Fall 2013

NORTHWOOD FAMILY OFFICE

ALSO IN THIS ISSUE:

Chairman's Message

Tom McCullough

The Importance of Perspective

I usually have several books on the go at any one time. Right now, among others, I am reading *Team of Rivals* (Abraham Lincoln) by Doris Kearns Goodwin and *The Next Hundred Years* (geopolitics) by George Friedman.

Both remind me of the importance of perspective -- not coincidentally, the name of this publication. It is always difficult to see the whole forest when you are in the middle of it, surrounded by trees. Yet, perspective is what all investors and wealthy families need -- a sense of what is important over the long term and not just what we see in the newspaper headlines today.

In the Lincoln book, I was struck by how significant and intractable key issues seemed to be in that era (slavery, states rights, the Whig Party) and how hard it would have been to imagine that those things would all pass into history.

George Friedman puts an even finer point on it. Imagine yourself, he says, in the summer of 1900 with Europe enjoying unprecedented peace and prosperity and dominating the Eastern hemisphere. In fact, war was thought by many to be virtually impossible. Then imagine yourself in the summer of 1920, in the aftermath of a horrific European war resulting in millions of casualties and ending in the destruction of the German, Ottoman and Russian empires, seemingly never to rise again.

Once more, imagine yourself in the summer of 1940. Germany had not only re-emerged but had conquered France and looked set to dominate all of Europe. Russia had also re-emerged as the Soviet Union and was flexing its international muscle. The summer of 1960 brought an entirely different reality than would have been predicted 20 years before. And so on.

In international relations, financial markets and family affairs, the way the world looks right now is not at all how it will look in 20 years. We tend to think that whatever we are seeing today is so permanent and dominant that it will always be the case. But things change. We need to retain perspective and be open to the long term shifts taking place in the world.

This perspective helps bring balance, rationality and emotional maturity to the management of private wealth, which can help avoid some of the errors caused by kneejerk reactions to day to day worries. It is particularly helpful when the focus is firmly grounded in the needs and goals of the family vs. the 'noise' of current events.

I hope you enjoy the 'Q&A' style of this quarter's Northwood *Perspective*.

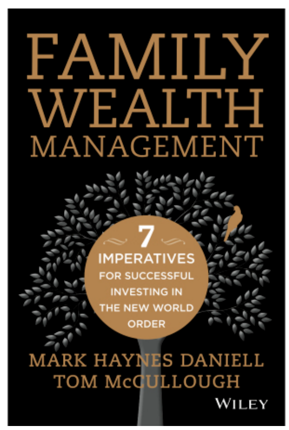
Tom

Q&A with the Authors of *Family Wealth Management: 7 Imperatives to Successful Investing in the New World Order*

Authors Tom McCullough and Mark Haynes Daniell are pleased to introduce their new book: ***'Family Wealth Management: 7 Imperatives to Successful Investing in the New World Order'***. It is published by John Wiley & Sons and will be available on Amazon and from other booksellers on October 7, 2013. In this Q&A article, the authors discuss the purpose of the book, the writing process, and address a variety of topics of interest to family investors.

Q. What is this book about, and for whom was it written?

A. The book was written to help private and family investors protect and grow their wealth over time – and in a manner consistent with family vision, philosophy and values. It was written for family leaders, family members, staff of family offices and the wide set of advisors – lawyers, bankers, investment managers and others – who seek to advise their clients wisely on long term family wealth preservation, growth and transition.



Available on Amazon Oct. 7/13
http://amzn.com/0470824298

Q. What is the 'new world order' you refer to in the book?

A. This particular crisis we have been through is far deeper and more significant than any crisis since the 1930s. While most credit crises last 5-7 years, the interventions by governments to stave off some of the more painful social and economic consequences of the crises may provide some buffers, but also may prolong the crisis. No matter how it is seen, there is still a long way for the dominos to stop falling – and the difficult environment (and the implications for investors) will be with us for some years to come.

Q. What lessons did families learn in the crisis? What should they have learned?

A. Different families learned different lessons, but many common perspectives emerged on the surprising correlation between assets and asset classes presumed to be non-correlated, the real risk of extreme 'tail events', the value of liquidity, the need to manage costs and monitor managers carefully, and the need to diversify in a different manner going forward.

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Q. How will the future evolve, and what are the implications for investors?

