Summer 2016

NORTHWOOD
FAMILY OFFICE

ALSO IN THIS ISSUE:

Chairman's Message

Seeing Past the Noise

Tom McCullough

I hope you are having a great summer. In our part of the world, summer started early and has provided welcome patio and cottage weather.

One of the summer traditions of this newsletter has been to share some reading ideas from a June conference that I chair. The conference was moved to November this year, so I don't have that list for you.

Instead I thought this would be a perfect time to tell you about the excellent collection of articles we curate on the Northwood website under Articles of Interest in our Resources tab. http://www.northwoodfamilyoffice.com/resources/articles-of-interest/

There are over 100 articles on all sorts of topics of interest to families and family advisors including: Behavioral Finance, Family Education, Family Governance, Family Wealth Psychology, Future Trends, Goals-Based Investing, Investment Manager Selection, Next Generation, Succession Planning, and Trustees and Executors.

They are written by some of the most thoughtful and insightful people in the world and are all freely available on the internet, but we have gathered them together in one place for you. I am a voracious reader of articles that help our clients manage their wealth, improve their lives and benefit their families, so I am constantly adding to the Articles of Interest. Please feel free to have a look at the articles and pick out a few for your summer reading.

Also, in the face of the Brexit surprise and general market volatility over the past six months, I wanted to offer a brief comment on perspective, not coincidentally the name of this newsletter. I have recently had the opportunity to read and listen to some really interesting points of view that serve to remind us that important long term trends often get lost in the short term noise. As one recent observer put it: "We now have 24 hour news shows, so guess what? They have to fill 24 hours of air time. Probably 80% of what we hear is entertainment, 10% is propaganda, and 10% is real. News shows and social media allow the most stupid guy to be heard, on par with the smartest."

Brexit may be serious indeed and almost certainly reflects the voice of the dislocated, disenfranchised and frustrated segment of British society. A similar group is also making its voice heard in the United States. This has had a worrying impact on markets and may continue to do so. But it is worth remembering that the world has been through many challenges over the past 100 years including two world wars (and countless regional ones), the rise and fall of communism, more than 30 recessions, and a dozen stock market declines of 30% or more. At the same time, over the long run, stock markets seem ultimately to have looked past the troubles and focused on the value of the underlying businesses that were building and growing profitability. Over the same period, longevity and GDP per capita have also increased dramatically across the globe.

Two speakers I have heard recently talked about two trends that are below the radar but that we should keep in mind. The Millennials (currently aged 12-31) are just emerging into the spending and household formation years of their lives. I was actually surprised to hear that Gen Y is even bigger than the Baby Boom generation (86 million vs. 78 million in the U.S.). This inexorable trend may have at least as big an impact on the economy as their boomer parents did.

Another recent commentator discussed the massive and imminent societal impact of four critical technologies: batteries, solar power, electric cars and self-driving cars. The costs of these technologies are declining precipitously and the capabilities are improving in leaps and bounds. He argues that once a technology hits a tipping point, the shift is enormous and faster than most people imagine. Think about digital cameras and how long film photography lasted (or didn't last!) once digital was introduced. He sees this starting in the next several years and argues that the industrial age of energy

Continued

WEALTH EDUCATION PROGRAM FOR FAMILIES – November 3-6, 2016

After two successful years, the University of Toronto's Rotman School of Management is once again pleased to offer the Family Wealth Management course. The 3-day intensive program for family members and family office staff will be held in Toronto on November 3-6, 2016, 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

and transportation will be substantially changed by 2030. I highly recommend watching this video by Stanford lecturer and author Tony Seba on Clean Disruption of Energy and Transportation. His introductory story comparing what *was* on New York City streets in 1900 and what *wasn't* by 1913 is remarkable!
https://www.youtube.com/watch?v=Kxryv2XrnqM&feature=youtu.be

Whether technological disruption happens that quickly or whether the demographic changes are muted by other considerations, no one knows. My point is simply this. The daily serving of news and hype that fills the airwaves, newspapers and blogs can be interesting, but can distract us from the long term perspective which, for most families, is the one that really matters.

