By Kathryn McCarthy

Shake Up!

Expect big changes: Marginal single and multi-family offices will close. But families fleeing failed or faltering firms will start their own SFOs or join the more stable MFOs. It's time to consider a new model: the regional co-op MFO

The economic crisis is hitting the family offices of America's wealthy.

Expect closings of both single family offices (SFOs) and multi-family offices (MFOs). Those that were just hanging on before the economic crisis won't survive.

Even the well-funded, well-run SFOs are tightening their belts. Indeed, a lot are wondering the best way to pay the office bills this year when investment losses are high and liquidity is down.

But while the weakest will fail, the strongest will profit. Top MFOs can expect to pick up clients from vanishing SFOs. And, because some of the wealthiest have lost faith in large institutions, they'll be looking to open their own offices—creating a whole new crop of SFOs.

In the end, there probably won't be a retraction in the family office market. There'll be a seismic shift.[1]

It may even be that the time has come for a flourishing of a heretofore underdeveloped model: the cooperative MFO.

Only one thing's for certain—it's no longer business as usual in the family office space.

SFOs

For marginal SFOs, the current market conditions are a death knell. Expect about 10 percent of SFOs around the country to close, downsize or substantially change the way they operate. Most have seen their asset base drop by as much as a third; so, if they had a relatively slim base to start, they're in serious trouble now. Indeed, depending on how the market fares in the coming year, it's likely that at least 20 percent of SFOs will make big changes in the way they offer services to their families.

Even the larger, well-run, well-funded SFOs are retrenching. They're saying: "We have to make sure we have a more efficient office, a more economical office. Because our asset base is down, it's a whole new ball game."

I'm seeing pressures on SFO budgets to cut ancillary services like travel assistance, on funding sources to pay for the office, and on staff to cut costs and find cheaper outsourced solutions. I'm seeing questions about investment strategies and the very underpinnings of modern portfolio theory. Families are asking: "Do we *really* understand our investment strategies? Are they appropriate in the future? How do we operate in a deflating economy? Inflationary environment?"

We probably won't see many employees being laid off at SFOs—because, typically, they're already so lean-staffed. In fact, the talent pool is opening for these offices. A lot of newly unemployed financial services professionals are looking for jobs. Probably something like 75 percent of these pros are not suited to the unique SFO environment.

Pros from major banks and other institutions often don't have the right skill set or personalities for it or are just too specialized. They need to have what recruiter and consultant M.J. Rankin, president of The Rankin Group, calls a "service heart." The right types? These are

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the people who're capable of doing a professional job at places like JP Morgan or the well-publicized investment banks, but also are mature enough to put their egos aside to attend to the needs of a variety of family members.

Many financial services professionals wrongly see the SFO as a safe haven and have unrealistic expectations about compensation in this community.

Still, there will be some financial services professionals who'll be willing to take lower salaries and are capable of doing the job. That's the good news for SFOs.

It's about the only good news they're getting these days.

That's because most family members are less interested in cherry-picking finance pros and more focused on calling their chief investment officers and investment advisors to find out what's happening to their portfolios. They're worrying about how hard they're going to get hit by income taxes.

One issue that's coming to the fore: everybody knew that hedge funds tend to be highly tax inefficient. Now, though, they are reviewing just how much the hedge funds have cost in taxes. They're asking: "Are we going to be taxed on income and capital gains earned early in the year even though we lost money later in the year?" Families hate to have assets down, then owe taxes on gains. It adds insult to injury.

The injury, of course, is that liquidity is down across the board. Most families have been very equity-oriented. Cash harvesting from common family investment pools was a way many funded their family offices. Now that's a lot harder to do.

So how are they going to fund the family office? They don't want to sell equities, particularly the few holdings that have held up in this market. Hedge funds have proved to be far less liquid than anyone anticipated as "gates" have come down. Should the family office bite the bullet and withdraw money? Draw on lines of credit? Borrow against illiquid assets? Some families fund their offices through dividends —but now even they are concerned about dividend cuts. Likewise, families that used cash from operating businesses to pay the family office bills are becoming more conservative as credit is tight.

The last thing those who run the family office want to do in this environment is ask family members to recapitalize the family office to fund the office operations.