A. The future is, of course, never entirely predictable, but the following are very likely to play a key role in investment decision-making for some time to come: increasing pressures for tax revenues from the wealthy, continued low yield on savings and deposits, increasing regulation and compliance requirements, a shift of the world focus from west to east (i.e. Asia), continued work-out for debt-burdened countries and consumers, civil unrest due to the rising wealth gap, a massive transition of wealth from boomers and their parents to the next generation, and need to blend family and financial perspectives, particularly given the increasing complexities within families. Investors will need to cope with these challenges in addition to the 'regular' ones of generating enough return to meet their needs, at acceptable risk levels.

Q. Where are major risks and opportunities for families?

A. The major risks are both family-related (too much spending, divorce, disengagement, dispute, etc.) as well as financial (bad investment decisions over-concentration, behavioral errors, poor advisors, high fees etc.)

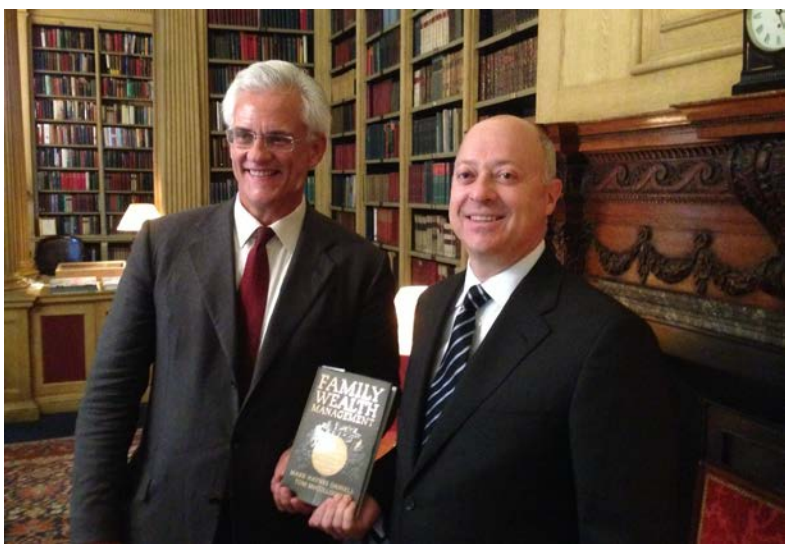
Failing to learn the lessons of the past on matters both family and financial may be the greatest risk of all, and, conversely, adopting a comprehensive and fully modern approach as advocated and spelled out in great detail in this book, may be the greatest opportunity for families interested in beating the heavy odds of a 'shirtsleeves to shirtsleeves in three generations' outcome, with very unfortunate consequences for both family and fortune.

Q. This is a big book. Why so much material?

A. This is a complex and serious subject with many interrelated parts that need considering as both individual elements and as part of an integrated whole. This is not a subject that benefits from 'one minute management', slick phrases or faddish themes. Long term successful investing for a wealthy family requires mastery and integration of many elements. This book shows how it can – and has been – done well, and we wanted to provide for our readers a very substantial input into their own plans, strategies and aspirations.

Q. What big mistakes have families made over the years? Is this changing?

A. There are as many mistakes made as there are family failures. Some recurring issues include not taking time to set out and prioritize family goals, falling prey to the dangerous patterns of behavioral errors, failing to adapt to changes in the environment, and proceeding without sufficient diligence or documentation.



Authors Mark Daniell and Tom McCullough at the pre-launch celebration of their new book *Family Wealth Management* in the Library of the Travellers Club, London, UK, September 19, 2013

Q. Is 'shirtsleeves to shirtsleeves in three generations' an inevitable pattern?

A. Not inevitable, but highly likely unless family investors and their advisors put in the effort required to set out clear goals, develop a forward-looking family culture, and establish a strong risk management regime to reduce the odds of this pattern occurring again.

Q. Did you two co-authors agree on all points as you went along?

A. We came at this issue from two different approaches developed on opposite sides of the world: Mark bringing in his experience, primarily in Asia and Europe, with fewer, larger ($1+ billion) investing families, and Tom contributing his experience, primarily in North America, with $10 million - $1 billion wealthy families.

Despite these initially different bases of experience, we shared a common set of family-centric values and were able to forge a common way forward that was well adapted to all legacy families and their advisors who are looking to apply the best available knowledge to their own investing objectives and challenges.