Your Most Important and Impactful Financial Planning Input

Barrett Lyons, CPA, CA, CFP, CIM

At Northwood we spend a lot of time working with clients to get an in-depth understanding of their financial situation. As part of that, we work with them to understand their goals and then do cash flow projections to plan for the capital they will require during their lifetime and for their estate.

Cash flow projections will obviously not be 100% accurate, nor are they meant to be - ultimately life happens and the results will change based on reality. Having said that, projections are our best tool to provide 'goal posts' for planning and helping clients make informed decisions. We revisit the cash flow projections every few years based on clients' life changes.

There are only four inputs that impact the results of the cash flow projections:

1. Income – From employment or return on invested capital.
2. Expenses – For lifestyle spending or other goals.
3. Time Horizon – The amount of time one has on this Earth.
4. Other Assets - That can be converted to liquid investments to produce income or fund expenses.

A couple of these inputs are controllable while the others are not. In the last newsletter we talked about 'controlling the controllables' with respect to these inputs, but I want to dig a bit deeper on the impact of one in particular – expenses.

Each of the four inputs has an impact on the cash flow results, but by far the most important is expenses. Why?

Each dollar spent requires an after-tax dollar, and takes a dollar away from compounding growth to produce future income. Given that, the impact of increasing spending has a negative compound effect on a projected portfolio or estate. Add to that, the ever increasing cost of inflation.

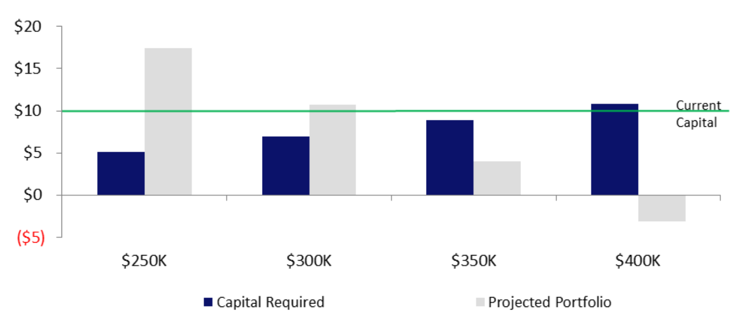
The table below shows the output of four scenarios and the 'compounding' impact of varying levels of expenses. For our scenario, assume the following:

- A 50 year old couple with a $10M taxable portfolio
- One spouse is a high-income earner, making $400K/year, while the other stays at home
- The high-income-earner will work to age 65 and the couple is expected to live to age 95
- Assume no CPP, OAS
- Portfolio returns of 5%, before fees of 1%
- Inflation of 2%

We project two results; first, the amount of capital required today, to fund their life to age 95 (at which point they will have spent their last dollar in their last breath); and secondly, the projected future value of their portfolio starting with their existing $10M balance.

Results

Spending Level	Portfolio Capital Required Today ($M)	Projected Portfolio Value at Age 95 ($M)
$250,000	5.1	17.4
$300,000	7.0	10.7
$350,000	8.9	4.0
$400,000	10.8	(3.1)



Continued

The results of the scenarios are quite interesting. In all scenarios, the couple will have sufficient capital to fund their desired lifestyle for their lifetime, with the exception of the $400K spending level (see the bar graph on the previous page), but the following are a couple of key highlights:

- The incremental capital required today for the couple to spend an additional $50K per year each year of their life is $1.9M. For instance, raising their spending level by 60% from $250K to $400K, results in more than double the capital (111%) required today to fund their lifetime spending goals ($10.8M vs. $5.1M), as you can see from the table on the previous page.
- Finally, the increased spending level from $250K to $400K also reduces the final estate value by over $20M ($17.4M vs. a $3.1M deficit), as shown in the table.

This last point demonstrates the long-term compounding cost of the incremental annual expenses. The actual difference in the sum of the future expenses between the $250K and $400K spending levels is very significant ($11.1M), but the longer term cost is much greater ($20.5M).

There is no right or wrong answer in this situation. It may be that a client wants to deplete their capital at the end of their lifetime, while others may want to maximize their estate, and we help them design a framework to achieve those goals. But the impact of expense levels is a very important input to consider in this process. Unfortunately, it's not a lot fun reviewing and compiling a year's worth of credit card statements.

