NORTHWOOD FAMILY OFFICE

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Chairman's Message

Observations on Asia 2014

Tom McCullough

"It is better to travel 10,000 miles than to read 10,000 books." There is certainly some truth in this old Chinese proverb, especially when it comes to understanding China. Actually being there and seeing how things operate versus just reading about it makes a big difference. I just returned from my second trip to China (in addition to stops in Hong Kong and Singapore) and my eyes were opened even more.

The reason for the trip was the semi-annual meeting of the Wigmore Association (www.wigmoreassociation.com). Regular readers of this newsletter will remember that Wigmore is a global association of eight leading family offices from seven countries and four continents around the world. (We welcomed our newest member at our recent meeting, one of the leading multi-family offices from Mexico.) The group is composed of the Chief Investment Officers from each family office and meets to exchange views on the outlook for the global economy and markets, share insights on investment strategies and managers, and discuss best practices for serving wealthy families. Meetings have been held in London, New York, Melbourne, Toronto, Frankfurt, Rio de Janeiro, and Montana.

This most recent trip took us (-- Northwood president Scott Hayman and me) to Beijing, Hong Kong and Singapore. We met with a remarkable array of government officials, regional experts and local practitioners. Our speakers and hosts included the following:

- A very senior official of the People's Bank of China
- Senior Chinese government leaders in the areas of statistics, urbanization and environmental issues
- Chief economist for Asia of a major investment bank
- Asian fund managers managing equities, real estate, private equity and hedge funds
- Local entrepreneurs and business leaders in China, Hong Kong and Singapore
- Professors from world renowned Tsinghua University (Beijing) and Singapore Management University
- Members of wealthy families
- Leaders of Asian family offices
- Ex-pats and other long term Asia-watchers

I thought I would share some observations from our recent trip, which I have summarized into the 11 following points. I do so with great humility both because Asia hosts many ancient cultures which cannot be captured in a few sound bites, and because so many others know Asia much better than I do.

1. Not so different from us.....

I got the sense that the Chinese government is really a massive corporation vs. primarily a political (ideological) entity. There was very little political rhetoric; rather the discussions seemed to be focused on how they are trying to solve incredibly complex engineering, societal, environmental and financial challenges. It sounded a lot like home. Senior government officials seemed open and candid, sometimes talking about mistakes that have been made and how they should to be corrected. People were friendlier than I thought and society seemed more progressive than the papers seem to suggest.

2. ....but in other ways, very different

There was much discussion with locals about Chinese culture. It was assumed that it is very different from the west and that it needed to be explained and properly understood. Democracy, such a visceral passion for many in the west, seems to be less important in China, especially in comparison to the desire for free commerce. We had interesting and open discussions about the need and desire for freedoms. The government blocks many websites, including Google (but not Yahoo, interestingly enough) and Facebook and some of the people we spoke to described this censorship in a positive light as the government's role as a 'parent' taking care of its 'children'. We were told numerous times that China has a very relationship-focused economy and not just about the numbers, and that Chinese culture is described as "head down, work hard, mind your own business, take care of family and friends, be self sufficient." Several times we were reminded that China has always been inwardly focused i.e. not invaders or empire builders.

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NORTHWOOD FEATURED ARTICLE ON WEALTH TRANSITION IN IMCA'S INVESTMENTS & WEALTH MONITOR MAGAZINE

Click the here to read the article.

NEW FAMILY WEALTH MANAGEMENT PROGRAM

Introducing a new 3-day intensive Family Wealth Management program for family members and family office staff offered through U of T's Rotman Executive Education department. The course will be held on October 23-26, 2014, and will be taught by Tom McCullough and other key faculty members and wealth management leaders. For more information and to enroll please visit: http://tinyurl.com/od5kr7s

3. China is a big country

While this sounds positively tautological, it was mentioned to us by most Chinese we met with. China has a massive number of people which means a lot of consumers and a lot of traffic and pollution. But it also has many regions and there are major differences among them. For instance, the average GDP per capita of China is nearly US$8,000 (2/3 of South Korea and 20% of the US), but it is very low in the west and very high in the east. In other countries, when a slowdown happens or production costs go up, you move to another country. In China, you can move to another province.

