
Objectivity and Alignment: New Choices for Families and Advisers

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The wealth management business is undergoing a significant change in its structure. Its clients are demanding advice untainted by conflicts of interest, and these clients are willing to pay for such advice. To meet this new demand, the traditional model, which sells products and offers advice as a free add-on, will be replaced with a model that unbundles advice, manufacturing, and distribution.

I have been in the wealth management business for 30 years. I am not in the asset management business. Although the two businesses are related, they are not the same, and my purpose in this presentation is to discuss recent developments in the wealth management business, particularly (1) fundamental changes in supply and demand, (2) the emergence of a new business model in wealth management, and (3) the implications of such developments for the families served by the wealth management industry as well as for the people employed there.

What I see happening in wealth management today actually started 15–20 years ago with two significant developments. One was the emergence of powerful investors, such as George Soros and Julian Robertson, whose investment strategies were less connected with the market than previous strategies. The other development was the migration toward passive investing and the emergence of Standard & Poor's Depository Receipts and other such innovative products. These developments caused a tectonic shift in the asset management business, which, in turn, caused a related shift in wealth management.

Previous Business Conditions

When I joined the private wealth area at Chase Manhattan Bank in 1983, ultra-high-net-worth wealth management (defined as \$25 million in net worth

and higher) providers tended to be relatively small, locally focused, high touch, and relationship based. Portfolio differentiation between a client of Chase and a client of Citibank was minor. The relationship, therefore, between the adviser and the client was the critical factor. In addition, investment choices were limited. As late as 1990, investment managers in U.S. wealth management firms considered foreign stocks to be extraordinarily exotic. Even holding stocks from the United Kingdom was out of the ordinary. The overwhelming majority of our clients had well over 95 percent of their assets in U.S. stocks and bonds. One portfolio might be 60/40 in stocks and bonds, and another might be 40/60 or 50/50, but the differences were minor.

Finally, there was a clear distinction between business models. Brokers were on the sell side; portfolio managers were on the buy side. The services offered by a trust company were entirely different from those offered by a wire house, a bank, or an asset manager. On the demand side were the ultra-high-net-worth clients. These consisted of a relatively small community of wealthy families. The number of such families grew very little, and their investment needs were relatively straightforward.

The prevailing business model during these years was also well established. Advice and product were bundled in a single offering. Clients came to wealth managers for advice, and the managers were paid for the products they offered. In that sense, the clients received advice for free because advice was included in the product fee.

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Business Changes

Changes began when mergers led to the creation of integrated, one-stop shopping financial supermarkets. In six years, I found myself in the midst of five major mergers. Everybody started coming together. Brokers began joining with portfolio managers; portfolio managers joined with trust officers. It became difficult to differentiate between roles.

Along with the mergers came an explosion of choice in the financial markets. In a relatively short time, the entire world, it seemed, became zoned commercial. Today, people can invest in anything, anywhere, and in any form imaginable.

With these changes came tremendous growth that led to a results orientation that caused financial service providers to scrutinize scale, distribution, volume, and efficiency.

Growth also increased on the demand side. Between 1995 and 2005, the number of ultra-high-net-worth families increased from 13,000 to 30,000. Moreover, between 2005 and 2015, about \$4.6 trillion of equity in private businesses is expected to be sold. This means that the number of ultra-high-net-worth families is likely to double again, which, in turn, means that even more families will need help dealing with all this liquidity. Such families will face expanding choices, the difficulty of dealing with increased complexity, the demands of consolidating vast amounts of information, and the need to determine whether their financial providers are offering them the best choices. Finally, a growing body of evidence is indicating that sustaining wealth across multiple generations is not a foregone conclusion and that doing so requires special effort.

