DENTONS

Using the 'Anna Karenina principle' to better understand and operate family offices

FAMILY OFFICE AND HIGH NET WORTH

"If you've seen one family office, you've seen one family office."

This is a common refrain in the family office space. But this dogma does the family office world a major disservice. The sentiment behind the notion points to the individuality of every family. However, taking the phrase at face value can be counterproductive and lead to suboptimal advice and outcomes for families.

While family offices often spend an inordinate amount of time and resources maintaining their privacy, they are neither unique (nor uniquely incomprehensible) entities that defy evaluation. While each family office is designed around the needs of its principals, best practices do exist and can be "fitted" to unique circumstances. So, it is actually quite possible for families to leverage best practices and proven methods to optimize their family office and produce superior results.

"Happy families are all alike; every unhappy family is unhappy in its own way." The beginning of Tolstoy's *Anna Karenina* provides a good metaphor to encapsulate the notion that best practices in the family offices can be studied and shared. This quote applies to family offices wherein many of the issues they face are predictable and sometimes preventable. In other words, like the happy families in *Anna Karenina*, the most successful family offices tend to adopt similar pathways to solve problems, as well as optimize their operations and service delivery.

The purpose of this article is to propose a universal, working definition of "family office," a term whose ambiguity has led to inefficient communication across generations, between families and family offices, and between family offices and their advisors. Sometimes just hearing "family office" will start to generate associations for individuals affiliated with a family office. But if those associations don't come close to matching an individual's experience with family offices, any insights they hear tend not to resonate or will be considered irrelevant (e.g., "family offices are increasingly looking at direct deals," or "next-generation members of a family office are allocating to impact-investing strategies"). We hope this article provides a framework to support the study, development, and testing of real world best practices for family offices.

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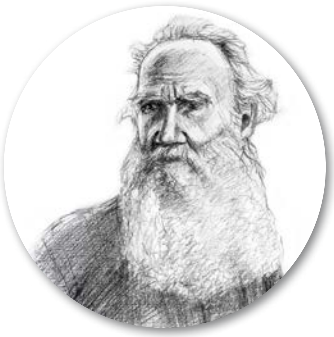
"Все счастливые семьи похожи друг на друга, каждая несчастливая семья несчастлива по-своему".

– L.N. Tolstoy



What exactly is a 'family office'?

The family office as a concept is not new. Wealthy families have long built structures to support the management of their assets and affairs. Those citing John D. Rockefeller as a pioneer in the family office field, date his family's use of such an entity to the late 19th century. However, history gives us many more examples, some going back to antiquity, across many cultures and geographies. While family offices have long been around, in some form or other, as a vehicle for safeguarding and managing the assets of wealthy families and supporting their other non-financial requirements, the difference is that today, wealth is more liquid than ever and the number of wealthy families that can benefit from this vehicle is many multiples of what it was just a hundred years ago. As more and more families have created significant wealth, the family office paradigm has become an increasingly popular way to manage a family's financial and non-financial matters.

What is a "family office"[1] anyway? Broadly defined, it is "an *entity* that is *leveraged* or *configured* to *manage* the *assets* and *affairs* of a *family*." This definition provides a baseline that the family office's principals[2], executives and staff[3], and external service providers can use to better understand the underlying dynamics at work. Let's break it down:

- **"Entity"** refers to the structure and strategy of a family office and comes in two flavors, depending on whether it serves one or multiple families. Single-family offices, or SFOs, serve the needs of one family. For SFOs, formal structuring is typically done through legal business structures that create a family office management company. Conversely, multi-family offices (MFOs) provide services for more than one family. In some cases, MFOs are created by a consortium of single-family offices that band together to support common goals and/or achieve economies of scale. More often, however, MFOs are designed and run by third parties as a profit-seeking business that caters to the needs of more than one family. While MFOs tend to incorporate a strategic planning process, most SFOs develop organically, evolving over time and usually operating without a robust strategic planning process and in a manner close to the family's roots (e.g., a real estate dynasty often also invests in real estate through its family office).
- **"Leveraged or configured"** delineates the use of either an SFO structure or the borrowing of resources by becoming part of an MFO. In the case of SFOs, there are often legal entities that cater to and are designed around the specific requirements of a family. With an MFO structure, the family can set up an entity to support a cluster of family offices or can tap into the resources of a third-party entity that supports multiple family offices.
- **"Manage"** refers to how things get done for the family regardless of structure. Families can make wide-ranging decisions around allocation of resources, prioritization, coordination of efforts and measurement of outcomes. This factor also takes into consideration the principals' preferences regarding the nature and extent of their involvement with the family office (e.g., Will the matriarch/patriarch be "hands on" with respect to the family office's daily activities?).
- **"Assets"** exist in many forms—marketable securities, cash, currencies, cryptocurrencies, commodities, collectibles, art, real estate, land, patents, wine and spirits, classic cars, yachts, aircraft, private equity, hedge fund holdings, direct investments in private companies, etc. What assets come under the purview of a family office and how the family office is expected to care for those assets, varies from one to the next.

