The Skorina Letter

News, Interviews, Research for Institutional and Family Office Investors

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The Affluent-family Pro

A conversation with Stuart Lucas: wealth manager, educator, and family scion

Stuart Lucas has double-barreled credentials as a wealth manager.

He's a Harvard MBA who worked for years with top-shelf financial firms including Wellington Management Company and Banc One (now JP Morgan Chase), where he led their Ultra HNW unit.

And, he is himself an heir to family money by way of his great-grandfather, E. A. Stuart, who founded the Carnation Company. In 1985, the closely-held business was sold to Nestle, and the proceeds were distributed among Mr. Stuart's descendants.

In 2004, Mr. Lucas merged his professional and personal worlds by founding Wealth Strategist Partners, which continues today as the investment advisor to his and selected other family offices.

He has gone on to design and lead a Private Wealth Management executive education program, designed specifically for wealthy families at the University of Chicago Booth School, now in its 12th year. And, as an adjunct professor, he has taught a Wealth and Family Enterprise Management course at the MBA level.

All this experience has also been distilled into his widely-read book, Wealth: Grow It and Protect It, for general readers; and into academic-quality papers for The Journal of Wealth Management.

We're delighted that he made some time to talk to us.

Keeping it in the family

It is better to have a permanent income than to be fascinating.
- Oscar Wilde

Skorina: Stuart, you've focused on high-net-worth families and their money for decades as a practitioner; an academic; and even personally, as a member of an extended, affluent family. You probably know as much about this stuff as anyone in the business.

Where do you begin with a new client who has to deal with all of this for the first time?

Lucas: Charles, it's true I've been doing this for quite a while, but no one knows everything about it. I learn something new every day.

A family office with significant wealth has many moving parts. There's money-management per se, which you focus on; and it's crucial.

But, there are also the structural, legal, and tax issues. And there are opaque but vital intra-familial and cultural issues that have to be dealt with. They're all important, and all inter-related.

The laws and tax rates keep changing, so do markets, and so do the families themselves. We try to design and execute an integrated strategy that balances all these elements.

Skorina: So, how do you start the conversation with a new client?

Lucas: When we sit down with a family who's thinking about hiring a wealth manager or setting up a family office, my top discussion points are:

1. What do you want to *accomplish* with your wealth?

2. What's the right *structure* for managing your family money? How will it be governed?

3. How will your family members be *educated* about their wealth and held *accountable* to each other?

4. Do you understand that *taxes affect everything*? Tax-planning is critical for wealth-preservation.

5. You *will need help*: a wealth advisor, an attorney, an accountant, and perhaps a family-office or outsourced chief investment officer.

The first - and foundational -- question to answer is: *What do you want to accomplish with your wealth?* A sense of purpose is as important in managing family money as it is in managing a business or any other human enterprise.

And it helps to weld a family together. To keep them engaged, they must find a balance between their common and individual needs.

Entropy never sleeps

Nothing in life is certain except death, taxes and the second law of thermodynamics.
- Seth Lloyd

Skorina: I think most people assume that the object is just to preserve the family's principal; don't spend more than your expected ROI, and you'll be fine. You seem to be saying it's a lot more complicated.

Lucas: It's entropy, Charles. And entropy never gives up.

Skorina: That's physics, though; not finance.

Lucas: Wealth is a form of order, and entropy attacks order of any kind.

Families expand over time, and outsiders with different views marry into it. Larger, more diverse families can lose their cohesion if they don't fight to keep it.

Members start to focus more on their individual needs and lose the delicate balance between individual and common goals.

When the family is coherent, wealth management benefits from focus and scale.

But when a family loses coherence the number of pools and strategies tends to multiply. Returns are harder to get. And, staying ahead of the taxman becomes impossible.

Skorina: So how does an UHNW manager beat entropy?

Lucas: Decades ago, when I first started thinking seriously about this, I realized that the fortune my great-grandfather had made four generations back, wouldn't last four more generations on a per-person basis.

Given the scattering among trusts, the after-tax returns we could realistically expect, and the growing number of inheritors; the math didn't work.