Unfortunately, through all the changes occurring on both the demand and the supply sides of the market, the prevailing business model remained largely unchanged. Advice and products were bundled in a single offering: Fees were earned by selling products; advice was included for free. In fact, the consolidation actually concentrated and reinforced the existing business model. The merged firms were able to attain certain economies of scale that allowed them to reduce expenses and raise margins enough to make the businesses quite attractive. As recently as October 2005, 10 of the top 40 wealth management firms in the United States held 73 percent of the assets of wealthy families, equaling \$3.3 trillion out of a total of \$4.5 trillion under management. And all of these top 10 firms use the prevailing business model of fees for product, advice included.

Changing Expectations

While the provider side was consolidating, wealthy families were waking up to a new reality. Like the rest of us, these wealthy families watched the boom of the late 1990s and the bust of the early 2000s. They also observed the Enron Corporation debacle and the other scandals and conflicts that came to light during those years, including the following:

- mutual fund timing, which demonstrated that not all investors are created equal,
- research settlements and the biased advice involved,
- failures of corporate governance, including its lack of transparency,
- insurance bid rigging and the ensuing conflicts with insurers' fiduciary roles,
- hidden revenue sharing that biased investment recommendations,
- abusive tax shelters, and
- sale of overly complicated and inappropriate products.

At the time, I was running the private bank at JPMorgan Chase and spent innumerable hours explaining to families that none of these problems had seeped into the wealth management side of the business. Yet, many leading families were beginning to ask some fundamental questions that I was trying to answer:

- Can I trust the advice you are giving me?
- Are the inherent conflicts in the financial services business model negatively affecting my family's wealth?
- Is there another way to manage my affairs?

Even as I answered these questions as reassuringly as I could, I began to notice that increasing numbers of families were putting somebody between us and them. Rather than dealing directly with the families as I had in the past, I found myself dealing with a family office or an independent adviser or someone whom the family trusted and who had the professional skills to meet their needs. This was their way of responding to the doubts they were beginning to have about the prevailing bundled business model.

In 2003, Spectrum Research, LLC, conducted a survey among ultra-high-net-worth families and found that 60 percent of those surveyed preferred to use an independent financial adviser unaffiliated with any product provider. Similarly, 39 percent of respondents preferred to get financial advice from one source and buy financial products from a different source. Such results indicate to me that a significant portion of the client base is asking for a different model from the one being offered.

According to the Cap Gemini/Merrill Lynch World Wealth Report of June 2005, the wealthy “struggle to validate the advice they receive from multiple providers, coordinate different providers’ activities, and track the progress of their wealth strategies across their numerous portfolios. . . . Even as they continue to add providers, [the wealthy] long for a simpler solution.” The report found that 70 percent of the wealthy are looking for a single provider to coordinate their financial affairs.

Finally, in 2006, Family Office Exchange surveyed its clients, who are all ultra-high-net-worth families, and found that the average family had 26 different providers that break down along the following lines:

- 11 investment managers,
- 2 custodians,
- 1 corporate trustee,
- 4 attorneys,
- 2 other consultants,
- 3 insurance advisers,
- 2 accountants, and
- 1 investment consultant.