Of course, it is important to sit down with a family to do a very detailed review of portfolio returns, and talk about the best performers, etc. But in fact, it is just as valuable an exercise (or maybe more so!) to sit down and review the family's bank and credit card statements.

Tips for Managing Investment Risk

Dan Solomon, MBA, CFA, CFP

Risk management plays a central role in so many areas of our lives. Sensible precautions are ingrained in our day-to-day activities. We stretch before exercising to avoid injury. We wear helmets and padding to participate in contact and speed sports. We set passwords to protect our personal data. And (most of us!) stay seated and wear our seatbelts during takeoff and turbulence.

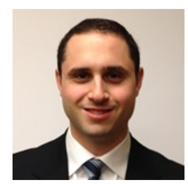
However, when families come to see us for advice on investing their wealth, we are often surprised by the amount of unnecessary risk they have taken on. For many families, the investment portfolio plays an important role in helping them meet their financial goals. Yet, a poorly structured portfolio strategy could compromise the value of their investments and their financial well-being as a result. In our experience, there are several reasons why investors take on more risk than they are required to, or can afford to. To name a few:

- Investing too aggressively, to make up for previous losses
- Getting caught up in investor optimism at the tail end of a bull market
- Chasing return from the hottest asset class
- Reacting to events that cause short-term volatility, but have no material impact in the long-run

Here are three steps that can be taken to avoid these types of pitfalls.

Identify and Quantify Your Goals

We recommend that all investors spend the time identifying and then quantifying their financial goals. It is worth the effort to specifically calculate how much you expect to spend on your living expenses over your lifetime, and how much you plan to give away during your life and at death. The answers to these questions will go a long way in helping you set the appropriate investment strategy. Quantifying these goals will allow you to establish the investment return you will *need* to achieve and reasonably assess the associated risk. Often, if a family has a large capital base, they will find that they do not need to take on a significant level of risk to meet their goals.



Focus on Capital Preservation

Many wealthy families, particularly entrepreneurs, took risk to build up their capital base. At later stages of their lives (when it would be hard to start over again), their primary objective is to protect this capital. In our years of practice, we have also learned that by employing the risk management strategy of investing first to protect capital, the family's portfolio actually ends up better off over time. The portfolios we manage for clients have historically offered significantly better downside protection when markets fall, while still capturing most of the market upside. This is a very conscious strategy and involves selecting managers with a focus on capital protection. By outperforming when markets drop, these managers need to cover less ground to recoup losses. By contrast, investment strategies that allow larger performance swings (including greater declines) have to work much harder to offset their down market losses. In fact, as losses become more severe, the required offsetting return escalates. The table on the following page in Exhibit 1 highlights the asymmetry of positive and negative returns. It was originally featured in an excellent article, 'Risk Management as Alpha Generator', by Jerry A. Miccolis and Marina Goodman of wealth management firm Brinton Eaton, in the *Journal of Financial Planning*.

Continued

For instance, if a portfolio drops 10%, it must subsequently rise 11% to get back to even. But if it drops 40%, it has to rise by 67% to recover the losses. This asymmetry works in favour of conservative, lower volatility managers (i.e. those that perform better when markets drop but can still 'keep up' when markets go up) to outperform over the long-term.

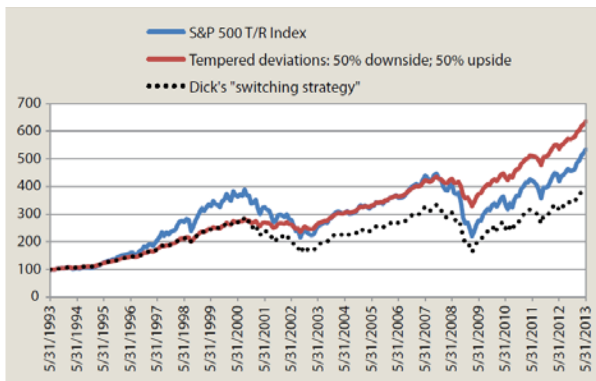
Exhibit 1: Asymmetry of positive and negative returns