Q. What was your biggest challenge in writing the book?

A. Actually, paring back and providing a simple framework was our biggest challenge! There are so many important 'moving parts' to a successful family wealth management program that we were constantly balancing the need for an integrated overall approach interesting for everyone with the fascinating detail (and real life examples) of the individual elements. We hope we have found the right balance.

Q. How can a family best put this book to use?

A. The best way a family can put this book to use would be for a few members (probably those who are, or will be, most engaged in wealth management) to read the entire book and understand its applicability to the unique family environment of their own family. They then can provide a summary and adaptation of lessons learned to other members of the family. There are many examples and case studies in the book that would make for good boardroom or dinner table conversations. Family advisors will also benefit from a better understanding the factors that are critical in preserving and growing family wealth over the generations.

The Value of Family Trusts for HNW Families

Barrett Lyons, CPA, CA, CFP with Gwen Benjamin of Wilson Vukelich LLP

Family trusts are frequently used by wealthy families as part of an overall financial plan, both during their lifetimes and for their estate. They are often used to maintain control or direction over substantial amounts of wealth as well as for the benefits of income tax savings in certain situations. Depending on the family circumstances and purpose of the trust, they can be very simple or very complex and there is a myriad of legal and tax issues that can come in to play.

Northwood sat down with Gwen Benjamin, a partner with the law firm Wilson Vukelich LLP to discuss family trusts and her experiences with them. Gwen's practice is concentrated in the area of taxation, focusing on estate planning and business succession planning. Additionally, Gwen has a particular interest in charity law including charitable giving, and acts for both charities and donors.

Northwood (Q). Trusts can provide significant tax benefits to high net worth families, but when contemplating the use of a trust, what other topics and considerations do families need to think about?

Gwen Benjamin (A). A trust is a relationship between the settlor, who makes a gift to settle the trust and the trustees who administer the trust for the benefit of the beneficiaries who are the objects of the trust. Like any relationship, there are complexities. For example, family law issues come into play as does the residency and sometimes the citizenship of the trustees and the beneficiaries. Since the relationship is one of trust, the choice of trustees is often difficult. Further, if the trust will be in place for many years, one must consider the succession of trustees. Sometimes there are concerns about the beneficiaries themselves – for example, whether a beneficiary would ever be able to hold capital or whether it would be preferable to be able to distribute capital to a trust for such a beneficiary.

Q. Mothers, fathers, aunts, uncles, and friends are frequently chosen as trustees of inter-vivos (living) trusts and testamentary (created by a will) trusts. What should individuals know about the duties and responsibilities of taking on this role before doing so?

A. Taking on the role of trustee means taking on a role of great responsibility. Trustees are fiduciaries and as such owe a duty of care to act in the best interests of the beneficiaries of the trust at all times, putting their own interests completely aside. They can't just 'pass the buck' – they must act and make their own decisions. Although, in the case of a discretionary family trust, the trust deed may provide broad discretion to the trustees to distribute income and capital among the beneficiaries, the trustees are required to act in good faith in making discretionary distributions. Trustees should also be prudent investors, and have a duty to account, which means from time to time, they may have to pass their accounts in court.

Q. From a family dynamics perspective, what are common challenges or stumbling blocks that can cause strain within families when dealing with inter-vivos family trusts based on your experience?

A. Beneficiaries of fully discretionary family trusts have a right to be considered in respect of every distribution. How can they exercise this right if they are not aware that the trust exists? One of the biggest strains on both trustees and beneficiaries is how much knowledge the beneficiaries should have about the trust. Should the trustees provide them with a copy of the trust document? When a trust has been established at a time when the beneficiaries are minors, should they receive a copy of the trust at 18? These are questions which come up frequently. While a beneficiary should know about the trust and perhaps receive a copy of it when he or she becomes an adult, what he or she knows about its underlying assets is another issue, especially in the case of a private corporation owned and controlled by a trust. At the end of the day, it is the courts who are the ultimate decision makers as to what a beneficiary is entitled to see in respect of a trust.

Q. In 2010, the decision reached in the case of *Antle et al. v. The Queen* highlighted the importance of the legal requirement for 'certainty of intention' when settling a trust. What is certainty of intention and what are the best practices for families settling a trust?