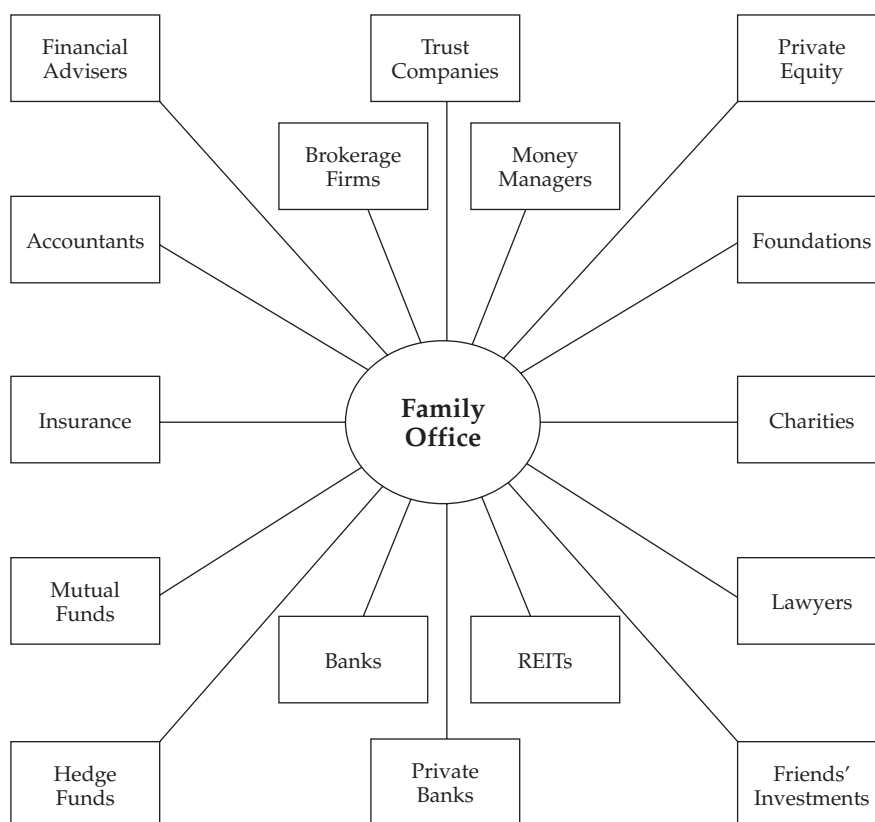
The single investment consultant at the bottom of the list may represent the desire among wealthy families to have one person provide them with

investment advice. Families are leaning more heavily toward a model that places advisers between them and the financial services companies that supply the products. The advisers are, in effect, buyers on behalf of the family.

Family Office Model

As families began to perceive the growing complexity and range of investment choices—choices that included a variety of tax and legal obligations—they decided that they needed someone on their side who was free of conflicts of interest but who also had the necessary skills and experience to help them make the needed decisions. One model that is gaining currency in the wealth management business is the family office. Granted, the family office is hardly a new idea. Families such as the Rockefellers and recently several Silicon Valley families have been using the model, shown in **Figure 1**. For example, Michael Dell has assets worth \$11 billion. He has a company called MSD Capital, directed by Glenn Fuhrman and John Phelan, that employs 100 people to manage Michael Dell’s wealth. MSD Capital has no client other than Michael Dell.

Figure 1. Family Office Model



The purpose of such a family office is to do the following:

- Oversee all wealth management activities and ensure that all such activities are appropriate for the family and that they are aligned and integrated with the family's mission and objectives.
- Ensure that the family's financial capital is working in harmony with its human and intellectual capital.
- Help the family sustain its wealth through future generations.

Unfortunately, the costs of this model are prohibitive. According to benchmarking done by Family Office Exchange, a proprietary family office requires about \$4 million a year to operate. A family's portfolio must outperform significantly to make up for such costs, and finding the right person to run such an office is particularly challenging. Even when the right managing director is found, finding and keeping younger talent is equally difficult because junior managers often doubt that such a firm can provide them with a fruitful career path.

New Model: The Multifamily Office

As a result of the growth in the market and the changing demands of ultra-high-net-worth families, a new model has emerged. This model makes the benefits of a single-family office available to families for whom such services might not otherwise be available. It delivers high-quality, replicable value to help families buy and integrate the right financial services solutions to meet their objectives. The model

- is cost effective,
- avoids the headaches of managing a single-family office,
- provides unbiased, objective advice with institutional quality resources, and
- shares its best practices.