Negative return	Necessary offsetting positive return
–10%	11%
–20%	25%
–30%	43%
–40%	67%
–50%	100%

Source: Journal of Financial Planning

The chart in Exhibit 2 from the same article demonstrates the long-term benefit of a risk management strategy centered on downside protection. The solid blue line represents a portfolio simply invested in the S&P 500 Total Return Index, which reflects the *'market'* return. The solid red line represents a more conservative investment strategy that captures just 50% of the market downside, but only 50% of the upside. The dotted line shows an investor that initially took the more conservative investment approach, but then became frustrated as the market advanced through the tech craze, and then switched to a *'market'* investment strategy just prior to the tech bubble bursting. You can see that committing (and sticking) to the more conservative strategy has yielded better results over time and through periods of significant market volatility.

Exhibit 2: The long term benefit of conservative investing



Source: Journal of Financial Planning

Invest for the Long Run

There is another benefit of a lower volatility investing strategy. We have also found that by experiencing less severe losses during down periods, investors do not feel the same emotional pressure to adjust their portfolios during periods of volatility. Instead, they can concentrate on the long-term, which is normally the period that matches up best with their actual goals. The recent 'Brexit' referendum is a good example. Britain's vote to 'leave' the European Union stirred up significant volatility in the global markets as investors processed the surprise. North American markets initially dropped significantly, only to completely rally back in a matter of days. There were surely investors that sold into the panic, crystalizing losses and missing the upside as markets quickly recovered. Because of our conservative low volatility investing style and a rigorous focus on the long term goals of our investors, during the turmoil we (nor our clients) never felt compelled to make a kneejerk sell decision based on the noise of the day.

As Warren Buffet has often said "Investing is simple, but it is not easy." It requires a dedicated effort to avoid risk while still participating in growth assets. Our experience shows us that above-average returns will be a natural outcome of a proper risk management process.

Sudden Wealth

Some Guidelines for Dealing with this Dramatic Change

Andrew Jeffery, CPA, CA, CLU, CIM

As an avid hockey fan, I found myself glued to the TV June 24th to watch the 2016 NHL draft. This year was particularly exciting as my beloved Toronto Maple Leafs used the first overall pick to select Auston Matthews, a highly touted and big bodied Centre that is already drawing comparisons to some of the current NHL elite. And while only time will tell if Matthews can live up to the hype, it's certainly a good reason to be optimistic about the future of the Blue and White.

For professional athletes being drafted first overall in their respective sport is an incredible achievement. Just as significant are the financial rewards that come with it. Large signing bonuses and seven figure endorsement deals transform these young athletes into multi-millionaires overnight – a term we refer to as 'sudden wealth'.

What is Sudden Wealth?

Sudden wealth is not just a phenomenon in professional sports. It can come in a variety of other forms. Some of the more common sudden wealth events we see are the sale of a business, receipt of inheritance or life insurance proceeds, winning the lottery, and the vesting of stock options. And while these events are very different in nature, the end result is the same – an individual or family get a

Continued

significant amount of wealth in a very short period of time.

To most people, the idea of receiving a significant sum of wealth is very positive. And while this is often true, sudden wealth can also bring an entirely new range of stresses, emotions, and complications to a person's financial and social circumstances. In fact, it's common to feel anxious or isolated as a result of the wealth and some can even come to resent it. For this reason, it's essential that these individuals take steps to help them come to terms with their new wealth and implement a plan to ensure its successful management for the long-term.

The First Six Months

The first six months following a sudden wealth event are easily the most critical, as it is the period where the most long-term damage can be done. Impulse purchases, lifestyle changes (like quitting your job), or immediate gifts to friends and family, can all start you down a road you may not be able to recover from.

Our advice to avoid these mistakes? Give yourself time to cool down and adjust to your new circumstances. For at least 3 - 6 months, leave the windfall in cash, carry on life as usual (to the extent you can), and only access the funds to pay off consumer debt or taxes. An exception could be taking a family holiday or other memorable experience, but is it important that no significant funds be spent during this time-frame. This cool-down period is essential to allow you to gain a degree of comfort with your new wealth, deal with the new emotions, and surround yourself with the right team to help manage the wealth successfully.