A. This means having the requisite intention to actually settle the trust for the benefit of the beneficiaries. By signing the trust deed after having read it carefully to ensure that it meets his or her intentions both as to terms and as to beneficiaries, and after providing the settlement property to the trustees, the settlor is evidencing that his or her intention has been met. However, the Canada Revenue Agency (CRA) has questioned whether settlors have had the requisite intention even where the trust deed is signed in certain circumstances. This is what happened in the *Antle* case. Such a case might be where the settlor was simply used to accommodate the setting up of the trust – in other words, he or she had no intention to make a real gift, or to settle the trust that was actually drawn.

The settlor should be a person who actually wishes to make this gift to the trustees for the benefit of these beneficiaries. For this reason it is often a family member, such as a grandparent. Whoever it is, that person should be comfortable reading the trust deed to ensure that it meets his or her intentions. Situations where the settlor's ability to read and/or communicate in English would cause concern, unless the document was translated for that person. Generally, when we are assisting with settling a trust, we wish to ensure that the settlor reviews all letters and other correspondence with respect to the essential terms of the trust before it is signed and we meet with the settlor to the extent possible in order to answer any questions. We also make sure that the settlement property comes directly from the settlor.

Q. In the March 2013 federal budget, the government announced it has begun consultations on measures to reduce or eliminate some of the tax benefits of a testamentary trust (trust created by will). Can you highlight the key changes that we may be facing, and the current status of the consultations?

A. Currently, estates and other testamentary trusts are taxed at graduated rates, generally in the same way as an individual is taxed. This does allow for a certain degree of 'income splitting' between the estate or trust and its beneficiaries. In the case of a testamentary trust, for example, which has a distribution scheme which allows for discretionary payments of income to its beneficiaries and also permits accumulation, such a trust may be able to both distribute its income to its beneficiaries and/or retain income in the trust – minimizing the amount of tax paid overall by taking advantage of the trust's and the beneficiaries' respective graduated rates. CRA is concerned

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with the question of fairness relating to the ability to access more than one and sometimes several graduated rates through the use of testamentary trusts and estates. In the last federal budget, the federal government announced that it would be holding consultations on this issue.

On June 3, 2013, the consultation paper was released. The consultation paper proposes that the Income Tax Act be amended to apply the top rate of taxation to testamentary trusts. Estates would also be taxed at the top rate 36 months after the death of the individual. Thus, for up to the first 36 months after death, an estate can take advantage of the marginal rate of tax but not thereafter. On the expiry of 36 months, the estate would be subject to a deemed year end and would thereafter be taxed at the top rate. These changes are proposed to come into effect in 2016 and would affect all testamentary trusts, including spousal trusts. While estates will have a 36 month grace period (which makes sense considering the inability in many instances to make any distribution for at least the first year), draft legislation has not yet been released so one should not conclude that every estate will have 36 months of graduated rates – in certain cases, the graduated rate may only be available for the executor's year or even a shorter period.

In reaction to the consultation paper, industry professionals have already expressed concern about the many situations where testamentary trusts are used to protect beneficiaries from receiving income (as in the case of minors) or to maximize a beneficiary's ability to access government support like the Ontario Disability Support Program (as in the case of certain disabled persons) – and the consequent unfairness of the income in those cases being taxed at the highest marginal rate.

Other technical rules proposed include the requirement of testamentary trusts to use the calendar year as a tax year and the requirement for estates and testamentary trusts to pay tax installments.

Some concluding thoughts:
Although sometimes complex, family trusts can be effective tools for high net worth families. Northwood works with families to help implement a structure that makes sense for them based on their individual goals and needs, taking into consideration family dynamics and relationships, as well as the technical legal, tax, and financials details.

Interview with the *Family Office Leadership Summit*

Tom McCullough, MBA, CIM, CSWP, CFBA

Northwood's Tom McCullough spoke at a family office conference in London, UK in September and was interviewed for an article in the conference magazine. Here are the three questions and Tom's responses.

Q. What does the word 'risk' mean to you and how does it compare pre and post crisis?

A. Risk is a very misunderstood and misused word. For most investors, risk should indicate the likelihood (or lack thereof) of meeting their objectives. In this context, there are three components of risk. (1) Risk requirement – the amount of risk an investor must take in hopes of achieving the returns they need to meet their objectives. Most investors don't know what their required rate of return is or the amount of risk they need to take. (2) Risk tolerance - how well an investor is able to handle the extreme movements in markets and their own wealth. Investors are very poor at assessing in advance their ability to handle volatility when it comes. (3) Risk capacity - the financial ability of the investor's wealth to withstand a significant loss. An investor with a large amount of discretionary wealth has much more capacity for risk than one who has substantial commitments the portfolio is expected to fund.