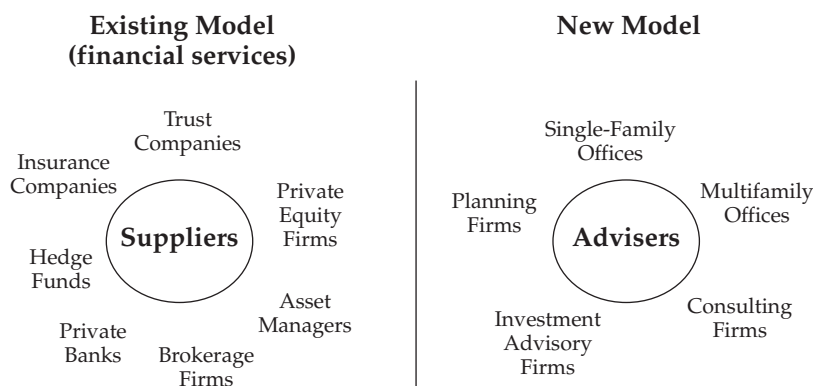
This new model has a different set of characteristics from the traditional bundled business model, which focuses on money management and distribution, offers advice bundled with products, and charges fees for products and services but not for advice. The new unbundled model focuses on helping families buy and integrate products and services. Its primary activities are (1) buying and sourcing, (2) overseeing, (3) negotiating, (4) educating family members and preparing them for future responsibilities, (5) sharing best practices so that all families can benefit, and (6) identifying and eliminating conflicts of interest. Under this business model, fees are charged for advice.

I consider this new model to be a major change in the wealth management business, especially because the compensation model of the new industry significantly changes the relationship between the client and the provider. In this new family office industry, the provider has "crossed over" from the sell side to the buy side.

When I was working at Chase, I described to one of my colleagues the changes that I saw occurring in the industry, and he assured me that clients would never pay for advice because they are used to getting it for free. They will only pay for product, he told me. I agree that as long as a provider is selling product, the client will not pay for advice because the advice is tainted by the conflict of interest in needing to sell the product. But if a provider is not selling product, then no conflict exists; the advice is untainted, and the client will pay for advice. That is the tectonic plate shift that is actually happening in the industry.

Just as the financial services industry comes in different flavors, so does this new model, shown in **Figure 2**. The existing model consists of a variety of suppliers, such as trust companies, insurance companies, and asset managers. The new model also has

Figure 2. Existing vs. New Model



variety. It includes not just multifamily offices but also single-family offices, planning firms, investment advisory firms, and consulting firms. All such advisers do slightly different things, but their commonality is that they are paid by the client only for the advice and integration they offer. Families can now choose between the traditional model and the emerging model. They can do the managing themselves by buying directly from financial services providers, conducting their own due diligence, managing conflicts, and integrating suppliers to be sure their own objectives are being met. Or they can hire advisers to work on their behalf and buy for them.

Looking to the Future

During the next 10 years, I expect the separation to continue between providers of product and providers of advice. The demand for objective, aligned advice will continue. The demand for world-class products and services will also continue, but the demand for product bundled with advice will wane. The traditional model will persist for a while—as most models do—because inertia takes time to overcome. But families are asking for something different, and the implications are tremendous, both for firms and for individual talent.

Under the traditional model, money management, sales and distribution, and advice and integration are all bundled together, shown in **Figure 3**. As firms realize that they must respond to families' new expectations, they will choose to reorganize according to what they do best. For example, if I were asked to make a prediction, I would say that

such asset managers as hedge funds and private equity firms—the types of firms that are especially skilled at creating alpha or cheap beta—will specialize in providing that product. Private banks and brokerages will focus on sales and distribution, and family offices and consultants will provide advice and integration. Thus, from an industry that was largely amalgamated, I foresee emerging many different models with different economics and different core competencies. The firms that will have trouble will be those that do not make a choice.