You can't beat entropy, but you may be able to fight it to a draw for a few more generations. You do it by capitalizing on the family's scale of financial wealth; and by using all of their assets, financial and non-financial.

Each member of each generation, on average, has to produce enough value through their own careers and businesses to supplement the returns on the inheritance.

The family wealth engine includes getting a good return on inherited money. But it also has to include the energy and talent of each succeeding generation, all coordinated with realistic spending limits.

If you can do that, then you might be able to stay ahead of entropy. But, it's not easy.

Skorina: I see your point. But, how do you go about developing a plan of action? And, from my perspective as someone who recruits chief investment officers, what should CIOs be aware of when joining a family office?

I'm thinking of a conversation I had recently with a former university chief investment officer.

This CIO has an excellent record, great credentials, and lots of experience, but went through a steep learning curve stepping into a new position as family office investment head.

I think anyone considering a family office CIO role should read your book!

Lucas: Thank you for the shout-out Charles.

My advice for a new family office CIO is to remember that managing family wealth is *different*.

Successful pensions, endowments and foundations pay no taxes, and usually operate as single pools of capital. Their legal structure, with formal lines of authority and goal-setting processes, usually produce a clear mission.

The key to a productive family office is to maintain focus in the face of fragmenting assets and multiple agendas.

You fight those things with structure and planning. You need patience, diplomacy, and listening skills. And a lot of discipline.

We've studied wealthy families and taxable investing for decades. And, we've developed frameworks and data to create a structure and planning on a bespoke basis.

Making it, then growing and protecting it

Every new beginning comes from some other beginning's end.
- Seneca the Elder (54 BC - 39 AD)

Skorina: In your book, you talk about the difference between managing money and managing other types of businesses. What did you mean by that?

Lucas: As you pointed out in your last newsletter on family offices, most highly successful people have made their money by building (and selling) companies.

They showed outstanding entrepreneurial skills as they built their business, and they often feel confident that these skills are transferable to managing their new, liquid wealth. But they're usually wrong.

When I talk to a client I try to highlight the difference between managing a business and managing capital.

Long-term investing, looking a generation or more ahead, demands a different mindset. Patience in the face of market volatility is a virtue that is hard to learn and the consequences if you don't can be very expensive.

Skorina: Are these some of the issues you discuss in your University of Chicago courses?

Lucas: It's an intensive five-day course, so we cover a lot of ground.

I encourage my students and prospective clients to educate themselves from as many sources as possible, including the Chicago Booth course.

Our goal is to help participants develop a plan to manage their family enterprise strategically, comprehensively and with discipline.

We talk about how to set strategic vision, build a good accountability system, and how to align interests and delegate tasks.

We also speak with them explicitly about family culture. A family's cultural assets are every bit as important as their business and financial assets.

In one session we explore what it's like to run a wealth advisory business.

My time at Bank One was very helpful in this regard. They hired me -- *after* our family replaced them as trustee of our family trusts! - to build their high-end business. They wanted me to do for their HNW clients what I had done for our family.

Joining the bank put me in the middle of trying to grow and run a profit center for a bank while also optimally serving clients.

Managing those conflicts was a real challenge and, in my view, remains one today for many institutions.

One reason for putting this session in my course is that the better families understand these conflicts the better they can protect their own interests.

Skorina: These conflicts you're referring to, can you give me an example?

Lucas: Here's one example. Customer service representatives at the major wealth managers are very good at their jobs. And their job is to make money for their employer. We emphasize to our students and clients that it's a good idea to keep the economics in mind.

My business partner makes an important observation. When you manage your own business, you get up every day thinking about how to serve your customers more effectively.

But when your wealth and wealth creation shift to financial assets and investment management, you become the customer.

That shift from "how can I best serve?" to "how can I best be served?", can have an insidious and corrosive effect on a family's financial and cultural assets, particularly over generations.

The point is that without a clear understanding of such conflicts, there's a real danger that family members can become passive and disengaged from the governance and investment of their financial assets.

