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Family Office Portfolio Construction: Balancing Tradition And Innovation

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Family offices are increasingly shifting their investment strategies away from traditional asset allocations and towards more diverse, alternative investments. This trend reflects a desire for higher returns, lower volatility, and better alignment with the long-term goals of multi-generational wealth preservation and growth.

Shift Towards Alternative Investments

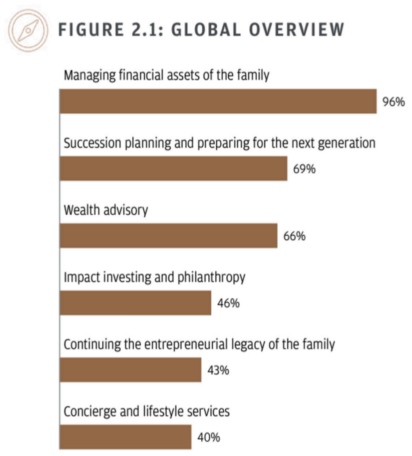
According to the J.P. Morgan Private Bank Global Family Office Report, large family offices now have nearly half of their investments in private markets and alternatives. Specifically, the report found that family offices have 46% of their total portfolio in alternative investments, including private equity, real estate, venture capital, hedge funds, and private credit. In contrast, only 26% of their assets were invested in publicly traded stocks.

William Sinclair, head of the U.S. Family Office Practice at J.P. Morgan Private Bank, explained the rationale behind this shift: "These clients are taking a multi-decade view of their wealth, and they can take illiquidity. Many of them are seeing opportunities outside of public markets."

The move towards alternatives is even more pronounced among larger American family offices. Those with over $500 million in assets had more than 49% invested in alternatives, with only 22% in public stocks. The breakdown of alternative investments was as follows:

- 19% in private equity
- 14% in real estate
- 5% in venture capital
- 5% in hedge funds
- 4% in private credit

What are your family office's objectives?



Source: https://assets.jpmprivatebank.com/content/dam/jpm-pb-aem/global/en/documents/2024-global-family-office-report.pdf Page 18 [-] JPMPRIVATEBANK.COM

Long-Term Perspective and Illiquidity Premium

Family offices are uniquely positioned to take advantage of illiquid investments due to their long-term investment horizons. As Sinclair noted, "Family offices typically have longer time horizons, investing for the next 50 to 100 years or more, so they can hold assets for decades and benefit from the so-called 'liquidity premium' of higher returns for more patient capital."

This long-term perspective allows family offices to weather short-term market volatility and potentially achieve higher returns. Unlike public stocks, which can experience significant daily fluctuations, alternative investments such as private equity and private companies tend to have more gradual valuation changes, smoothing out portfolio volatility.

Entrepreneurial Roots and Direct Investments

Many family office founders have entrepreneurial backgrounds, having built and sold successful businesses. This experience often translates into a desire for more direct involvement in private companies. Sinclair observed, "There are companies that want our clients on their board and on their cap table to be alongside some of the biggest venture capital and private equity firms out there."

This trend towards direct investments allows family offices to leverage their expertise and networks while potentially achieving higher returns than those available in public markets.

Beyond Traditional Asset Allocation

The complex needs of multi-generational families are pushing family offices to move beyond traditional portfolio construction methodologies. Anik Lanthier, newly appointed chief investment officer at Richter Business Family Office, emphasizes the importance of a more nuanced approach:

"Traditional portfolio construction methodologies typically follow a standardized framework, aiming to diversify assets across various categories to mitigate risk. This approach, while effective for individual investors with a clear, singular financial objective, does not accommodate the layered complexities of multi-generational wealth."

Instead, Lanthier advocates for a goal-based asset allocation approach that considers short-term, medium-term, and long-term objectives. She explains, "A crucial aspect of this process is defining what success looks like for each family, acknowledging that success criteria can vary significantly from one family to another. This clarity is fundamental in tailoring investment strategies that may lean towards lower immediate income or capital appreciation in favor of long-term growth."

Educating the Next Generation

A key component of successful long-term wealth management for family offices is educating younger generations. Lanthier stresses the importance of this aspect: "By engaging and educating the next generation, there's a seamless transition and alignment of the family's wealth objectives with their personal definitions of success."

This focus on education ensures that the family's investment philosophy and goals are understood and maintained across generations, supporting the preservation and growth of wealth over the long term.