Build a Team

Prior to a sudden wealth event, most individuals are capable of handling their financial affairs on their own. However, the receipt of significant wealth represents a change in one's financial circumstances that often signals the need to engage outside professional advisors to help them understand the impact of the wealth and how it can be structured to best suit their needs.

At a minimum the following are the key advisors that should be consulted:

- Accountant – an accountant will identify if there are any tax implications associated with the receipt of the wealth and will structure your affairs to minimize the family tax burden as the wealth is utilized.
- Estate Lawyer – an estate lawyer will update your wills to reflect your new circumstances and ensure your wishes are represented should you pass away. This is especially important if there are dependent children that need to be protected from receiving significant wealth at too early an age.
- Financial Planner – a financial planner can help you understand what the wealth means in terms of allowing you to live the lifestyle you want. Ideally, they will help you understand what various large purchases, spending levels, and investment returns will have on your ability to live the life you want in relation to your new wealth.
- Investment Manager – an investment manager will develop an investment strategy and construct a portfolio that will provide you the greatest opportunity of achieving the rate of return required to meet your financial goals and objectives.

The above is not an all-encompassing list, as every family's circumstances are different. Additional advisors such as insurance, philanthropy, and even family coaching, might also be beneficial to a family's unique situation. For some families, a family office will be a good solution to manage all aspect of their wealth and family issues in a comprehensive manner.

Our advice to finding the right advisors is to take your time and do your homework. Ask for referrals from people you trust, check references, and interview multiple advisors before choosing. The goal is to partner with an advisor and firm that will be with you for the duration of your lifetime and in many cases your children's lifetimes as well.

Define Your Goals

According to a joint study performed by the University of Kentucky, University of Pittsburgh, and Vanderbilt University, the rate of lottery winners filing for bankruptcy within 5 years of winning is double that of the general population. This is a staggering statistic that highlights the fact that many people who receive sudden wealth are unprepared and fail to understand the long-term repercussions of poor short-term decisions.

Our experience has taught us that the best way to avoid falling into this trap is to gain a solid understanding of what you want to accomplish with your wealth by defining clear financial goals. The following is an example of what those goals might be for a typical family:

- We would like to plan to spend $200,000 per year for the rest of our lives
- We would like to pay for our children's education and help them finance major life events such as marriage and the purchase of their first home
- We would like to give $50,000 to charity each year and become more active in the community
- We would like to travel and pursue new hobbies

In addition to defining your goals, it is important to quantify them to determine how much of your current wealth is required to satisfy them. For example, if you're 50 years old and want to spend $200,000 per year until age 95, you will require approximately $4,900,000 of your current wealth (assuming a 3% net annual return is earned) in order to satisfy your spending goal. This is important information to know if you are considering making a large purchase that would require the use of your wealth and could potentially jeopardize your ability to support your lifetime spending.

Continued

Stay the Course

Managing sudden wealth to achieve long-term financial goals is no small task. It requires the ongoing involvement of the family and their advisors to navigate the economic, regulatory and relationship changes that are inevitable to occur over a lifetime. With that said, sudden wealth represents an opportunity for families to make a positive change in their lives and should be celebrated, enjoyed, and shared.

Who is Northwood Family Office?

Northwood Family Office is an independent, privately-owned boutique family office which provides comprehensive Net Worth Management™ to wealthy Canadian and global families. Northwood clients have significant family net worth, typically in the $10 - $500 million range. The firm acts as a Personal CFO or Chief Advisor to client families using a dedicated team of professionals who oversee and manage their integrated financial affairs. Northwood Family Office is Canada's leading independent multi-family office and has consistently been ranked the '#1 family office in Canada' in the *Euromoney* Global Private Banking survey. For more information, see our website at www.northwoodfamilyoffice.com or contact Tom McCullough for a confidential conversation at tm@northwoodfamilyoffice.com.

NORTHWOOD FAMILY OFFICE

For more information, please call Tom McCullough or Scott Hayman at

Main: (416) 502-1245
www.northwoodfamilyoffice.com

Email: tm@northwoodfamilyoffice.com
sh@northwoodfamilyoffice.com