Family Office and Wealth Management Industry Trends

By Pat Soldano and Jan Vega, CFP®, PFP, CTFA

The family office and wealth management industry is facing challenges front and center. These challenges range from proposed consumer-first legislation and regulation, to the emerging influence of millennials, to tax reform. These challenges, and the change they demand, make it more crucial than ever that the family office and wealth management industry remain flexible, adaptable, and able to retain talent, so it can achieve the scale necessary to provide sophisticated solutions to increasingly complex issues. This article summarizes the key issues that are demanding industry transformation.

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Increased Accountability

After delays and scrutiny, the Department of Labor (DOL) Fiduciary Rule went into partial effect June 9. Full implementation of this landmark Obama-era investor protection rule is set for January 1, 2018. This sweeping proposed DOL rule elevates all financial professionals who work with retirement plans or provide retirement planning advice to the level of fiduciary to assure that advisors put client interests first.

As with any industry facing extensive changes in regulation, the wealth management industry as a whole has been assessing and preparing for the challenges the fiduciary rule will present.

Nicole Newlin, president of Efficient Advisors, wrote in the *Journal of Financial Planning*: "The fiduciary wave has hit the financial services industry in a similar manner to the way the Y2K wave hit computer technology back in the 90s. Although the entire computer world did not crash when the digital calendars shifted to the year 2000, most people considered the huge amount of time and money invested in updating their systems well spent."[1]

Just as Y2K spurred businesses worldwide to update, new regulations within the wealth management industry mean additional work and expense.

According to a 2016 *InvestmentNews* report about a study by management consulting firm A. T. Kearney, "The new rule ... will result in several important changes, including [requiring] advisers to adhere to a 'best-interest standard,' new compliance protocols, an increased level of scrutiny on fees and adviser compensation, and accelerated product shift to fee-based and robo-advisory." This study concluded that implementing the fiduciary rule will cost the brokerage industry $11 billion in revenue over four years.[2]

"Certainly, it is important to ensure that savers and retirees receive prudent investment advice, but doing so in a way that limits choice and benefits lawyers is not what this administration envisions," U.S. Secretary of Labor Alexander Acosta wrote, parroting the rules' naysayers. The rule's proponents contend it's critical to shielding retirement investors from conflicts of interest.

Demands for Increased Services

As more families have more generations involved in family businesses, demand has increased for services such as family governance and education. A survey conducted by the Family Office Exchange indicated the number-one programming topic of the future is education of the next generation.[3] This education has become increasingly more complex because issues have become more complicated within client families and family offices.

Investors need sophisticated and complex solutions for these complicated issues, which intersect with regulation and compliance requirements. The high-touch services traditionally employed by family offices may become less personalized and/or customized due to regulation and requirements imposed by the Dodd–Frank Wall Street Reform and Consumer Protection Act.

Communication with clients has continued to be challenging, because texting and social-media messaging, albeit convenient and popular, may not be compliant with regulations. At the same time, clients are trending toward fewer face-to-face meetings and more remote communication.

Cybercrime Is a Continual Threat

Keeping a tight lock on clients' assets, privacy, and security persists as a 24/7 concern.

In February 2016, hackers accessed Bangladesh Bank and sent fraudulent orders to the Federal Reserve Bank of New York requesting the transfer of nearly $1 billion, demonstrating the extent and growing sophistication of cybercrime.

Experian has reported that 43 percent of the wealthiest U.S. households have a chance of experiencing identity theft.[4] The 2016 PwC Global Economic Crime Survey notes that "cybercrime continues to escalate—ranking as this year's second most reported economic crime."[5]

According to a CNN Money report, more than 317 million new pieces of malware—computer viruses or other malicious software—were created in 2014, leading to nearly 1 million new threats released each day.[6]

Changing passwords, using cloud services judiciously, and maintaining a strong network with a good quality firewall on all systems remains imperative. Clients who don't understand these necessities or shrug them off as a nuisance leave themselves open to cyber breaches.

As use of technology grows, protection thins. Entering a password to access an account, shop online, make a mobile payment, or send a message opens gateways to our secure information. Travel presents risks as well and digital exposure can vary among countries.

The wealth management industry must dedicate resources to protect against cyber breaches and keep clients informed about how easily breaches can occur. Each member of a client family must adhere to identified best practices regarding cybersecurity, and so must the industry itself. The 2016 PwC Global Economic Crime Survey referred to above identified best cybersecurity practices by leaders in the digital age, noting that a proactive stance is the best defense. "This necessitates that everyone in the organization—from the board and C-suite to middle management and hourly workers—sees it as their responsibility."