Oh yes, there's going to be a lot of rethinking in the SFO space.

It used to be that SFOs were very isolated because their mandate was to preserve confidentiality at all costs. Most SFOs focused on just the family, the direct bloodline. Now, you find even the offices that call themselves "single family" serving ex-business partners, a friend of the family and even the in-laws' in-laws.

These offices, particularly the newer ones started in the last 5 years, became more accessible because they were driven by investment opportunities. It's unclear how that trend will develop now. Those SFOs were generally all about money management and that used to be relatively easy. Not anymore.

But while there's definitely going to be serious changes at most SFOs, the biggest change will be at the MFO level, because they are newer, less-tested business models.

Commercial MFOs

Commercial MFOs are really going to be challenged —because their profitability came from investment services and they were struggling to be profitable even when the market was consistently up. Asset-based fees were really how MFOs made their money. Their revenues are going to be way down. The real pinch will start to be felt in the next quarterly billing at most firms. Clients also will be exerting pressure on fees, particularly on fees for underperforming hedge funds.

What many MFOs are trying to do is market their way out of this dilemma: Recruit new families. And there are some very good operations out there. Problem is, the people to whom they're marketing are frozen in their tracks—frightened into a "wait and see" by the current economic conditions.

That means fallout among the MFOs. There will be mergers and acquisitions. There has got to be. Many were struggling for profitability before the global economic crisis.

Expect the same failure rate for MFOs as for SFOs: 10 percent who were at the bottom of the profitability curve will fall off. The failure rate could be even higher. There are hundreds of firms that call themselves MFOs. But, of course, the problem in my saying all this is the blurry definition of an MFO: Is it a true commercial operation or simply an SFO that took on a few other families to try to cover costs? Or is it an investment shop masquerading as an MFO?

Co-op MFOs

The best economic solution for many families in this environment are regional cooperatives. There are some of these co-ops out there now. A few families own the office together. It's not a client, but a collaborative, relationship. They equally own the entity that provides services.

When families band together, they share the costs of basic investment, back office and accounting services. The reason it should be a co-op and not a commercial MFO is because family offices are simply not highly profitable businesses. Few services other than investment services are scalable.

Over the years, a lot of families wanted to create such co-ops, but many efforts failed. Often it was because the offices were trying to serve too many people and the office was not economically viable itself.

What does work?

The minimum amount of family assets needed for a co-op MFO in the New York area is, maybe, $500 million to $1 billion in total. Cut these figures in half if the families are outside major cities.

A co-op should serve more than two families but less than five or six.

The co-op should be regional, because local resources—lawyers, accountants, insurance professionals and household managers—are still used by many family offices and the families generally have better buying power.

The family offices that join into a co-op can't be about to fail. There has to be a merger of equals—or almost equals. It can be hard to do. But hard times will make people more flexible about their needs, egos and what can be achieved.

The Strong Will Profit

Having expressed all this doom and gloom, I must say that there still will be wealthy families who still will have wealth. Many will be looking to leave the larger institutions—because, in the family office world, small, not big, is beautiful.

Indeed, there's a push away from "bigger is better." There are a lot of conversations these days along the lines of: Do we really want relationships with larger institutions? What's going to happen as large institutions layoff staff? All these financial services types kept telling us "diversify, diversify, diversify," and that isn't working right now! Were our best interests being considered?

I know a couple of families who are newly liquid and they are simply frozen in their tracks. They don't trust the system. But eventually they're going to have to make a decision.

Wealthy families may still want to set up their own offices. They definitely will be asking, "Should we do it ourselves?"

So, overall, the SFO market probably won't retract absolutely—because you may actually see more families reconsidering some type of family office. But, in all likelihood, it just won't be a pre-crisis SFO model.

Families who have $100 million may decide that SFOs are simply too much work, so they'll be joining the strong, surviving MFOs.

So, while there will be many failures and many reorganizations, the SFO is not dead. There may even be an increase—a real flight to the control, quality and transparency that the family office provides.

It's certainly going to be an interesting next few years. TE

Endnote

1. There is no official tally of the number of single family offices (SFOs) in the United States as they are, by definition, private. But insiders say a fair estimate is about 2,000 SFOs.