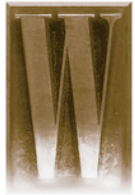




THE PARADOX OF PROSPERITY

MARCH, 2010



WATERSTREET
FAMILY WEALTH COUNSEL

Where there's wealth, there's always a story to tell. A story of how the wealth was created – and each family's story is unique. The story may be recent, or may go back many generations and, more often than not, the story begins with the focused, driven pursuit of a dream. Such is the way of the entrepreneur.

Successful entrepreneurs have taught the world that risk can be a good thing, since little is accomplished without it. Yet, risks must be understood and managed. This is particularly true when the family's wealth is intended to last for multiple generations. The reason? A great paradox of prosperity exists: The very risks that can generate wealth for the family can also dissipate it.

It remains true that great success in one endeavour, or by one individual or small group of individuals, does not easily translate into success in the next stage of life or in future generations. Why not? After all, the wealth was created using a successful formula – why should that formula change over time?

“The management of family wealth becomes more complex over time because the initial accumulation of wealth by a single individual or small group is converted into a process involving potentially many family members,” explains WaterStreet President and CEO Tim Cestnick. “These family members have different interests, pursuits, levels of determination and skill.” The result? Families often find it difficult to make the transition to multi-generational wealth.

According to Cestnick, significant wealth will often last one or two generations be-

yond the generation that created the wealth, but the saying “shirtsleeves to shirtsleeves in three generations” is almost an axiom. “Families that want their wealth to continue for five, six, or more generations need to be deliberate about creating the right structure, otherwise it simply won't happen,” Cestnick says. “The wealth can easily dissipate – if for no other reason than the number of family members can grow significantly, diluting the wealth per capita.”

In this paper, we'll look at five of the greatest risks to preserving, growing, and enjoying multi-generational wealth. Specifically, we'll consider the following risks:

- ***Failure to understand capital pools***
- ***Unsustainable spending patterns***
- ***Ineffective tax and estate planning***
- ***Inadequate asset protection***
- ***Ignoring family governance***

This paper draws upon the experience of WaterStreet's professionals in working with some of the wealthiest families in the country over many years. The insights here may offer lessons for the next chapter of a financial story being written by your family.

RISK ONE:

FAILURE TO UNDERSTAND CAPITAL POOLS

A “capital pools” approach to managing the family’s wealth is critical if the wealth is to be truly multi-generational. While the specific pools can be different depending on each family’s situation, there are commonly three distinct pools of capital: (1) Safe Capital (the capital required to look after the needs of the patriarch and matriarch, or the oldest generation of the family, for the rest of their lives), (2) Family Legacy Capital (the capital set aside for future generations), and (3) Social Capital (the capital set aside for strategic philanthropy).

Why is it so important to define each pool of capital? Simply, each pool has its own “virtual owner” – the person or group of people that the pool of capital is intended to benefit. And since there are different “virtual owners,” there are different uses, risk profiles, and time horizons that apply to each capital pool.

The Safe Capital is generally intended to be depleted over the lifetime of the patriarch and matriarch, or over the lifetime of the oldest family members, for a number of reasons – including tax efficiency. The Family Legacy Capital is intended to benefit future generations, and may have a time horizon of 150 years or more, while the Social Capital is designed for an entirely different purpose and should generally create sufficient income to fund charitable activities. Given the different virtual owners, each pool of capital deserves to be managed differently.

“It’s not uncommon for the individual who created the wealth to operate with blinders on” explains Cestnick. “Often, he or she sees just one appropriate use of capital, and more often than not is willing to take on significant risks with that capital – after all, it was taking those risks that created the wealth in the first place. This person may need a lot of support and counter-balance in order to operate differently when moving to a multi-generational focus.”

Having said this, there’s room to continue taking on the risks that created the wealth initially. This is typically done with part of the Family Legacy Capital, where private equity often plays an important role.