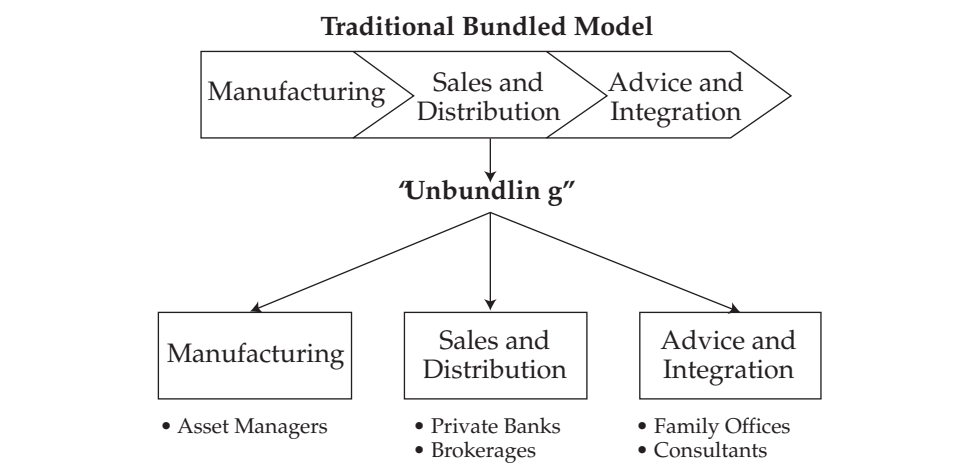
This change in the industry will also require the talented people within the industry to make choices of their own. All of us will be challenged to reassess our skill sets and decide in which part of the industry we are best suited to function. Is our talent in creating products and real value on the investment side, is it in sales and distribution, or is it in purchasing, advice, and integration? The sooner we make these decisions, the sooner we will be successful—both personally and for our clients.

Conclusion

Ultra-high-net-worth clients will pay for advice—as long as it is untainted by the conflicts of interest inherent in the traditional model. Clients want such advice, and to provide it, the wealth management business is in the process of evolving into a new model that unbundles advice and sales, with advice moving from the sell side to the buy side.

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Figure 3. Choices Required for Unbundling



Question and Answer Session

Maria Elena Lagomasino

Question: Is the new unbundled business model merely a different way of charging a fee for advice? Will it be more expensive for the client?

Lagomasino: The fees that firms in this area charge range from 15 bps to 85 bps. Ultimately, fees are based on what the provider delivers for the client after taxes, inflation, and fees. If clients see value in the advice offered, they will pay for that advice.

Question: Are any providers in this area charging a flat fee?

Lagomasino: Not to my knowledge. Some family offices might be charging flat fees, but everyone in our space is charging some sort of sliding scale because we all know that there is some scale managing \$200 million versus \$50 million. The complexity of the family's situation represents the greatest challenge in terms of cost to serve.

Question: What skills are required in the team that works with the family?

Lagomasino: We typically have two strong professionals who interact with the client. One is the family investment officer, who is always a CFA charterholder and who must, first and foremost, understand the family. Without such understanding, the process will not be effective. Family investment officers must also have the courage to tell clients things that they do not want to hear as well as the courage to be open to new ideas in the investment world.

The other member of the team is usually an accountant or an attorney and sometimes both, and that person has to analyze the

family structures, including tax issues and family governance, and make sure that we are working in tandem with the family because asset location is just as important as asset allocation and preserving wealth is as much about preparing the next generation as it is about establishing the right tax structures.

Both of these lead people need to use their skills with professionalism and courage on the side of the family, not to sell products. The success of our model requires that we separate sales and service entirely. One portion of our firm identifies and recruits new clients; another portion advises the families and has no sales or product goals. Such advisers have a maximum of 20 clients so that they can give adequate attention to each family.

Question: With the growth of multifamily offices, what is the future for single-family offices?

Lagomasino: There will always be a demand among the wealthiest of clients to have people who work exclusively for them. Certain wealthy people demand that level of control and are willing to pay for it. Therefore, in the \$1 billion and higher range, single-family offices will continue. In the \$25 million to \$1 billion range, multifamily offices will increase, largely because manager due diligence has grown increasingly difficult and expensive. As their costs escalate, families find that they are giving up too much in terms of return.

Question: Will the traditional model remain in the \$2 million to \$15 million range?

Lagomasino: In my experience, trends start at the top and gradually sift down. So, some smart person will figure out how to provide this new model at lower levels of wealth. The Cap Gemini/Merrill Lynch study from a few years ago proposed the idea of a virtual family office for certain clients. Also keep in mind that clients with less wealth have simpler situations to manage and fewer options to complicate their decisions. Nevertheless, I believe that we will see emerging models to serve that population.

