

Private Bank



# Timeless investment portfolio best practices for family offices

Citi Private Capital Group

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# Introduction

Ultra-wealthy families often see investment management as one of the most important roles undertaken by their family offices. However, despite the significant time and attention given to this, many family offices fail to achieve their desired portfolio outcomes.

Family offices are increasingly overseeing large and complex investment portfolios covering multiple assets and geographic jurisdictions. Robust portfolio management is the key to achieving long-term returns and objectives, as well as protecting against losses and potential risks.

In this paper, we outline the ten portfolio best practices Citi Private Bank's Global Investment Lab team has seen from working with over 1,500 family offices around the world. Whilst every family has unique investment requirements, we believe there are some fundamental actions all family offices can do to improve their processes.

These best practices take into consideration the unique needs of a family office as opposed to ultra-high net worth investors in general. Many family offices are very small in size with only one or two employees who rely on service providers as much as possible for portfolio advice, investment strategies, and consulting on solving their investment problems. Other family offices that are more sophisticated may have in-house resources who can help in consolidation, performance monitoring, and risk management.

For the first set of family offices, working with their providers in ensuring consistent asset allocation based on their investment objectives, focusing on risk management and timely investments in opportunistic strategies will help the family offices with overall investment strategy along with ways to enhance alpha as part of the overall portfolio. Investment management takes time and sophistication and this is where external advisors can be one of the keys to success.

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# Top ten best practices

## Consolidation

*'We consolidate all assets and liabilities on a regular basis'*

Family offices typically manage investment portfolios spanning global markets, direct investments in real estate, venture capital, and private equity which can be difficult to integrate, analyze, and report on.

However, family offices should have access to a consolidated view of their entire balance sheet and be able to aggregate accounts and cash flows across all providers of investment services. Family offices typically work with between two to four providers, so this insight enables them to review and analyze the holistic asset allocation and return profile, any liquidity matching requirements, the net impact of portfolio leverage, and concentrated exposures.

Family offices that do not consolidate all their assets and liabilities on a regular basis run the risk of not clearly identifying excess cash and missing potential opportunities to invest in certain asset and sub-asset classes where there is underexposure.

Many family offices turn to master bank custodians or consolidated reporting solutions to address this challenge. The best solutions provide performance data versus custom benchmarks for each asset class, asset manager, and family branch, identifying key portfolio characteristics and risk metrics.

## Objectives

*'Our overall portfolio objectives are well defined and investment policy statements guidelines are in place for each provider'*

Due to the busy and demanding lives of very wealthy families, it is important that a family's investment process objectives are well understood by all family office investment professionals from the start. This is so the family office can follow the family's wishes even during times where they may not be able to communicate immediately.

Family offices need to have a very clearly defined set of objectives which forms a foundation for how the family wealth is managed throughout generations. These objectives can help resolve any conflicts from various family members regarding investment strategies and/or positioning as long as they are identified in the objectives.

Objectives should be clearly defined in an investment policy statement (IPS) and can be categorized in a way that best suits the family; whether driven by return criteria, investment horizon, or cash flow/liquidity requirements. They should also consider a range of potential goals, for example: philanthropy, tax optimization, or other unique issues.

## Diagnostics

### *'We perform a regular comprehensive portfolio diagnostic across all our providers'*

Family offices need to have a clear understanding of the investment portfolio's asset allocation, risks, sector and regional concentrations, scenario analysis, and historical performance of the various asset classes, amongst other things.

In order to do this, family offices should perform a regular comprehensive portfolio diagnostics across all providers. This is essentially a health check that takes into account historical performance, risks, and stress/scenario analysis.

Family offices that do not perform any portfolio-level diagnostics are unlikely to have an accurate understanding of the overall investment asset allocations and various risk concentrations. Therefore, they may have an overoptimistic view of any potential problems with an inability to solve these efficiently and effectively.

We recommend using probabilistic analysis to determine risk levels associated with components or the entire portfolio. This methodology can address issues of path dependency and assist in more robust cash flow planning. Capital market assumptions deployed within this modelling should be reviewed and validated by an expert third-party.