Your WaterStreet professional can help by performing a multi-generational wealth analysis showing how long the family’s wealth is expected to last based on current assets and spending patterns. We can explain the concept of generational wealth and income per capita, and show what can be done to maintain defined levels of wealth and income for future generations.

STEWARDSHIP APPROACH

If your family’s wealth is going to last for multiple generations, certain risks will have to be managed, including: Overspending, overtaxation, asset “shrinkage” and liabilities. “Many wealth creators have not paid much attention to some of the leakages that can erode the family’s wealth – they haven’t seen the need in the past. They’ve been too busy making money,” Cestnick observes. “But for wealth to last the long term, these things have to be dealt with properly.”

Minding these risks, or leakages, is part of a “stewardship” approach to wealth management where each generation considers themselves as the keepers of the family wealth, not only for their own benefit, but for the benefit of generations down the road. Contrast this with a “distribution” approach to the wealth, where the family intends to spend the wealth or allow it to dissipate over a shorter period of time – perhaps two or three generations. If wealth is going to last several generations or longer, a stewardship approach is necessary.

RISK TWO:

UNSUSTAINABLE SPENDING

Most wealthy families believe that the creation of the wealth is not an end in itself. Most believe that the money was made in order to be

spent, or given away. Yet, as the number of family members grows, the growth of the family's wealth may not keep pace over the generations. To be sure, inflation and the number of family members alone will erode the family's wealth. The bottom line? If the wealth is going to last several generations, there will have to be balance between spending and stewardship.

Spending is not just about setting limits. It's also about the family's values. What is important for each family member to have and receive? What should each earn on his or her own? It's important for each generation to educate their own children to be conscious of spending. "Speaking the words is not enough," Cestnick suggests. "Unfortunately, 'do as I say, not as I do' generally won't work when it comes to managing spending. Parents need to model a sustainable lifestyle for their children."

The good news for wealth creators is that there's generally more wealth per family member in the early years of the family's wealth (because there are fewer family members), so that the level of spending can generally be higher. As time goes on and the family grows, the family's governance structure will have to effectively control the level of distributions to family members. This could make it more difficult for children to maintain the spending patterns of their parents, so parents should keep this in mind as they model a lifestyle for their children.

WaterStreet can help by working with trusted money managers to craft a portfolio designed to sustain the rates of withdrawal that meets the family's objectives. "We'll also help families decide which assets to draw down first, in order to minimize tax and other costs," says Leigh Vyn, Vice President at WaterStreet. "We're able to model for families how their wealth is expected to look several generations down the road, and work with them to create a plan designed to sustain their desired level of spending. Our aim is to help the family maintain its

spending patterns through many markets and generations," she explains.

RISK THREE:

INEFFECTIVE TAX AND ESTATE PLANNING

Income taxes can significantly erode a family's wealth over time if not kept in check. Recent studies have shown that income taxes can reduce the rate of return on a portfolio by between 1 and 5 percent annually, depending on the make-up of the portfolio. Over the long term, this impact on the growth of a portfolio is significant.

"It's important to understand that tax planning can't be done in a vacuum," explains Audrey Robinson, Chief Investment Officer at WaterStreet. "The family's tax strategy has to be carefully thought out in light of the other planning that has been done around the investment portfolio, asset protection, debt management, cash flow planning, and in light of what the family wants to achieve."

Sometimes, the best tax strategies become inappropriate where a family wants to simplify their lives, or where the strategy might obligate future generations to take certain courses of action. For example, if tax planning calls for a philanthropic gift that might impact the ability of future generations to be involved in the philanthropic process, or where a strategy requires the creation of a complex offshore structure when the family wants to simplify its affairs, the family may need to rethink the plan in order to balance personal and financial benefits.

Since tax law, precedents, and government administrative policy are constantly changing, the family needs a team of tax professionals close by. Further, these specialists should be intimately familiar with all aspects of the family's planning – the investments, risk management, philanthropic plans, and ownership structures, among other areas.

Your WaterStreet professional is part of a multi-disciplinary team that works together

to ensure that any gaps in your planning are closed. WaterStreet's tax expertise and depth is unparalleled, providing clients with confidence that they are not paying more in taxes than necessary – both domestically and abroad.