4. Generally very positive on new the government vs. the previous administration

Almost everyone we spoke to was very positive on the new government of Xi Jingping. The politburo has been reduced from 9 to 7 people. They are also younger than the prior group and grew up with a more positive view of the new 'economic openness'. Many of the leaders have practical experience running provinces or large cities. There seems to be good progress being made on the major issues facing the country. And Xi has begun a serious crackdown on corruption that seems to be having an impact.

5. They seem to have a good awareness and admission of their problems

There seemed to be a good assessment of risks and challenges they are facing as a society e.g. slums, pollution, corruption. They admitted to significant environmental problems and explained how they plan to go about solving them. They discussed the classic trade-offs, including the fact that cleaner natural gas is 30% more expensive than dirty coal. They talked about the need to raise fines on polluters because at the current low rates, it is cheaper for companies to simply pay the fines and keep polluting. They know they need to solve the massive traffic and urban livability issues and have some very specific plans to deal with it. They know they have transparency issues and are working to address them. They have immense traffic problems, especially in the larger cities. Beijing has 30 million people and 5.5 million cars. It took us an hour and a half to get to our hotel from the airport, which would otherwise be a 15-20 minute drive without traffic.

6. Growth is slowing, but most don't expect a crash

Growth is definitely slowing from the 9.8% per year average since the start of the reforms. What it will slow to (7%, 6%, 5%?) is still anyone's guess but slowing growth is normal at this stage of development (as has been the case in other recently developed economies). Due in part to the one child policy, the population will peak soon and the labour force peaked two years ago. Growth will ultimately be powered by continuing urbanization as over half of the country still lives in rural settings and many will migrate to the cities. This is how they expect the 'ghost towns' that dot the country will ultimately be filled up. This seems to be an example of how state planning got just a little bit ahead of itself, but the massive population shifts to come will ultimately solve the problems.

One interesting side note is that the anti-corruption drive is slowing economic growth over the short term. (Sales of moon cakes, a common 'gift' to grease the wheels of business, are down 50% this year.) Government crackdowns in jurisdictions without consistent rule of law can cause paralysis as people try to figure out what the true intent of the 'new sheriff' is. The consensus is that the anti-corruption focus will be positive over the long term. It is also important to remember the important role of the state in command economies and its role in creating cyclical swings. For instance, the previous government put home purchase restrictions in place in 2011/ 2012, so when they were removed in 2013 all the pent-up demand pushed new home sales up 50%, and then so far in 2014 they have fallen 10%.

7. Debt is rising, but most don't expect a crisis

The Chinese government has significant debt, much of which has been accumulated over the past 6 years. It now stands at 200% of GDP, well above international medians. Many economists, while concerned, discount the probability of a China debt crisis because most of the debt is domestic and not owed to other countries. Foreign debt is $600 billion and foreign currency reserves are $4 trillion. Most of the government debt is held at the local level, which does raise some concerns. Corporate debt (private and state owned enterprises) is 115% of GDP but is also mostly domestic and companies have a lot of cash and good assets behind them. Household debt is low (20% of GDP) and mostly in the form of mortgages.

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8. Things are changing

- We may have thought of China's role is the world as a 'factory' in the past, but it is slowly shifting to a 'consumer' market which will buy the world's goods.
- Internally, it is also shifting from a manufacturing economy to a service economy, which will have a significant impact on the labour market.
- Much of the local government debt is being collateralized so the switch from bank debt to bonds will increase transparency.
- The government is making changes to the education system to boost independent thinking vs. traditional memorization and rote learning.
- There seems to be an increased focus on initiating some property and intellectual property rights. China's patents per capita are about one tenth of South Korea's and one third of the US, and they want to see them grow.
- There is a shift to private companies from state owned enterprises (SOEs) and mixed ownership based on the substantially higher productivity of the private ventures. (But this will be a very long process given that there are over 100,000 SOEs.)
- Increasingly, political success is being judged, not just by GDP, but also based on quality of life of the citizenry. In fact, government seems to gradually be viewing the people as 'clients' of the government.