1 The term "family office" can refer to both a strategy or the client segment defined as individuals with a net worth of more than $100 million USD. For the purposes of this article, we focus on the strategic version of the definition. The net worth discussion is another great area to explore but therein readers will find large variance as to the exact net worth that should be used for a "family office" designation (e.g., $50 million, $100 million, $250 million, $500 million, or nearly any net worth).

2 The term "principals" refers to the wealth holders or family members.

3 The phrase "executives and staff" refers to the personnel who work for the family office. The personnel in a family office can be family members but, in most instances, they are non-family members.

- **"Affairs"** refers to the non-financial responsibilities of a family office, such as estate and residence management; personal service and staffing; philanthropy, wealth education, family meetings, private aviation, project management, personal service and staffing; travel arrangements (domestic and international); private schooling and tutors for children; management of art, collectibles, and classic cars; concierge; and other arrangements.
- **"Family"** is a word that is often overlooked—inadvisably so—when structuring a family office. What constitutes a "family member" ranges from broadly inclusive to strictly circumscribed. Understanding this issue can be just as important to the original wealth creator (often called "Generation One" or "G1") as it is to dynastic families. Moreover, as described above, SFOs concentrate on serving one family while MFOs support multiple families.

The many roads to Rome: Nine family office archetypes to consider

Defining the elements of a family office also allows us to classify them according to archetypes, which can be helpful to all stakeholders in this space. For the principals themselves, it offers a glimpse of models that other successful families have effectively implemented. For family office executives and staff, it provides frameworks and best practices that can be leveraged to more productively manage the family office. For service providers, it provides a clearer understanding of the "how" and the "why" behind family office mindsets and operations, allowing for innovation and more valuable client service and better results.

The following are the nine most common archetypes of a family office whether the family is located in Montreal, Macau, Montevideo, Moscow, Mumbai, Monaco, Manchester, Mombasa, Muscat, Melbourne or Memphis.

The nine most common archetypes

- **Full-service** - Insource staff functioning across many domains. Activities focused on executing "in-house." Also referred to as a "traditional family office." Services include, but are not limited to, finance, investments, lifestyle, risk management, philanthropy, next generation, fiduciary services, governance and operations.
- **Embedded** - Leverage resources from an existing family-owned operating business to provide family office services through trusted personnel.
- **Administrative** - Centered around supporting non-investment activities, such as estate management, private aviation, special projects, scheduling, operations, next generation support, etc.
- **Real estate** - Manage and invest predominantly in real estate assets. Commonly leverage family-owned operating company staff to support family office services.
- **Active trader** - Activities are concentrated on supporting managing a family's wealth through investment strategies in capital markets (varying on approach, instrument, market sectors, etc.). Examples include former hedge fund managers who convert their operations to manage their own capital.

- **Virtual family office** - Focuses on optimizing resources by outsourcing capabilities, staff and operations. Service delivery is typically coordinated by a single external party (e.g., a law firm) and with a varying mix of insourcing and outsourcing. Also known as "family office as a service," "fractional family office," "managed services family office," or, more commonly, as an "outsourced family office."

- **Direct investor** - Concentrate on supporting investment in private companies. Can be executed by a single family or with a group of families.
- **Cluster** - Multifamily structure where one family partners with other, unrelated families to share services, gain economies of scale, share deal flow, etc. Sometimes referred to as a traditional multi-family office.
- **Commercial** - A multi-family entity, acting as a third-party profit-seeking business that provides various family office services. Typical revenue models for these entities are either based on a fixed-fee in exchange for specific services provided or on a fee derived from a percentage of financial assets under management.

The above archetypes are specializations. However, no one family office will fit neatly into a single paradigm. This occurs because family offices commonly exist on a spectrum of these archetypes and therefore employ multiple strategies based on a variety of requirements and motivations. There are even emerging cases and potential archetypes where family offices center their activities heavily around managing philanthropic interests. Moreover, there are many critical elements to consider with these archetype classifications (e.g., scope of functions, insource/outsourcing, prioritization, customization, stakeholders, etc.). We will discuss these archetypes in detail in a future article.

Evolving the way we think about family offices

Whether you are a principal looking to set up or maintain a family office, or a family office executive or staff member, you are acutely aware of the lack of reliable and actionable information in this space.

There is no such thing as a "true family office" or "best-in-class family office" that works in all cases for all families. However, there are structures and strategies that families should use to optimize outcomes. Conversely, structuring a family office in a way that doesn't align with a family's motivations and goals will almost certainly lead to suboptimal results. The best-performing family offices work on ensuring alignment and promoting communication among stakeholders, robustly and regularly testing their strategies and operations, and evolving when necessary.

Let's update the opening quote with a nod to Tolstoy and, more importantly, to add context to benefit the family office ecosystem: "If you've met one family office, realize that you haven't met all of them. You never will meet all of them. But you can learn a lot from that experience because meeting one is a good start."

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