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Peer Insights REPORT

How Family Offices Protect, Expand, and Nurture Wealth for Multiple Generations

Bavelas Principle Series:

Seven Family Office Rules for Financial Security, Antifragility, and Growth

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Arthur A. Bavelas, an internationally-known entrepreneur, Bavelas Group family office investor, founder of Family Office Insights Peer-to-Peer gatherings, and the originator of the Fortune's Fortress process of safeguarding family wealth over multiple generations. He is a frequent speaker to the hedge fund, private equity and family office communities.

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THE BAVELAS 7

Seven Family Office Rules for Financial Security, Antifragility, and Growth

Rule#1 DON'T LOSE MONEY

"I am more concerned about the return of my money than the return on my money"

MARK TWAIN

An obvious rule? Perhaps. But there are thousands of not-so-obvious ways to lose money, and they can drain the family fortune even if you think you're prepared for pitfalls. It is very important not to let this happen as recovering from a loss is much harder than holding onto the money in first place. The difficulty of bouncing back from a loss is most effectively illustrated using the concept "time-to-recovery."

We love the magic of compound interest.

We don't love it when it is working its magic against us.

Suppose you had $100,000 that you have saved after tax over a period of 10 years. Now you want to grow this money and are considering a variety of investments, including one from a local financial advisor who suggests a risky investment, one where the rewards "could" be exponential. You are worried that if you don't take risks, you will not be able to grow your money at a satisfying pace. While you are not completely comfortable with the risk, you are sure the local advisor would not lead you astray as they are part of the community. So you invest. All of it.

Then you get hit with a loss of 10%, or $10,000. So you figure you need to earn an annual rate of 10% to get back to even, right? Wrong. "Time-to-Recovery" refers to how long and at what rate of return (not considering taxes, which is a whole other discussion) it takes for a fund to get your account balance back to the value the month just before their biggest draw down (loss). So it's math. Two variables, time and rate of return. After your loss you now have only $90,000. 10% of 90,000 is only $9,000, making you $1,000 short from recovery. So at what rate and over what period would it take to get back to even? An annual rate of 11.1% (chart), not 10%. That is 12 months for time-to-recovery, not counting taxes, fees, opportunity cost, and inflation.
Ouch!

Don't let this happen to you. Keep Rule #1 in mind at all times. It is easier to hold onto your money than it is to recover from a loss. And it's easy to get hit with unforeseen losses, especially when you are caught up in the excitement of an opportunity. The action impulse is natural and can result in financial progress or revitalization. But only when tempered with one of the most important pieces of advice you will ever hear: **There is genuine benefit to sleeping on an idea.**

Rule#2 SEE RULE #1

"The lack of money is the root of all evil"

MARK TWAIN

www.getsmarteraboutmoney.ca

Hold onto your money in the first place and you will be ahead of the game. You will save yourself a lot of time and effort if you never have to face that uphill battle to recover your loss.

If the explanation of Rule #1 was not real enough for you, put your own numbers in this tool. It will calculate time-to-recovery for you. **Click here to go to website**

Rule#3 TO THINE OWN SELF BE TRUE

"Money is only a tool. It will take you wherever you wish, but it will not replace you as the driver"

AYN RAND

If you're not honest with yourself, you're not likely to be as honest with others. When taking responsibility for the family fortune, it is of utmost importance to know your own motivations.

In other words, don't lie to yourself! Period! That's not good for anyone, and it's not good for the family finances. If you are not crystal clear on the merits of your proposed action and you can't explain those merits to someone of average intelligence in less than 5 minutes, then you are not armed with the honest truth. It can be very easy to justify action with exaggerated or fantasy merits if you are acting from an emotional or pleasure-seeking impulse. **When pleasure and emotion get involved in the decision-making process, logic doesn't have much of a chance.**

This advice also applies to that moment after you make an illogical choice and things didn't turn out well. Taking responsibility for the family fortune takes discipline, courage and study. It doesn't mean you have to be perfect. If you made a bad call, or adopted a bad strategy, take your medicine, and move on, but learn from the experience.

Rule#4 EVERYONE HAS AN AGENDA

"Where one stands, often depends on where one sits"

JOHN BOGLE

Everyone connected to the family fortune has an agenda. Paranoid? Not really. When it comes to large amounts of money, there is no such thing as an agenda-less stakeholder. But I'm not necessarily talking about nefarious, destructive, or selfish agendas. Agendas can simply mean plans, hopes and EXPECTATIONS. These stakeholders could simply have a different idea of what could or should happen with the family money.

One of the greatest pitfalls of family wealth management is being blindsided by conflict. If you are not clear on the agendas of the stakeholders to your wealth, this will happen to you… at some point, sooner or later. However, that doesn't necessarily mean that the stakeholders even know themselves what their agendas are. Sometimes motivations and desires remain amorphous for years, hard for even the stakeholders themselves to articulate.