RISK FOUR:

INADEQUATE ASSET PROTECTION

Most wealth creators pay little attention to the protection of the assets they've accumulated. They are, after all, risk takers who have been focused on creating the wealth. They are often confident that, if a loss were to occur, their productivity will pull them through.

Protecting assets, however, is critical to the long term maintenance of the family's wealth, particularly given the prevalence of litigation and the possibility of natural disasters. No family is immune.

There are a number of tools that can be used to protect assets. "We use a multi-faceted approach to asset protection," explains Vyn. "Ownership structures, if designed properly, can help to localize potential liabilities and manage risks. Insurance can also play a role in protecting against liabilities, and it's important that clients find the best insurance strategies at the most favorable costs."

Trusts and offshore structures can reduce access to assets by creditors, and are often considered in asset protection planning. The costs of these vehicles must be weighed against the benefits, but for those with much wealth, these are tools that can be very effective.

Wealthy parents also frequently worry about the stability of their children's marriages. Marriage break-down can be a significant threat to the family's wealth. Many parents and children will consider prenuptial agreements or domestic contracts as a means to protecting the family's wealth. But there's a caution: "Legal agreements can't replace careful decision making, and so we encourage parents to educate their children about being wise with

their decisions to the extent they might impact the family's wealth," says Cestnick.

RISK FIVE:

IGNORING FAMILY GOVERNANCE

Many families fail to keep wealth intact for multiple generations because they fail to create proper family governance. In fact, this is perhaps the biggest risk to your family's wealth. If you think of the family's wealth as a business, with many owners, it becomes easier to understand the importance of a good governance model.

"Family governance is all about the right people, talking about the right issues, at the right time, to make the right decisions about the family's wealth," Cestnick says. If the family fails to create a governance model that looks after these things, the seeds of family conflict can be sown, which invariably drains resources, wastes time, and can lead to bad decisions.

WaterStreet supports the family governance process by offering practical help in setting up governance models and ensuring your model is working properly.

A proper family governance model will ensure that four critical issues are looked after:

- *Sharing of values*
- *Communication*
- *Governance structure*
- *Education*

SHARING OF VALUES

The most successful families have a shared purpose, mission, and values that are passed down from the founding generation. This is not to say that there's no room for change or individuality. "Multi-generational wealthy families understand that it's important to respect the vision and values of those who came before, while also fostering their own dreams and living them out," explains Cestnick.

There are tools that can be effective in

sharing family values, including letters and videos to descendants, biographies, family histories, family mission statements, ethical wills, and purpose trusts – to name a few. “It’s important to realize that family values and dynamics take shape and are passed along over many years,” Cestnick says. “There is no single planning meeting, or series of quarterly meetings, where these dynamics and values become understood.” Yet, a proper governance model ensures that all family members understand the shared values that can lead to successful multi-generational wealth.

COMMUNICATION

Not surprisingly, proper communication is at the core of successful financial families. “The opportunity to communicate will arise through different avenues, including the operations of a family business, sharing philanthropy, or managing the family’s wealth – a business in its own right,” says Cestnick. “Given the importance of communication, it should be frequent – usually quarterly – and structured.” A proper family governance model will ensure this takes place.

The family’s wealth will be at risk when emotions override the rational discussion of issues. Emotional responses are typically driven by each family member’s sense of what is right and just. If a child, for example, feels as though one sibling is favored over the others, or feels as though certain roles or benefits have been “promised” but have not materialized, resentment can grow. Resentment can lead to deep hurts that, in some cases, can lead to lawsuits.

How should the family communicate? Regular family meetings make sense. While family meetings can have different purposes, the main objective is to share information and solicit input. “Everyone attending these meetings should understand the process for making decisions,” Cestnick explains. “And not everyone will necessarily have a say. Young people, for example, might be there to listen and learn.

The older generation, however, will have a great share of the responsibility for decisions.”