Millennials

Millennials are the generation born after 1980 and before 2000 or so, they make up 27 percent of the population, and they stand to inherit $30 trillion from their baby-boomer parents.[7]

Engaging this wildly independent generation continues to present a challenge for the family office and wealth management industry. The forecast intergenerational wealth transfer will pose significant challenges because the millennial generation is so different from its parents' generation. The family office that doesn't take a hard look at its total business model—from investing to communication—is going to falter.

Smart, confident, and demanding, millennials won't engage without trust, require personalized attention, and embrace quite a different outlook than the boomers for whom the family office model was designed.

Millennials' skeptical attitudes and sharp opinions aren't without merit. They grew up in an era of some significant failures: first, the tech bubble implosion in 2000; second, the global financial crisis of 2008. These events have left them wary. They do not, for instance, embrace the long-term, positive investment views held by their boomer parents.[8]

Add the fact that they grew up with the world's accumulation of knowledge accessible to them in the palms of their hands. According to a Campden Research report: "These two factors alone are enough to make the millennial's attitudes and opinions quite different from their predecessors. On the one hand it colors the way they think about issues of trust, dependence and security … On the other, it allows them to construct their own worldview quickly and emphatically, from a broad range of possibilities."[9]

Advisors need to understand that millennials come with beliefs and views independent of their parents, and that they seek a framework of understanding that will allow them to run with their own ideas. They do not seek shrink-wrapped solutions. As the Family Office Exchange has stated: "Millennial clients appreciate it when their trusted advisors not only help them achieve their goals, but also help them develop life-long skills that can be applied in other situations. For goal-oriented, results-driven advisors, this type of client relationship and the shift in focus that it requires may feel uncomfortable. For Millennials, it feels natural."[10]

Changes from generation to generation are nothing new. And yet there are some significant differences between boomers and millennials—from the issue of trust to religion to politics.

The Pew Research Center has cited the following contrasts between boomers and millennials:[11]

- 40 percent of boomers say that, generally speaking, most people can be trusted. A mere 19 percent of millennials agree to that statement.
- 50 percent of millennials consider themselves political independents compared to boomers at 37 percent.
- 29 percent of millennials are religiously unaffiliated compared with 16 percent of boomers.
- 81 percent of these digital natives are on Facebook.

Clearly, the family office is looking at a new breed of client who is confident, educated, and idealistic. How their parents' financial advisors engage with them will be crucial to whether they decide to retain their parents' advisors. Recognizing and understanding generational differences and biases helps bridge these gaps. Generational change expert Cam Marston says financial advisors must become “gen-savvy” and “understand their own generational biases that come out of their coming-of-age years and how they are generationally unique.” He adds that being self-aware opens up the ability to see and understand the “subtleties in how the different generations communicate, what they prioritize in their communications and in their relationships.”[12]

The Pew Research Center writes that a culture change is necessary for family office and wealth management advisors to work with millennials. For boomer-era advisors, millennials are a puzzling generation; and they are expected to continue to grow more distrusting, more anti-religious, and more independent.[13]

This it would seem is not a trend, it’s an evolution.

Marston, however, said he feels millennials have drawn attention away from an important, overlooked audience: Generation X, the group immediately following the baby boomers. Despite X-ers’ disdain for financial services and an I-can-do-this-myself attitude, they are a “target-rich audience” that will show great loyalty to advisors who show their value. Marston suggests reaching Xers through events that fall directly into their daily lives: “For example, “an event for a 45-year-old would be protecting your child from online predators and how to raise a child in a technology-driven environment. So much about raising children protectively while, at the same time, enhancing their experience as a child … will get their attention. … (and) hopefully lead to a new client for that advisor.”[14]

Impact, ESG, and Robo Investing

Impact investing is a quickly expanding destination for investment dollars. A 2016 Global Impact Investing Network (GIIN) report captured data through a survey from 158 impact investors. The survey was distributed between December 2015 and February 2016. In total, GIIN reports the respondents committed more than $15 billion to impact investments in 2015 and planned to commit 16 percent more capital than that in 2016.[15]

We’ve seen clients remain very passionate about impact investing, with some willing to accept sub-par returns. We’ve also seen how an environmental, social, and governance (ESG) strategy straddles both the demand for performance and the desire to do good—a value vs. values analysis.

Getting ESG into a portfolio allows investors to feel more comfortable knowing that the companies they are investing in have been vetted against ESG criteria. Incorporating this non-financial data in security analysis is, arguably, a more holistic view of the company and results are showing that it is adding to risk-adjusted returns.