9. Wealth management in China

Wealth management is very underdeveloped in China but it seems to be growing quickly to keep up with the substantial new wealth that is being developed. There are not many investment options available so people default to the ones they know and can access. Property often fits the bill and has turned into bubbles because of it. People seem to use property as a store of value (almost like gold) and care less about renting it out. Stock markets are becoming somewhat more developed and expanded and there is the expectation that Chinese people will ultimately be able to buy foreign securities. The general consensus is that much of the seriously large wealth is being quietly shipped out of the country through illegal means.

We had meetings with the resident wealth management and family office specialist at the world-renowned Tsinghua University in Beijing where they have developed global partnerships to meet the growing demand for wealth management and education in China. We delivered a lecture on our book, *Family Wealth Management*, to the Canadian Chamber of Commerce in Hong Kong. And we presented to the Business Families Institute at the Singapore Management University and expect to do further collaborative work with them both from a Northwood standpoint and in my role with the Rotman School of Management at the University of Toronto.

10. Hong Kong is skeptical

Following a productive visit to China and a general sense of progressive movement there, we arrived in Hong Kong and were met with a chorus of China detractors. Many of the people we met told stories of the risks of working and doing business in China. The lack of property rights and rule of law means that it is very important to watch your business interests very carefully and to find trusted locals who know the ropes. Hong Kong is also experiencing major air quality issues as many factories (both in southern China and in Hong Kong itself) spew foul chemicals. It has become a major lifestyle issue in Hong Kong. The recent demonstrations in Hong Kong echo the comments from long time Hong Kong residents about what they referred to as the 'Chinese creep' as Beijing continues to integrate themselves into day to day Hong Kong life.

11. Singapore is humming

If mainland China is the 'wild west' in terms of transacting business, Singapore is the opposite. It is regulated, there is rule of law, there is transparency, and there are serious consequences for misbehaving.

There is significant state control but it seems to be behind the scenes and the island of 5 million people runs extremely efficiently. When traffic congestion started to develop several years ago, the government put in toll roads, built expressways and required drivers to buy a permit every ten years for USD$60,000. We had no traffic issues! Among many other meetings, we met with the Monetary Authority of Singapore who made it clear that they are proactive regulators but are also working hard to make Singapore an attractive place to do business and manage money. Many excellent global money managers are now located in Singapore and Singapore is probably a pretty good place from which to venture into investments in the rest of Asia. We held our Wigmore Association meetings in Singapore and had an extremely useful dialogue among the members, exchanging investment approaches, contacts and best practices. This collaboration is an extremely valuable process and helps to make us wiser managers of wealth and better advisors for the families we serve.

Overall this was an extremely enlightening trip and I look forward to the next one.

How a Family Should Approach Investment Risk

Scott Hayman, CPA, CA, CFP, TEP

Most wealthy families have likely been through the standard risk assessment process that takes place at the beginning of a new advisor relationship. They are asked to answer a series of boiler plate questions to gauge the level of portfolio volatility that they can stand emotionally, which is often characterized as *risk tolerance*. The advisor then takes an inventory of the family's assets and liabilities and considers their financial needs to determine their *risk capacity*, which is their actual ability to take on risk. This information establishes the risk profile for the family, which acts as the foundation for the advisor to build an investment strategy for the portfolio.

Assessing Risk Based on What Your Family Requires

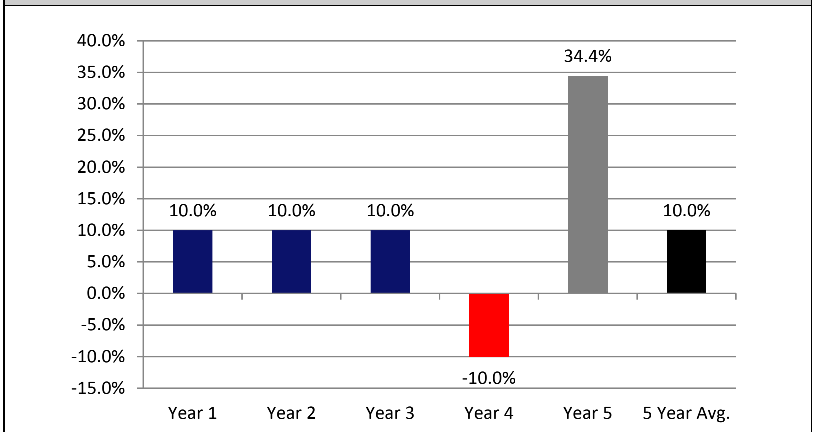
While this typical approach to measuring risk meets all the necessary regulatory hurdles, in our view it is missing one critical component. At Northwood, our definition of risk is 'not having the funds available at the time you need them to meet all your goals'. In conducting a risk assessment, it is imperative for the advisor to consider the family's *risk requirement* as well. This is the rate of return they will need to meet all of their liabilities (goals) throughout their lifetime.