There have been some encouraging signs, since the onset of the credit crisis, that investors are beginning to understanding risk not just as volatility but rather as a permanent impairment of capital and the possibility of not being able to meet some or all of their goals. But as markets rise, the memory and required self-discipline can fade.

Q. What are your investment targets for the next 5 years?

A. There is a large body of evidence that suggests that asset class forecasts are notoriously inaccurate and inconsistent, yet despite that, such forecasting remains at the heart of the modern investment process. In our family office, we spend much more effort focusing on a family's required rate of return and the factors they have control over vs. simply forecasting future returns.

When forecasting is required, factors like history, mean reversion and common sense can provide some helpful handrails. Two examples: (1) There is a very high correlation between the current yield on bonds and the expected return from bonds, so in this low rate environment bonds returns are likely to offer poorer returns than the historical average. Higher interest rates will be welcomed by wealthy families with cash to deploy. (2) Equities are likely to provide higher returns than bonds over the long term (due to the equity risk premium required), but we expect lower than average returns over the next 5-10 years based on not-cheap valuations, debt drag from governments and consumers, and the inevitable end to an unsustainable easy money policy.

Q. Are you outsourcing the functions and services of your family office more or less than 5 years ago?

A. No, but the outsourcing trend is increasing among single family offices (SFOs). For many SFOs, it just doesn't make financial sense to perform every activity internally. The costs are too high, they can't access the most qualified people or best opportunities, and it is increasingly difficult for them to manage the complexity. As a multi-family office (MFO), we are receiving a growing number of requests from SFOs who are asking us to perform specific functions for them, including investment manager due diligence, customized reporting, and integrated planning. Working with a MFO in this way allows SFOs to benefit from significant economies of scale. We expect this trend to continue.

Noteworthy Links

In this edition of the Northwood *Perspective* we are introducing a new recurring section that features links to interesting articles that we think our readers might enjoy. You can access each article by clicking on the title.

***Is US Economic Growth Over? NBER Working Paper*, Prof. Robert J. Gordon**

In this NBER working paper, professor Robert Gordon of Northwestern University questions the assumption that continued economic growth in the U.S. is a foregone conclusion. The author argues that periods of slow and rapid growth in the U.S. can be explained by the country's three major industrial revolutions (IR #1 1750-1830: Steam/ railroads; IR #2 1870-1900: Electricity/ internal combustion engine/ running water/ communications; IR #3 1960-present: Computer/ web/ mobile phones). But, he suggests, the pace of economic growth spurred by these revolutions is unlikely to be sustainable going forward due to six major headwinds: demographics, education, inequality, globalization, energy/ environment, and the overhang of consumer and government debt.

***The Stories That Bind Us*, New York Times**

This New York Times article highlights the benefits of building a family narrative. Families which have a deep understanding of their roots and history and continuously reflect on both their constructive and difficult periods, will increase their chances of prospering over future generations.

***The Lessons of History*, John Bogle**

In this classic 2011 speech, Vanguard Mutual Funds founder and low-fee funds advocate John Bogle looks back at a 1996 publication in which he and other prominent industry professionals contributed investment advice to the endowments of their respective alma maters. Through pithy prose and insightful charts (e.g. page 10), Bogle draws the conclusion that although 'this time is different', there are still meaningful lessons to be learned and applied from the history of investing.

***10 Behavioral Pitfalls: A Primer*, Morningstar**

In this brief article, Morningstar outlines 10 of the biggest psychological pitfalls of investing from the field of behavioral finance and how investors can recognize them and protect themselves.

***Disruptive Technologies: Advances That Will Transform*, McKinsey**

The McKinsey Global Institute sifts through the world's evolving and emerging technologies in an attempt to distinguish which of them could have large scale, transformative, and economically disruptive impact from now to 2025. The report lists 12 economically disruptive technologies, from autonomous vehicles to advanced robotics to 3D printing.

***Saving Investors from Themselves*, Jason Zweig, WSJ**

In a recent *Intelligent Investor* column for The Wall Street Journal, investment journalist Jason Zweig writes about the tiresome task of 'saving investors from themselves' over the course of his career. A true believer of 'regression to the mean', Zweig reaffirms his high calling to keeping investors out of trouble and provide helpful perspective in the face of irrational markets.

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