GOVERNANCE STRUCTURE

Wealth simply cannot survive multiple generations without the proper governance structure in place. The best governance structures typically have three levels: The Family Assembly, the Family Council, and the Board of Directors or Trustees.

Family Assembly: For any governance structure to be effective it will require the support of family members who have a forum in which to voice their interests and concerns. The Family Assembly serves this purpose. It’s a gathering of all adult family members, including in-laws, usually annually for one or two days, to receive information about the family’s wealth, and to share their values, needs, and expectations.

Family Council: The Family Council is a group of representatives from the family, often elected, who are responsible for developing a family mission statement, making key decisions on matters important to the family, identifying and developing family talent, planning Family Assembly meetings and retreats designed to maintain harmony in the family, and acting as a link between the family and the board of directors or trustees. A Family Council generally makes sense once the number of adult family members reaches 15 or more. The Family Council can be composed in different ways, but often will look much like the family itself, including members from different branches of the family, men and women, young and old, from different geographic regions where the family is located.

The Board: Finally, there is a board of directors or trustees of the family holding company, trust, or family office. The Board is the legal steward of the family investments, and is usually made up

of several members of the Family Council, along with independent non-family members that may have much to contribute based on their experience. Too often, when family governance is under-developed, the defacto “board” is made up largely of employees from the operating business of the family. While some of these individuals may be good choices for the board, outside individuals are often better suited for the role since they are more likely to be exposed to the best practices of other families, often have broader knowledge on issues the family is facing outside of the core operating business, and have the time to devote to board activities since they are not busy running the family’s operating business.

As a family grows, the need for clarity and structure in governance grows. Having said this, even first-generation wealthy families have to consider appropriate governance if the intention is for the wealth to last multiple generations.

Along with the appropriate governance structure, proper processes must be established. “If structure is the engine of governance, the oil needed to make it function smoothly is governance process,” explains Cestnick. “If there’s no oil, there’s no movement.”

The professionals at WaterStreet are able to assist with independent advice on the issues of governance structure and processes using knowledge of the many issues that family governance should cover.

EDUCATION

A proper family governance model will also ensure that all family members receive the education they need to effectively contribute to discus-

sions and decisions around the family’s wealth. This education is focused partly on soft issues such as the purpose of the family’s wealth, the values espoused by the family at large, and the expectations of family members. Practical education on how the family’s capital is managed, and on personal financial issues is also important.

SOLVING THE PARADOX

The story of your family’s wealth, if it’s like most, is a story of rewards that have been received by taking on risks. As a family moves from a single generation of wealth to a focus on creating wealth for multiple generations, the complexity involved in managing the wealth grows.

The approach that created the wealth can also cause the wealth to dissipate over time as the number of family members grows, each with different interests and capabilities. This paper has identified five of the key risks that can undermine the creation of a multi-generational legacy: Failing to understand capital pools, unsustainable spending patterns, ineffective tax and estate planning, inadequate asset protection and liability management, and ignoring family governance.

Creating an appropriate governance structure and processes, founded on good communication among family members, will go a long way to mitigating the risks identified here. Solving the paradox is possible. Please consider an open discussion with your family and your WaterStreet professionals about the issues in this paper, and experience firsthand how these risks can result in rewards for your family.

FURTHER RESOURCES

“Raising Children Amidst Wealth,” WaterStreet (2006)

“The Family Governance Pyramid: From Principles to Practice,” Patricia Angus, *The Journal of Wealth Management*, Summer 2005

“Family Wealth: Keeping It in the Family,” Jay Hughes, Bloomberg (2004)

ABOUT WATERSTREET

WaterStreet Family Wealth Counsel is a multi-client family office firm, providing strategic advice to wealthy families.

CONTACT US AT:

WaterStreet Family Wealth Counsel
5500 North Service Road
Suite 1004
Burlington, ON L7L 6W6

T. 905.332.4455

F. 905.332.5955

group@waterstreet.ca

WaterStreet is a trademark of The WaterStreet Group Inc. (2010)