Barron’s recently published a list of the top ESG funds, and the research reveals the top 50 of the 200 U.S. large cap actively managed funds with the most sustainable portfolios beat the S&P’s 15.4-percent return in the year ending September 30, 2016.[16]

Robo-advisors joined the scene in 2008, allowing mainstream investors access to portfolio management, disappointing advisors who viewed the development as disruptive technology. Despite its less than warm welcome by the industry, robo-advising has been embraced by millennials and adopted by advisors, providing them with more time for clients. The future of robo-advising lies in how advisors use the technology to redefine their true value with clients.

Direct Investing

Interest in direct investing continues to grow because clients want to have more control over their investments and be directly involved in their investments. The desire to have investments that align with values fuels this trend. More clients are asking for something different from the standard marketplace of stocks and bonds, signaling change in the investment climate.

This change is not going unnoticed, according to the *Wall Street Journal*:

> *Wealthy families have always found ways to protect and build their money, and the savvier among them have pursued their own business deals, from acquiring farmland to seeding hedge funds to buying companies. Today their ranks are ballooning, and many, put off by the high fees and sometimes weak performances of Wall Street money managers, are shifting to investments they can pursue directly through family offices.*[17]

Industry insiders note the same trend. Seth Katz, partner and head of investments for Summit Trail Advisors, was quoted: “We definitely see an appetite among ultra-high-net-worth [investors] to see direct deals. … I think we’re going to continue to see more capital moving into the private markets.”[18] Ravi Ugale, director of private equity at GenSpring Family Offices, said he continues to see a growing trend of family offices reallocating capital away from managers of private equity funds into direct investment in private companies. “Following the financial crisis, investments by institutional investors, pension and endowments and family offices have been on the rise,” Ugale said.[19]

Ugale reports that the motivation lies in the following various factors:

- Potential to increase returns by avoiding management fees and carried interest
- Belief that traditional private equity fund incentives are misaligned
- Greater control and transparency over the investment
- Opportunity to work with a portfolio of private equity investments and leverage the investor’s operating experience[20]

Succession Plans

Today’s advisor is, on average, 50 years old, and nearly 100,000 brokers are expected to retire over the next decade, creating a challenge for all wealth management businesses.[21]

In the mid to late ‘80s, the wealth management industry was attractive to the freshly minted MBA student. By the late ‘90s, that love affair began to fade. The industry no longer was attracting that student. Furthermore, starting with the Great Recession, the industry at large has been under siege by politicians and activists and its advisors vilified. This trend has now become a big issue as these 50-plus-year-old advisors head toward retirement.

As the next generation of family office executive takes over the family office, or wealth manager takes over the business from another, the new clients most likely will be millennials, who may want a very different type of advisor with different skills. Additionally, they may want someone of their generation. The service delivered by prior advisors, and family office executives, may not meet the service requirements of this millennial-based client. Millennials—as well as their predecessors, the Gen X-ers—may prefer to do much of what was done by the firm themselves. So the challenge for the retiring advisor is how to train a replacement.

Tax Reform

Although tax reform is a perennial topic in financial circles, some observers see it coming to the fore in the near future.

"Major tax reform is high on the agenda for the United States in 2017," writes Martin Feldstein, professor of economics at Harvard University. "The Republican-controlled House of Representatives has been preparing for this for years, creating detailed plans for overhauling how corporate and personal income are taxed. Now, with a Republican majority in the Senate and a Republican president in the White House, those plans can provide the basis for legislative action."[22]

For the wealth management industry, tax reform—coming 31 years after the Tax Reform Act of 1986—would be an historic game changer and something everyone needs to plan for.

"Prudent action will be required to protect yourself in order to ensure that your property distributes in a manner which protects and preserves your assets for your family," says attorney and estate planning expert Philip Levin. "Planning is the best way to protect your wealth against any future changes."[23]

Changing Business Model

More complicated tax and estate planning systems combined with complex investment options will require the wealth management industry to attract, recruit, and retain sophisticated talent. The number-one program request from client families seems to be governance and education for their next generation, but that cannot be delivered without specialized advisors.

The commitment to update technology comes at a cost, and so does succession for client-facing teams and compliance with increased regulations. That said, can the single-family office and wealth management firms retain their high touch?

Technology and how it changes communication methods, online services, and connectivity to clients remains a constant challenge.

These changes are bigger than anything the industry has experienced over the past two decades. The family office and wealth management world is facing dramatic, constant transformation, and the industry needs to focus on it.

Pat Soldano is a family office consultant with GenSpring Family Offices. She earned a BA in business administration from California State University and an MBA from Claremont Graduate School. Contact her at patricia.soldano@genspring.com.

Jan Vega, CFP®, PFP, CTFA, is a family wealth advisor with GenSpring Family Offices. She earned a BBA from Loyola Marymount and an MBA with a concentration in finance from the University of Southern California. Contact her at jan.vega@genspring.com.

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