"Some things are better left unsaid." You hear this aphorism a lot. But when it comes to managing sustainable multi-generational family wealth, this is the worst attitude to take. Agendas are best uncovered and explored in plenty of time to iron out any difficulties. Otherwise, the stakeholders to your fortune will later feel backed into a corner, and more likely to act out of fear and other negative emotions rather than information and logic. If this happens, things could turn out badly.

Here is a short list of potential stakeholders to consider:

- Matriarch/Patriarch
- Offspring
- Offspring of offspring
- Spouses
- Ex-spouses
- Spouses of ex-spouses
- Offspring of ex-spouses
- Illicit lovers
- Illegitimate children
- Household staff
- Operating company employees
- Accountants
- Lawyers
- Wealth Managers
- Bankers
- Insurance agents
- Real estate agents
- Hedge fund managers
- Private equity managers
- Nefarious characters of all types trying to get their "unfair share"
- Legitimate characters that may or not know that what they are doing may not be in your best interest

Realization #1

People do things out of emotion, a desire to be appreciated, fear or loving kindness.

Realization #2

What people do with money is driven from some emotion. Period!

So why is this important?

Whenever you are considering anything about money, follow the money back to the emotion. It will be revealing and instructive.

Take a money manager, for example. They appear polished, competent, and professional. But what are their motivations? There are many smart, talented, and trustworthy money managers out there, but they might not be one of them. Their goal to sell you the fund might not be motivated by your best interest. They could be looking only to increase the assets under management, or to demonstrate their superior intelligence. In many cases ego, not just income, is the motivation for persuading investors to commit. In this specific case, the way to reveal the "real agenda" is to ask the manager this simple question: "When does your strategy not work?" Sit back and wait. If they fumble for the answer, this means they have not truly acknowledged to themselves that there may be situations in which their strategy doesn't work. If they suggest that it always works, they are lying. If either of those two occurs, it's time to exit or move on.

Rule#5 WRITE IT DOWN

"The mind is connected to the hand"

ANONYMOUS

Construct and communicate a written plan. Write it down and show it to others. This may sound ridiculously fundamental. And yet, every day, computers crash with no backup and take all their data with them or that "brilliant idea" is forgotten because surely you'll remember it tomorrow so there's no need to jot it down, right? **Write your plan down.** This can't be expressed with enough urgency or often enough. Once you put something in writing, it has a life. Even an average plan is better than no plan. Successful family offices make it a point to go through the process of constructing a thoughtful plan, and they're not just doing it to fill up time and paper.

Constructing a plan forces you to think of contingencies and issues you would not have otherwise considered. It also allows others to follow in your absence because your ideas and intentions were clearly outlined and recorded. This plan will be of enormous value in assisting with recall of details that are easily forgotten.

Another important benefit of Rule #5 relates to Rule #4: often when this plan is communicated to stakeholders, it will reveal conflicts and uncover potential solutions to problems you did not know you had. And more importantly, it will help you uncover hidden agendas. Successful family offices use the written plan as a living schematic to not only prepare for contingencies and map-out strategies and tactics, but as a way to align the interest of stakeholders.

Rule #6 FACTS CHANGE, CHANGE WITH THEM

"When the facts change, I change my mind.
What do you do, sir?"

JOHN MAYNARD KEYNES

No matter how good you think you are at managing your finances, no matter how much experience you have, you must maintain mental flexibility. **One of the best advantages you can have in building a fortress around the family fortune is the ability to question your own assumptions.** If you don't know or aren't willing to accept that the facts change, you can't change your mind. A plan sitting on the shelf has limited value. One thing is certain: some facts will change. Reexamine your plan at regular intervals and adjust your strategies as needed.

Rule #7 NOT ALL "FRICTIONS" FEEL GOOD

"It's not what you look at that matters,
it's what you see"

HENRY DAVID THOREAU

When considering any money move, you must ask the following questions:
1) Tell me everything that can go wrong before I consider the benefits.
2) What can you do for me that I am unwilling to do for myself or don't know how to do as well as you?
3) What are the "all in" economics of that trade?

Entering into a trade, transaction, or investment without understanding all the "frictions" involved is like agreeing to go on a blind date arranged by your Ex. There is a high probability of disappointment.

What are "frictions"? By frictions, I am referring to everything that will cause you to net less from an investment.

For example, in real estate investing, have you considered: utility cost, maintenance, hazard insurance, title insurance, environmental hazards, the right of condo boards to impose assessments, transfer taxes, real estate taxes, local taxes, interest, points, and so on?

When hiring a money manager, have you considered all fees; up front, deferred, ongoing or otherwise? If you are paying 1% for money management, and you earn 3% gross return, net 2% and pay nearly half of that in taxes, then what exactly is the point? The money manager made nearly as much as you did on **your** money! In some cases, avoiding frictions can be as simple as better tax planning. You could save more money with improved tax planning than you can make with some investments. These are all important considerations that will be explored in more depth in a future issue.