Emerging Trends and Opportunities

Family offices are also keeping a close eye on emerging trends that could impact their investment strategies. Lanthier highlights two significant developments:

1. **Generative AI:** "The emergence of generative AI is particularly noteworthy. While its full impact remains to be seen, it's anticipated to bring about deflation through significant productivity gains, potentially disrupting numerous industries."
2. **Evolution of Private Markets:** "Private markets are another trend to watch, since in the past 10-15 years, most investors or capital allocators were trying to increase their private allocation. We are now approaching a juncture where many are reaching their target allocations, marking a new phase where management and strategic rebalancing of illiquid assets become critical considerations."

These trends underscore the need for family offices to remain agile and forward-thinking in their investment approaches.

Customization and Flexibility

One of the key advantages of family office portfolio construction is the ability to tailor investments to the specific needs and goals of each family. Riady Gozali, managing director at Golden Vision Capital, a Singapore-based single-family office, emphasizes the importance of customization:

"We prefer to work with managers who actively collaborate with family offices. These managers typically have programs tailored for smaller investors, offering good access and co-investment opportunities."

This level of customization allows family offices to build portfolios that align closely with their unique objectives and risk tolerances.

Balancing Risk and Diversification

While family offices are increasing their exposure to alternative investments, they are not abandoning traditional asset classes entirely. Gozali notes the importance of maintaining a balanced portfolio:

"A family office heavily invested in hospitality, or restaurants faces the risk of being overly concentrated in one sector. Diversification into non-correlated sectors like healthcare or technology is crucial to mitigate this risk."

To achieve this balance, family offices often work with external advisors and fund managers. The J.P. Morgan report found that 80% of family offices use external advisors, mainly for investment management, access to managers, trade execution, and portfolio construction.

Challenges and Considerations

Despite the potential benefits of alternative investments and customized portfolio construction, family offices face several challenges:

1. **Liquidity Management:** Balancing illiquid investments with the need for readily available cash can be complex. The J.P. Morgan report found that U.S. family offices had an average of 9% in cash, which is historically high.
2. **Performance Benchmarking:** Less than half of family offices have an overall investment return target, according to the survey. Among those who do, the median return target was 8%. Establishing appropriate benchmarks for diverse, customized portfolios can be challenging.
3. **Cybersecurity:** As family offices increase their direct investments and handle sensitive financial information, cybersecurity has become a major concern. The J.P. Morgan report found that 40% of family offices said cybersecurity is their biggest "gap" in capabilities, and nearly 1 in 4 said they have been a victim of a cyberattack.
4. **Talent Acquisition and Retention:** Building an in-house team with the expertise to manage complex, diverse portfolios can be difficult for smaller family offices.

The Interest Rate Pendulum: How Family Offices Adapt Their Portfolios

Interest rates have a significant impact on family office portfolio construction and performance. During periods of low interest rates, as seen in recent years, family offices have tended to reduce their allocations to fixed income and increase exposure to alternative investments. According to the UBS Global Family Office Report 2021, low interest rates led to a significant reduction in fixed interest allocations and an increase in investments in private equity and hedge funds. The 2023 UBS data shows that only 15% of family office portfolios were allocated to fixed income, while 19% went to private equity and 7% to hedge funds. As interest rates rise, family offices are adjusting their strategies. The UBS report notes that 37% of family offices are now investing in high-quality, short-duration bonds as a source of diversification in fixed income.

Regarding Internal Rate of Return (IRR), while specific figures for family offices are not provided in the given sources, private equity investments (a significant component of family office portfolios) typically target IRRs in the range of 20-30% for venture capital and 15-20% for buyouts, according to industry standards. However, it's important to note that actual returns can vary widely based on market conditions, investment strategy, and individual performance.

Conclusion

Family office portfolio construction is evolving rapidly, moving beyond traditional asset allocation models to embrace more diverse, alternative investments. This shift reflects the unique position of family offices to take long-term views, leverage entrepreneurial expertise, and tailor investments to specific family goals.

As Anik Lanthier summarizes, the key qualities for success in family office portfolio management include "depth of investment knowledge, independent thinking, strategic and analytical mindset, innovation, collaboration, and the ability to listen and educate."

By balancing innovation with prudent risk management and a focus on long-term, multi-generational wealth preservation and growth, family offices are well-positioned to navigate the complex investment landscape of the 21st century.