Building a new family office requires founders to face challenges that are quite different from other investment firms.

From Star to Founder

EastRock

When Founders Shine – and When They Don't: Family Office Edition

Adam Shapiro

November 28, 2022

IN THIS NEWSLETTER SERIES I have written mainly about investment firm founders who are focused on private equity, hedge funds, and real estate.

But there is another type of investment firm — the family office — that involves a very different type of founder.

To state the obvious: single family offices are founded not by investment management entrepreneurs but by families.

Why is that important? Because these founders face a special set of challenges that we at East Rock have witnessed up close — challenges that we believe we can illuminate and help solve.

Before continuing, a disclosure: Over the last sixteen years, East Rock has helped families outsource portions of their investing functions, and for most families we advocate family office setups that make substantial use of outsourcing. In our dialogues with families, we've found that they tend to treat outsourcing as an all-or-nothing choice, and we think this is a mistake (more on that later). Our comments should be read with these views in mind.

Despite our positive view of outsourcing, we admire a number of single-family firms in our orbit that do most of their investing in-house, such as Glick Family Investments, Willett Advisors, and Centaurus Advisors.

As families seek to replicate the success of these firms, however, there are three significant challenges to keep in mind:

1. Family office Chief Investment Officers (CIOs) are hard to find, and there are clear reasons for that

2. In the quiet world of family offices, it is difficult to learn from the mistakes of others

3. Family offices juggle a daunting number of objectives, not just profit and loss

What follows is a brief dive into these three challenges and some concluding thoughts on what can be done about them.

CIOs Are Hard to Find

The supply of family office CIOs is limited for three reasons:

- Reason 1: Family office CIOs are required to assume an exceptionally broad set of investment responsibilities

- Reason 2: There are few, if any, natural training grounds to acquire the broad set of skills required

- Reason 3: Investment stars who are not exposed to the opaque world of family offices may not identify themselves as potential family office CIOs, and they tend to have options elsewhere at attractive compensation rates that families may be reluctant to compete with

Many years ago, I wrote an overly ambitious job description for a position I was looking to fill. I presented it eagerly to a recruiter who I thought could help. His first question to me: "And how far do you want this person to be able to walk on water?"

I'm reminded of this story whenever I think about a family trying to find a CIO who is able to oversee the selection of asset classes, sub-asset classes, investment managers, and individual investments, while monitoring liquidity, factor concentrations, and correlations.

Where does one look for this person? Where did they train and where do they likely work today? The reality is that most family office CIOs must learn at least some of these skills on the job, which creates risk. For families with investing backgrounds, assessing this risk may be feasible. For others, it can be tough.

Can We Learn from the Past?

Investment firms often stress the importance of learning from their mistakes. But it's even better to learn from the mistakes of others, and there is academic evidence to prove it.

When it comes to family offices, the press is drawn to the schadenfreude of wealthy families making investment mistakes in the public eye. But most family office mistakes are swept under the rug, where they do little to inform their successors.

Here is a short sample of mistakes we've seen that future family office leaders could benefit from knowing about:

- Failing to diversify away from a highly concentrated stock position; the stock later went to zero
- Family office staff not understanding that their public behavior is an extension of the family and has an impact on the family's reputation; this included rude treatment of investment counterparties and speaking poorly of family members to outsiders
- Permitting a CIO with a non-VC background to make direct investments into technology startups, which went well initially (leading to rapid growth in the strategy) but later proved disastrous
- A harassment case that family members had to deal with personally because the top executive was involved

Because family offices often must learn from their own mistakes, several of the best family offices are "Version 2.0" rather than the family's first try. To the extent that there is friction between a CIO and the family, the period in between can be a long and painful winddown.

What Matters Most

Is the purpose of a family office to maximize investment returns? Sometimes. But usually, it's more complicated than that.

To share one point of view, a successful family office manager told us that his mandate is to insulate family members from negative surprises and discomfort. A bit like a goalkeeper, if he keeps the family protected from liquidity shortfalls and sticky employee issues, the rest is gravy.

But as I often hear, "if you've met one family office, you've met one family office."

Even within a family, individual preferences differ widely:

- Some care about investment gains; others avoidance of loss
- Some desire control over their portfolios; others specifically don't want it
- Some look for maximum economic gain; others place priority on societal impact and/or learning
- Some seek assistance with personal real estate, art, and philanthropy; others prefer to keep those things separate

And so it goes, with nearly endless permutations. Even if all agree on the virtues of family peace and sleeping well at night, they may not agree on how to get there!

The Option to Build AND Rent

When it comes to building a family office, perhaps the biggest change in mindset we advocate is to stop thinking about "build it" versus "rent it" as a binary choice.

We believe that accessing talent in an aligned way is the key to having a better family office. And sometimes the best way to reach that talent is through a mix of hiring and outsourcing.

Two of our family clients invest both via internal teams and outsourcing partners. This setup provides them with multiple perspectives on markets and allows them to direct capital to wherever the best opportunities are showing up. Other families in our network outsource investing while keeping legal, tax and bookkeeping operations in-house.

There are many combinations that can work. If there is one guiding principle to follow, it would be this: family office founders should consider it their goal to have talented and trustworthy people of high character in every critical role.

East Rock Capital

NEWSLETTER
From Star to Founder
Insights from partnering with exceptional investment managers as they launch and build new firms

Published by **Adam Shapiro**
Managing Partner @ East Rock Capital, LLC | Generational Wealth Manager

EastRock

65 East 55th St, 33 Fl
New York NY 10022

T 212 630 5000
F 212 624 0231
info@eastrockcap.com