When risk requirement is left out of the equation, investing families can end up taking on more risk than they should. A family may have high risk capacity due to their significant financial resources, and the financial stability they enjoy can also result in a high risk tolerance. This combination can lead an advisor to structure a portfolio that aims for a return that well overreaches what is actually required for the family. This approach of 'going for the highest possible return' may seem appealing when markets are in an uptrend. But taking unneeded risk to earn 'higher' return could result in investment losses in down markets, which can be detrimental to the ability of the family to achieve its objectives.

Taking Unneeded Risk Can Be Detrimental to Your Family's Capital

Consider the following hypothetical example where a family's risk requirement isn't factored into the mix. Under the guidance of their advisor, a wealthy family with both a (perceived) high tolerance and capacity for risk strives to earn an average annual return of 10% per year over five years. The family manages a 10% return in each of the first three years, but in the fourth year suffers a 10% loss. Now to achieve their goal they will need a 34% gain in year five (see Exhibit 1). So what is that family likely to do after year four? Given the fragile nature of risk tolerance (which tends to be high in good markets and low in bad markets!), they might get nervous and go to all cash, abandoning their goal and missing out on any potential market upside in the final year by not being invested. Or they might feel compelled to take on much more risk to 'get back' to their long term 10% annual return goal. Neither outcome is likely to yield desirable results for the portfolio.

Exhibit 1: Hypothetical Return Scenario



Source: Northwood Family Office

What if this family, based on a detailed cash flow analysis, actually only required a modest average annual return of 4-5% to meet their objectives? Had the advisor tempered their goal to that level at the outset of the relationship, perhaps more of the focus could have been on preserving capital and ensuring all of the family goals could be funded, leading to a much better and more predictable outcome by the end of the period. In the serious pursuit of wealth management, "Discretion", as they say, "is the better part of valour."

Consider the Big Picture When Measuring Risk

In order to ensure the most optimal outcome to the risk assessment process, it is also important that families do so in context of their complete portfolio and not just their investible assets. This includes illiquid assets (i.e., the business, private investments), personal assets (i.e., house, cottage) as well as human capital.

With respect to human capital, if your income stream is less risky (i.e. a teacher's income might act more like a bond than a stock), your investment portfolio may be able to withstand greater risk. However, if your money is tied up in your business or your income stream is volatile and unpredictable (i.e. an entrepreneur's or an investment banker's income might act more like a stock than a bond), then your investment portfolio might need to be more conservative with a focus on preserving wealth and funding both near term and future needs.

Similarly, business owners should take the expected value of their business into account when calculating the asset mix of their investment portfolio. It may be that the ownership of the business

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already represents a substantial commitment to risk assets and the balance of the liquid portfolio should be tilted toward less-risky assets to ensure capital protection and proper diversification.

At Northwood, we help entrepreneurs and high-performance professionals manage the often challenging transition from wealth creators to wealth owners, which is a significantly different stage of life. These families have already taken substantial risks to create their wealth and do not want to lose it. For these families, we suggest that when they think about risk it should not be in relation to making the most money, but about ensuring all of their goals can be funded (both now and into the future) and protecting what is most valuable to them.

In our initial meetings with clients, we recommend a plan that concentrates on aligning the family's portfolio to meet their actual objectives instead of trying to 'shoot the lights out' because they have the means and inclination to do so. By taking this approach we are better able to ensure that that their financial needs are met while preserving the wealth that they have worked so hard to build.