## Gap analysis

### *'We undertake a regular analysis of the gaps between our own allocations and providers' recommended allocations to spot opportunities'*

Whilst protecting portfolios against losses is a key focus for many family offices, identifying potential opportunities is also an important part of successful investment management.

Family offices should perform regular analysis of the gaps between their own investment portfolio allocations and provider's recommended allocations to identify any potential opportunities.

Where overlap analysis highlights those positions in which the portfolio is too concentrated, gap analysis identifies

the inverse, namely those areas in which the portfolio is underweight from an asset allocation perspective.

Many family offices frequently fail to achieve their desired portfolio outcomes, which is in part down to not undertaking a regular gap analysis. Those that do not do this cannot identify potential opportunities to improve performance or ensure they are meeting or even fulfilling the family's expectations.

This analysis considers the risk tolerance level defined within the IPS to determine if and where portfolio exposure has diverged from plan utilizing a model or benchmark portfolio as a reference. Understanding and remedying these gaps in a timely manner is critical if the portfolio is to meet the strategic return expectations detailed in the capital market assumptions section of the IPS.

## Stress test

### *'Our portfolio risks and sensitivities are well understood. We stress test and run historical scenarios on a regular basis to help mitigate unexpected events'*

All family offices will place risk management high on their list of portfolio responsibilities. However, there may be some hidden portfolio risks and sensitivities which are not always immediately clear without specific action to monitor and mitigate these.

Family offices should stress test extreme or unfavourable financial and economic conditions on a regular basis to measure and monitor any potential risks and unexpected events. Once risks have been identified, remediation could be through portfolio replacing, hedging, risk reduction or option strategies.

The nature of financial markets is that they do not continue to go up in a straight line and economic conditions vary based on several factors. Family offices that do not stress test their portfolio create major risks when economic conditions deteriorate.

Tests can be executed across various considerations including liquidity, market, volatility, foreign exchange risks, equity shocks, and credit/counterparty exposures. Typical risk metrics or indicators could include volatility, value at risk (VaR), sensitivity, or leverage. Once family offices have done this, they can make an informed choice on how to remedy this, for example hedging or replacing.

## Hedging policy

*'Our portfolio has a clear hedging policy in place that also identifies potential risks'*

Hedging is often a misunderstood term but it is a practice that all family offices should know about in the context of managing a portfolio. When hedging, an investor is seeking to protect his or her portfolio against a negative market event. This strategy will not prevent the negative event from happening, but if the situation arises then the impact of the event could be reduced.

Family offices should incorporate a clearly defined hedging policy within their IPS to guide all hedging decisions (which will likely vary materially across each asset class). In addition to the hedging beliefs and policy statement, the family office should identify potential risks arising from hedge positions (for example basis risk, cross-hedge risk, sizing risk, and change in relationship) and detail the frequently and process for monitoring these unintended consequences

## Managing concentration

*'We have developed a complementary strategy for concentrated positions'*

Ultra-wealthy families tend to accumulate their wealth from various sources, including big events such as inheritance, investments in stocks, or the sale of a business. These events can result can introduce high-levels of concentrated risk to investment portfolios.

However, managing this risk is far from simple, for example family members may develop an emotional attachment to a particular asset and refuse to sell.

How family offices manage wealth is different from how the wealth was created. This is due to different investment objectives, level of risks, and generational wealth transfer along with capital preservation for the years to come.

From our work with family offices, we have seen that they are on average overweight in cash by a considerable margin of 26% compared to our proprietary AVS reference model 3 allocation. This is in comparison to an average underweight in developed investment grade (14%), developed equities (11%), and hedge funds (11%).

Having too much concentration in a stock or a group of stocks exposes the family wealth to varying market movements, resulting in performance degradation if a sector goes out of favor. Having too much cash also drags down the performance of the overall portfolio. Without proper steps to manage family wealth, family offices will not be able to meet the respective investment objectives effectively.

As a result, it is important family offices evaluate security concentration across a range of scenarios to fully understand any implications and incorporate a level of objectivity into the management of these positions. Once understood, family offices should mitigate concentration exposure based on their risk tolerance via strategies such as: short selling securities, completion portfolios, exchange funds, options strategies, and outright sales.