Question: Approximately how many families internationally can benefit from this type of model?

Lagomasino: The demand is global. The United States has more families in this area than any other country, but adding international demand probably doubles the number of families.

Although the model is global, the tax piece is local. Local tax expertise is required to pull the whole thing together. A few firms in Switzerland and the United Kingdom have such a global-local perspective. There are multifamily offices for Middle East families. Similar firms are starting to emerge in Hong Kong. Besides taxes, the biggest difference between the United States and the international side is that international families are more likely to be concerned with privacy and confidentiality. The wealthiest families do not like to share inside information with any firm that is not completely controlled by them. That is the area where single-family offices dominate, making it difficult for the multifamily offices to gain access, but I think that will change.

Question: Do you provide ancillary services—such as hiring household staff—internally or do you outsource that to another provider?

Lagomasino: We do not provide ancillary services; we outsource to other providers. If clients have personal assistants, we may let the assistants use our office space so that they can be supervised, but we do not take on their functions.

A recent benchmarking study found that single-family offices spend the majority of their time on such functions as bill paying, family payrolls, and purchasing and maintaining airplanes. But when the families were asked what they wanted their family offices to concentrate on, they named such functions as the integration of the investment piece, tax work, and the education of family members. This indicates a big disconnect between what families actually want and what they are getting from their own family offices. Because the individuals who head these families are smart people, they will see the gap, and they will find ways to close it.

Question: How do you handle the technology platform that allows you to integrate all your clients and all their accounts?

Lagomasino: Technology is critical because our investment advisers must have access to all relevant family data. That is the beauty of being a multifamily office business. When I was in the financial services industry, I often felt as if I had a patch over one eye:

I was allowed to see only a portion of the relevant data, yet I was supposed to make good decisions based on this limited access. Now, I have full access, but I am faced with a different problem: Putting all the necessary data on a technology platform and having that data accessible is a difficult task.

Originally, we used a download from the Advent system. Today, we are working with two technology companies to integrate all of our data. I believe we do a good job, and one reason is that we work with only 360 families. Establishing a technology platform is one of the most complex tasks a multifamily office can address. To do it well, a firm needs a certain amount of scale because the investment is tremendous.

Question: Are you seeing increased merger activity among multifamily offices?

Lagomasino: A lot of consolidation is going to happen in this area, which is natural for any changing business model. We saw it in automobiles and telecommunications, and we are going to see it here. The Family Wealth Alliance, which specializes in multifamily offices, asked the same question of its members, and approximately 70 percent said they expected to either buy or sell in the next two years.

Question: Assuming there is a maximum amount that a buyer is willing to pay, how should that amount be fairly divided among manufacturers, distributors, and buyers' agents, such as your firm?

Lagomasino: Clients buy different things from different providers. Much depends on the buyer's perception of value because there are different perceived values for different activities.

The McKinsey study on asset management seems to indicate that there is no end in sight to the fees that people are willing to pay for the alpha managers.¹ For beta managers, in contrast, it is all about cheap. The huge pressure in the asset management industry is on the people who are caught in the middle—between the time spent negotiating fees and the downward pricing pressure on the product. Ultimately, it is all about where the buyer perceives value.

Question: Looking five years out, what do you perceive to be your greatest challenge and your greatest opportunity?

Lagomasino: The greatest challenge for a firm like mine is to create itself as a branded player with enough scale to represent a knowledgeable choice for families while retaining that small-boutique, high-touch, high-service culture that made the firm's reputation. Today, there are no nationally or globally branded players on the advice and integration side, but in the coming years, some great branded players—new names and new brands—will emerge.

¹For the McKinsey study on asset management, go to www.mckinsey.com/client-service/bankingsecurities/pdf/a_growing_gap_between_the_winners_and_also_rans.pdf.