Conversations on the Transition of Wealth

Barrett Lyons, CPA, CA, CFP, CIM

We often use the contrasting stories of two wealthy families from the 1800s, the Vanderbilts and the Rothschilds, to describe the value of preparing the next generation to receive wealth. The Vanderbilt's surrounded themselves with great finance people, accountants, and lawyers, where as the Rothschild's focused on family legacy, values, and preparing the family for the transfer of wealth. The Rothschild family continues to prosper to this day while the Vanderbilt's wealth was not sustained over time.

Preparing a generation for a transfer of wealth is a multi-faceted long term process. You can think of the non-technical ('soft side') of the planning equation as the mortar in the process of building a brick foundation. The bricks (trust planning, tax structures, life insurance, etc.) are the pieces that build the foundation but the mortar (values, family culture, etc.) is what holds the foundation together and provides its strength. Even if you have the greatest technical plan, the chances of long-term generational success are reduced if the heirs are not prepared to receive it. To prepare the heirs, one of the most challenging steps for families are the conversations surrounding what triggers the transfer of wealth – death.

Conversations about death are difficult and there are lots of reasons why many families avoid them. However, they are mandatory for any family that wants to have success in transitioning wealth from generation to generation because communication is the key to the entire process. Depending on the level of wealth in the family the conversations topics will vary. For families with significantly more wealth, questions of governance will be of much more importance. In addition to varying levels of wealth, emotional baggage, family history and dynamics for each need to be considered. For families that haven't begun the conversation, I found Tom Deans' book, *Willing Wisdom*, has seven questions that are a great primer. I like these questions as a starting point because they address fundamental topics, including family history, values, goals, that encompass the family's culture without delving too deep, but also address the practicalities of the transfer and needs that come along with it such as planning for your long-term care.

Find the list below[1]:

1. What word best describes our family? Share a family story that helps explain the word you select.
2. Describe how your parents acquired their wealth. Share a memory about something your parents did to provide for you that left a lasting impression.
3. How would an inheritance advance your dreams for yourself, your family and your community?
4. In the context of planning for the division of your assets, does fair mean fair or does fair mean equal? Who are you planning on leaving your wealth to, and will you share a copy of your will with me?
5. Describe how your parents divided their assets and when you first learned of the contents of their will. What would you do the same and what would you do differently?
6. Describe the role you play or played in the final care of your parents. Can you name one thing that was or is being done well, and one thing you could change or wish you had done differently?
7. Describe in detail your last wishes.

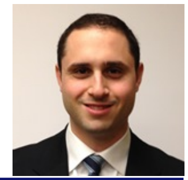
Whether it's these or other questions, the point is to start (or continue) a dialogue that will bring the family's questions and concerns to the forefront, and strengthen the family culture for when the parents are gone. Given the significant wealth transfer that is taking place now from the Depression-era generation to baby boomers, and the expected larger transfer from baby boomer to their heirs in the coming years, there is a lot at stake for families.

For most families it would be prudent to have this conversation every few years after reviewing their wills, or in a family meeting. At Northwood, we help clients frame these conversations and even moderate them with their families. It is one small piece of preparing heirs but an important one nonetheless.

[1] *Willing Wisdom: 7 Questions Successful Families Ask*, Thomas William Deans PhD

The Power of Dividend-Paying Stocks

Dan Solomon, MBA, CFA, CFP



In one of the many compelling guest essays originally featured in Tom McCullough's new book (click here to learn more or purchase), James Garland draws on a comparison between "Chicken Farmers" and "Egg Farmers" as a helpful metaphor to characterize two main groups of investors. On the farm, chicken farmers own chickens to eventually sell them, and consequently care very much about the market value of chickens. However, egg farmers own chickens for the eggs those chickens will lay, and so egg farmers care very much about the quantity of eggs.