## Cash flow planning

*'We understand the needs for our cash and liquid holdings and engage in a periodic review of how to maximize yield earned on cash'*

Ultra-wealthy families can often require large amounts of cash at any point for activities including buying properties or businesses, therefore efficient cash management is of utmost importance.

As yields between deposits and alternative, short-term investments can vary dramatically; reviewing these allocations can have a very real impact on overall portfolio performance. This is more relevant for family offices where various family members can potentially demonstrate wildly different spending patterns encompassing income needs,

Family offices should incorporate a clearly defined hedging policy within their investment policy statement to guide all hedging decisions

discretionary expenses, tax payments, automated savings, and fixed liabilities.

Without a clear picture of the various factors affecting cash flow, including events affecting the family such as divorce or death, family offices will not be able to meet their investment objectives effectively.

Understandably, accommodating all the above across numerous family office stakeholders can be challenging, as such it may be useful to partner with third parties including technology providers or banks with tools to manage and potentially enhance cash returns, or the capability to educate and advise on cash portfolio structuring.

## Alternatives cash flow

### *'We undertake analysis to help manage private equity and real estate investing cash flows'*

Private equity and real estate can represent a significant share of all investments managed by family offices. However, investing in these alternatives can introduce additional complexities to portfolio and cash management processes, as poorly managed cash or collateral positions can quickly result in a drag on total returns.

Private equity and real estate managers may call capital during the investment period, therefore family offices need to ensure that there is enough cash available to accommodate these needs. In addition, family offices should codify policies to manage the cash flow distributions, whether choosing to reinvest the flows or diversify away, informed by portfolio rebalancing rules and gap analysis.

Having too much cash is a drag in a long-term focused investment portfolio. The risk of not looking into a potential 12-month estimate of cash flow schedule could result in having excess cash in the portfolio and as result, drag on performance. In addition, understanding the overall cash flow commitment

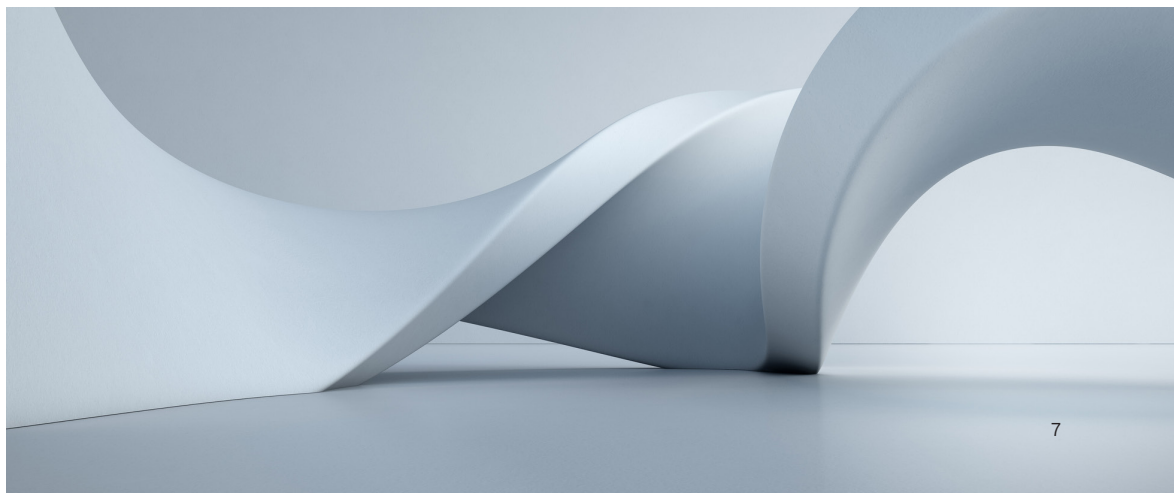
in maintaining the asset allocation and % exposure to the illiquid asset class will help manage the total cash availability in the portfolio.

Therefore, family offices should undertake a comprehensive analysis of all private equity and real estate investment across various managers to address the above needs in addition to highlighting the gross and net cash flows for the committed capital over the time horizon defined in the investment objective.