Build, borrow, or buy: who should manage the money?

Investing should be more like watching paint dry or watching grass grow. If you want excitement, take $800 and go to Las Vegas.
- Paul Samuelson

Skorina: When I have a call from a potential UHNW client, they usually have a half-billion or more in investable assets. With money on that scale, they can realistically think about establishing a full-service family office, including a professional investment manager.

What are the pros and cons of an internal office versus an outsourced solution (an OCIO or separate-account provider)? In other words, the build-versus-buy decision?

Lucas: Hiring a chief investment officer suggests that the family office is going to be predominantly a profit center, not just a service or administrative office.

Making the right hire is critical and it's not the place where you want to skimp on talent to save a few bucks.

Building a family investment office means you are prepared to design and manage a profitable business, one that is likely very different from the one that built your wealth in the first place.

Skorina: Fortunately, I am here to help!

Lucas: And we all appreciate that, Charles!

And, so are we at Wealth Strategist Partners. We are tightly focused on serving large-scale taxable families, and we have the experience and expertise to do it effectively.

Families can outsource certain functions, including investing, and remain responsible stewards of their wealth.

A good family-office CIO -- whether in-house or outsourced -- will add many times the value you pay him or her in after-tax investment results.

Taxes and estate planning affect who and what to invest in, how to structure trusts and pass on wealth to the next generation, how and when to engage in philanthropy, even where to live. It's all connected.

One other thing: conflicts of interest. An internal chief investment officer, by design -- especially with a creative compensation package -- is not potentially conflicted.

If a wealthy family goes the outsourced CIO route, they should work to minimize conflicts.

At WSP, we are principals serving principals; we are paid only by our clients and our fees are transparent.

The taxman cometh. And stayeth

Taxation with representation ain't so hot either.
- George Barzan

Skorina: Stuart, you've emphasized the difference between managing taxable versus non-taxable money. Can you put some meat on that?

Lucas: It can get pretty technical, but here's an example from an article I wrote a while back, **Lucas** and **Sanz**, The 50% Rule: Keep More Profit in Your Wallet (2017). It highlights the tax drag on family investment returns, something a nonprofit wouldn't have to consider.

Let's say a family office sets a 5 percent return target on investments, net of fees and taxes.

What kind of investments make sense when you are constrained by taxes?

We found that typically an index fund must generate 6.8 percent before fees and taxes, an actively managed mutual fund 8.8 percent, a private equity fund 10.2

percent, and a hedge-fund manager 12.9 percent, respectively - all in order to meet the family's target of a net 5 percent return.

"Active" management means that managers are routinely buying and selling marketable assets - either in pursuit of better returns, or just to rebalance and track their index.

But since most of those transactions are taxable events, they generate "tax drag" which reduces after-tax returns to the family-office investor.

The IRS wants their money now. That means draining cash out of the portfolio to pay taxes. And that reduces the assets you're trying to grow.

It's stating the obvious, but the money you pay out in taxes cannot continue to compound in value for your portfolio.

Also see: **Lucas** and **Sanz**, Pick your battles: the intersection of investment strategy, tax, and compounding returns (2016).

Skorina: You're pointing out, of course, that it's very hard to make a pre-tax 10 to 12 percent consistently, year after year, if that's what you need to generate an after-tax 5 percent return.

Lucas: Exactly. Active management increases tax drag.

We analyzed the performance of the stock market over a 20-year period, adding assumptions on taxes.

We concluded that an active equity manager will have to outperform his or her tracking index by 1.2 to 2.5 percent to generate the same net return as the index.

Skorina: Here is a related point. Standard & Poor's recently reported that only 1.43 percent of all domestic mutual funds investing in stocks were persistent top performers for five straight years through September 2018. That's not encouraging.

Lucas: But wait, it gets worse! We all know that diversification is essential. It's investment dogma, the holy grail. Therefore, most asset owners invest with more than one external manager.

And, since managers specialize in different asset classes and different strategies, the number of external managers in a portfolio tends to proliferate along with diversification. That has important implications for taxable money.

