by the third generation. In other words, virtually everyone who manages to amass big cash will fail in his or her quest to pass it on.

Ouch.

What exactly goes wrong? The top reasons for wealth evaporation are generally recognized as:

• Unreasonable lifestyle expectations and spending levels

• Exponential growth of family over generations, outstripping portfolio growth

• Poor planning — or no planning

• Asset split and dilution after death of a generation

• Lack of governance and strategic vision

• Business and financial skills not successfully transferred to next generation

"When a family doesn't set expectations that a child will have to work and make a living and not just have money handed to them, it creates big problems," says Wendy Craft, COO of the Favara Family Office in New York.

Instead, Craft says, new generations of family members need to know from a young age they are responsible for making their own way in life, rather than relying on the support of family financial resources. Failure to set that expectation from the get-go often results in kids more interested in buying "toys" to fill idle time than developing their intellects and business and social skills.

"That's the main reason I see families lose their money," Craft says, "because the wrong expectations are set."

The former head of a European single-family office, who requested anonymity, explains that his family office he managed had to be dissolved because the parents in charge of family resources were incapable of saying "no" to their children's spendthrift ways, which included parties, vacations and expensive private schools. That resulted in overspending during economic good times — under the assumption that investment returns would cover their excesses, as well as provide a cushion for the eventual economic downturn. Eventually, though, the family nest egg dwindled.

"They are now struggling, relatively speaking," he says.

Three of the family's four homes were sold and they had to give up their fractional ownership of a private jet. Meanwhile, the family patriarch is trying to self-manage the family's finances without professional help, believing he can singlehandedly restore the lost fortune.

"That would require a rather large miracle," the patriarch's former financial chief observes. "Bottom line, they are not going to leave much for their kids and there likely won't be anything by the time grandkids come along."

The problem many affluent families face, according to Linda Mack of Mack International, is that they do not hire the right advisers to guide them. Mack, whose global consultancy specializes in human capital for family offices and asset management, takes it a step further, noting that some family leaders make the mistake of not hiring financial expertise at all, thinking they have the moxie to manage the investment portfolio.

DJ Van Keuren of Arsenault Family Office in Denver offers this cautionary tale: "I remember hearing about a family with a younger generation member who wanted to invest in real estate to create wealth because that's what everybody was doing before the downturn. What ended up happening was he lost hundreds of millions of the family's capital."

Especially surprising to Van Keuren is that many successful families created their wealth through businesses built around consistent planning meetings, the hiring of top-flight personnel and implementation of strong governance, only to forego those business practices when it came to managing family resources.

Many of the families who have experienced financial windfall followed by epic wipeout are household names, such as Vanderbilt and Woolworth. Other well-known American financial tragedies are Gould (railroad magnate), Pulitzer (publishing), Hartford (A&P stores) and Stroh (brewing). But for all the well-publicized implosions, there are many that can weather storms with the wealth intact, such as the Busch family (brewing) and the DuPont, Coors, Rockefeller and Pitcairn families.

Successful families tend to observe some of the following best practices:

• Have a core competency in operating business or investing

• Help their subsequent generations develop life and business skills

• Team-up with other families to invest

• Hire great advisers

• Limit inheritances

• Implement good estate planning

The most successful families demonstrate discipline and constant vigilance, says Tom Handler, principal of the private client law firm Handler Thayer. The idea, he says, is to manage risk through asset protection, liability management, insurance, conduct protocols, premarital planning, contracts and so on.

"With respect to investments, they seek reasonable returns," Handler says. "They try to hit singles and doubles and get on base, rather than swinging for home runs and getting struck out."

Indeed, Handler says he sees a strict focus on risk management as the determining factor in long-term wealth preservation.

Van Keuren offers another key factor in family wealth that stands the test of time: The bringing together of multiple generations to be educated about the family's situation, the systems it is putting in place, and the goals it is working toward. That is often effected through the hiring of an experienced multifamily office, or the hiring of an internal CIO or single-family office.

Mack advises affluent families to work with experienced and skilled outside partners and learn the lessons they have to teach. Only then should family patriarchs and matriarchs attempt to self-manage their financial affairs and all the due diligence that requires.

"Trying to be cheap or trying to do it themselves will almost never work out for a high-net-worth family," Mack says. She stresses, however, that families should "delegate" but not "abdicate," calling the latter a "big mistake."

Whether hiring professionals or self-managing, families must make good investment choices that will sustain and grow the wealth, both in asset allocation and individual deals. With the stock market troubles of 2008 and the unpredictability of inflation and interest rates, many successful families are investing a greater share of their portfolio in real assets.

Real assets have been gaining favor over the past few years with institutional investors and the trend appears to have staying power, according to a BlackRock 2014 study of institutional investors. Family offices are following suit, as many possess the same characteristics of institutions, and are often referred to by wealth managers as "instividuals." Family offices also seek the same benefits that real assets provide versus paper assets — higher returns, steady income, portfolio diversification and a hedge against inflation and rising interest rates. For the family offices whose investment horizons range from decades to centuries to perpetuity, the long-term supply and demand outlook for real assets is also favorable.

“Real assets are where the real money is at,” Mack remarks. “How many retailers do you know who are wealthy these days? In the case of McDonald’s it wasn’t the franchise that created wealth, it was the land underneath.”

Craft adds: “With real estate or a real asset, if the investment goes south, at least they’ve got something, something that may regain its value. If you gave all your money to the hot hedge fund manager and they lose it, it’s gone forever. If you buy an office building and the value goes down, chances are it will go up at least enough to sell it and either get something back on it or maybe even make money on it, if you wait long enough.”

Typically real assets are important for a number of reasons, Van Keuren says, including their relatively low correlation with stocks and bonds, and real assets are especially well suited for inflationary times because of their tendency to outperform non-tangible assets. Real estate, for example, is a real asset most families are already invested in, as most own a home and often a vacation home or other income-producing property type such as multifamily properties, warehouses, office buildings, etc.

“A lot of families will even create their second round of wealth through real estate because there are tax advantages and the ability to use leverage,” says Handler.

In fact, real estate is part of almost all single-family office and virtual family office portfolios because of its utility as an inflation hedge and potential source of cash flow. Moreover, Handler points out that real estate is one of the favored industries in the U.S. tax code as well as the tax codes in a significant number of foreign countries. Those tax benefits enhance the yield produced by real estate assets and make development projects and other real estate deals less likely to fail.

“You get lower risk with real estate and consistently better tax treatment,” Handler says.

Handler saw a number of his clients sustain massive losses in private equities, venture capital, collateralized debt, collateralized mortgages and other financial instruments during the 2008 financial collapse, while unlevered or reasonably levered real estate did far better.

“Real estate yields fell a bit and defaults increased,” Handler says, “but most developed properties survived and continue to provide cash flows, even if curtailed.”

Could doing more real asset investing actually solve some of the issues families experience maintaining their wealth over time? Possibility. One adviser who specializes in real estate acquisitions for family offices, who requested anonymity, says while he has seen intergenerational family members fight over whether to hold or liquidate buildings and land, he also has seen cases where families rallied around real estate assets.

“Hard assets are harder to dispose of on a whim,” he says. “Hard assets can be a unifying point among family members — they get involved with running the assets to keep the value up in some cases, and that can create unity and loyalty and a sense of teamwork.”

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