Any analysis should also include J-curve modeling which tracks the potential movement of a curve initially falling before steeply rising above the starting point. These analytics are calculated using historical averages of calls and distributions curves as percentages of commitment levels for a large number of funds. The source of the historical data depends on access to various data providers that collect cash flow information for the private equity and real estate funds.

Intelligent analytics that incorporates these features across all investment managers are highly relevant to the advisor, whether done by the family office's investment team, or outsourced to private banks and service providers.

Having too much cash is a drag in a long-term focused investment portfolio





## Innovation

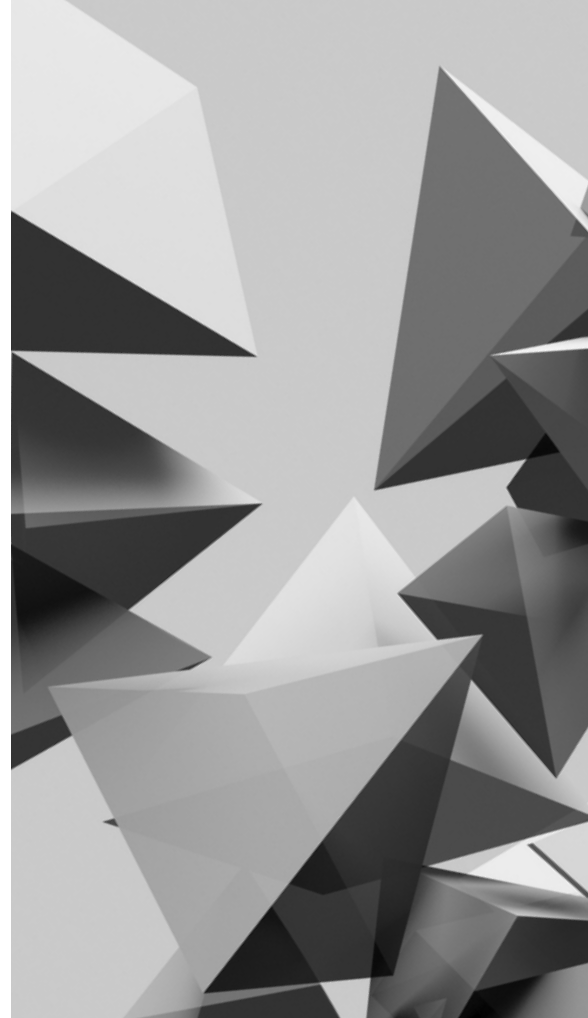
*'We have the necessary skills and established processes for identifying and exploiting innovation'*

Whilst keeping up-to-date with the latest technology trends is unlikely to be a primary objective, family offices will benefit from partnerships with third parties including technology providers, banks, and other providers that can help family offices innovate their processes, including portfolio aggregation, consolidated performance reporting, continuity planning, regulatory approvals, and trading tools.

Increasingly, family offices are also hiring chief technology officers to ensure they have the right skills and experience needed to find and manage the technology solutions needed to help the family office run efficiently and effectively.

Family offices often have limited resources to buy the latest technology to help them work efficiently, but need to embrace innovation otherwise run the risk of having to continue performing many tasks including communication and consolidation manually, which will take up a significant proportion of their limited time.

Family offices should also have processes in place to identify opportunities to invest in innovation as part of the portfolio. Family offices should keep up-to-date with the latest developments in key areas of interest to the principals by reading research, attending industry events, and building a network of contacts including other family offices and private equity insiders.







## Citi Private Bank's Investment Lab

Citi Private Bank's Global Investment Lab undertakes in-depth and institutional level analysis of clients entire wealth across all their banking relationships. Our quantitative and qualitative analysis supplies the framework to develop investment portfolios, as well as implementation possibilities.

The Lab for Family Offices is service dedicated to family offices that draws on expertise from across the Private Bank to provide portfolio advice, insights, and customized and actionable analytics.

We assess your assets, liabilities, and business interests in light of your investment goals and risk appetite. We also seek to uncover any potential opportunities and risk exposures you may have been unaware of. Based on these, we work with you to create a personalized strategy for success.

To find out more about investment portfolio best practices for family offices, or how we can help you please reach out to your Private Banker who will be more than happy to set up a meeting.

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