Take active mutual-fund managers for example, for whom there are a lot of available data. We assumed in our article that, best case, one in seven managers can beat the S&P 500 after taxes - that's a more optimistic assumption, by the way, than the S&P study you cited.

What does that mean? For every additional active equity manager a HNW family (or its CIO) picks, the odds of their overall portfolio out-performing the S&P after taxes - which are already slim -- drop dramatically.

If you hire one external manager to beat the S&P, the odds of succeeding in that part of your portfolio are 1/7. If you hire a second one the probability is 1/7 x 1/7 = 1/49. That's about 2 percent. That's just basic probability theory.

How about finding three, or four? The math says that the odds of getting acceptable after-tax returns by actively managing your core equity allocation are terrible. In developed economies, public markets are pretty efficient and, as we've seen, hard to beat.

We advise our clients to index their core public equity exposure. Coupling that with properly structured tax-loss harvesting, they can lower the tax drag from active management in less efficient markets where the odds of success are better.

Skorina: So, from a marketing standpoint, it's no wonder so many hedge funds and private equity firms tailor their offerings to the pension and E & F group.

Lucas: To be blunt, Charles, active managers in general, including most hedge funds and real estate funds, and even some private equity funds are not appropriate for individuals and families.

That's the bad news. The good news is, knowing that, we can target our analytical resources on those niches where the odds of success for taxable family assets are materially higher -- investment strategies and tax-efficient structures that optimize after-tax, dollar-based returns.

We believe in buy-and-hold; after all, my family deferred our tax bill on Carnation Company for 86 years. There was a lot of value in that and I've learned from that example.

At WSP, we focus on concentrated, low turnover, long-only, actively managed strategies in less efficient markets, with incentives that are strongly aligned with client results.

We manage for asymmetric return profiles and multiple ways to add value. Every client's core equity portfolio is indexed, with a tax-loss harvesting overlay.

This approach may incur more volatility in the short term, but we believe it offers greater potential to maintain and grow wealth over the long term.

Family enterprises are each unique, but they do rhyme

Your profession is not what brings home your weekly paycheck, your profession is what you're put here on earth to do.
-- Vincent van Gogh

Skorina: Why did you decide to go down the path of managing the assets of individuals and families? You could have managed institutional capital, or maybe something entirely different.

Lucas: Managing wealth for families and individuals is a calling, and it's personal.

When the Carnation Company was sold, the Stuart Family did not develop a plan for how to manage prospectively. As a result, entropy took over: each family group took their share of the proceeds and went their own ways.

Outcomes have varied a lot, both financial and personal, and we lost forever any commitment to shared purpose.

A decade later, I started to see similar patterns emerging with the Lucas family: my siblings and parents. That's what drove me to join our family office, redesign it for long term success, and over time, to become a student of multi-generational family enterprise management.

Rolling the clock forward to today, we're working with a family enterprise now that has an operating business with nearly a billion dollars in revenues, as well as hundreds of millions in financial assets.

It has an 80-year-old patriarch and members of the next two younger generations figuring out what the family enterprise, including the family business, should mean to their futures, professional and personal.

Over the next 3 to 5 years they have critical decisions to make - literally, their clock is ticking.

Who is going to lead the family? Will the business be run by a family member or "professional management"? In either case how will they orchestrate the transition in management and in governance?

As financial assets grow will they remain an anchor to windward or become the jet fuel for future growth? What are the investment management implications?

Helping this family -- my family -- and others like them to make and execute these critical decisions is our life blood.

We are experienced, successful investors and we understand tax and estate planning. As importantly, we work and think strategically across the business, financial and cultural dimensions of family enterprises.

Family enterprises are each unique, but they do rhyme. We are students of their shared characteristics and their differences. We've studied their patterns. We know how to help them as they continuously evolve.

If this family makes right decisions in the next few years, and I think they will, they are going to flourish for additional generations. Stay tuned....

Thank you, Charles, for taking the time to speak with me.

Skorina: My pleasure, Stuart. It's been fascinating.