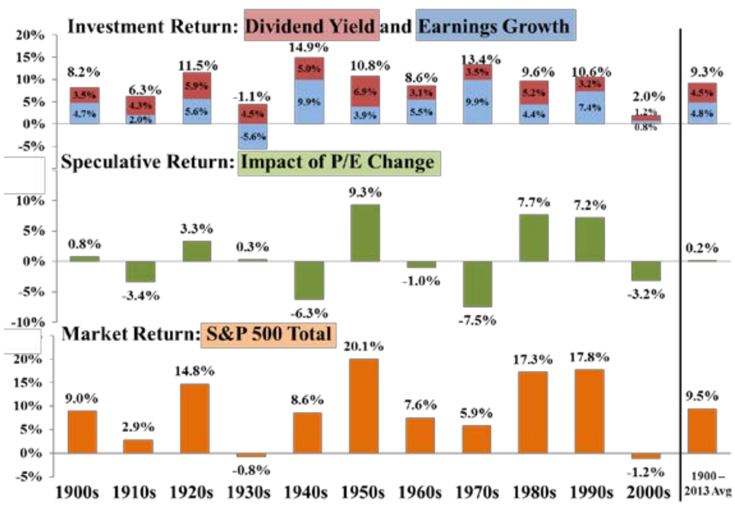
In financial markets, chicken farmers are investors who buy securities with the intention to sell them and very much care about the market value of their "chickens", while egg farmers own securities to enjoy the dividends and interest (i.e. the "eggs") that those securities will produce over time. Chicken farmers spend both the income and principal of their investments, while egg farmers spend only the income.

Most investors are in the chicken farmer group. They view their portfolios as retirement assets and are comfortable spending most of what they have by the time they die. Because there are so many investors who must draw on the principal of their portfolio, the financial industry and media are often geared towards the chicken farmer. As a result, in the world of finance too much attention is paid to short term fluctuations in stock prices while the long term merits of investing in dividend-paying stocks are often overlooked. However, in our view, investing in dividend-paying stocks can be a very powerful contributor to portfolio performance and investing rewards over time. We believe dividend-paying stocks are not just for the egg farmer, but can also be an integral component of the chicken farmer's portfolio.

Chicken farmer investors, who are very concerned with the price of their chickens at any given time, should understand that the returns earned by their chickens in the long run are heavily influenced by the eggs they lay. This is because market movements that occur in the short term are often speculative in nature, while in the long run the market does place value in the dividends and earning growth of companies.

The accompanying chart (see Exhibit 2) from a speech by Vanguard Group founder and industry veteran John C. Bogle, shows the total return of the S&P 500 over time, breaking out the contributions from (1) dividend yield and earnings growth (top chart) and (2) the speculative return (middle chart). Dividends and earnings contributions are relatively stable and predictable and each accounts for nearly half of the average market return. In contrast, the speculative return is volatile, and its impact over time is negligible. To us, this is evidence of how critical dividend paying stocks can be to the portfolios of investors with a long time horizon.

Exhibit 2: Real and Speculative Return in the S&P 500



Source: John Bogle, A Reminder: Stocks (and the Stock Market) are Derivatives, 2013

Wharton School finance professor and scholar, Jeremey Siegel, is a well known champion of the importance of dividends to portfolio growth. He has conducted research on the effectiveness of choosing to reinvest dividends when received. Some of the most stable, mature, secure and relatively profitable companies scored the best in his analysis. At the top of the list are household names such as Kraft Foods, Coca Cola, and Exxon Mobil. These are not the most exciting stocks, but their nature has allowed them to consistently pay and grow their dividends.

As an example, going back to 1925, through to 2003, Siegel calculated that tobacco giant Philip Morris produced a 17% average annual return when its dividends were reinvested in its shares. This compares to a 7.3% gain for the S&P 500 for the same period. Had an investor put $1,000 in Philip Morris in 1925 and reinvested dividends received along the way in the stock, the value of the investment would have been more than $250 million 80 years down the road. Those are convincing figures that suggest well-established dividend paying stocks should not be ignored.

Most powerful are fundamentally-sound companies with a long

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history of paying dividends who also tend to grow their dividends over time. This can have a profound effect on the portfolio as reflected in the growing yield that investor earns on their original investment. Clients have experienced this benefit firsthand at Northwood within our Canadian Dividend Growth mandate. From late 2009 to March of this year, about half of the stocks in the dividend mandate were still in the portfolio. When they were purchased in the portfolio, they were yielding about 3%, and now they are yielding 6% on the original investment. This is nearly twice the yield of the mandate if you were to invest in it today, which shows the positive impact that dividend growth can have on a portfolio in just a short period of time. In addition, the average share price of the holdings rose substantially as well.

NORTHWOOD FAMILY OFFICE

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