The International Family Offices Journal

Editor: Nicola Saccardo

September 2023 • www.globelawandbusiness.com

STEP ADVISING FAMILIES ACROSS GENERATIONS

Globe Law and Business

The International Family Offices Journal

Contents

Volume 8, Issue 1, September 2023

Welcome to the 29th issue of The International Family Offices Journal!

Nicola Saccardo

Welcome back from the summer break and to the 29th issue of *The International Family Offices Journal*. We have another excellent selection of articles in this issue for your consideration. The return after the summer months often has a back-to-school feel for both families and professionals in the family office space, as we look to the challenges and opportunities ahead.

This issue includes interesting insights on family enterprises. Jill Barber, Torsten M Pieper and Greg McCann examine dynamics affecting family enterprises and those who serve them, including the assumptions that can hurt the dynamics and distract from the fulfilment of a family's desires. In his article "Why does family governance fail?", Dominik v Eynern looks at the importance of family governance and why family systems are more prone to behavioural risks than non-family businesses.

Barbara Ruth Hauser and Winnie Qian Peng focus on how traditionally Western-facing family offices might be tailored to meet Eastern values. They explore research undertaken by the Bank DBS Singapore and set out a thought-provoking new family office model, drawing on Confucian values from the East.

On the other side of the world, we focus on Spain. While Spain has not traditionally been thought of as an attractive jurisdiction for high and ultra-high-net-worth individuals, Florentino Carreño and Beatriz San Basilio of Cuatrecasas in Madrid, set out details of why it is a more favourable jurisdiction than people might initially assume. They focus on the 'impatriates regime', introduced for those moving to Spain for employment or investment purposes, and its interaction with other taxes.

> *As family offices grow and become more sophisticated so do their requirements for the families they serve.*

How to engage with families on environmental, social and governance (ESG) factors is the focus of Shelly Meerovitch's article, where she draws on her experience in this space. She looks at how to integrate ESG factors when the outlook of family members to such matters can vary significantly, with a focus on the Investment Policy Statement as a key tool.

The use of private trust companies is something we see more and more in the family office sphere. A new Swiss alternative has entered the market, the dedicated trust company (DTC). Jessica Schaedler introduces this structure and provides a helpful comparison of PTCs and DTCs in the Swiss environment.

Litigation in and around wealthy families continues to be an important topic and provides lessons for those advising them. Marcus Parker and Judith Swinhoe-Standen look at recent litigation trends focusing on mental capacity and the restructuring of trusts in the UK context. They go on to examine conflicting global cases focusing on the use of trust powers for improper purposes.

As family offices grow and become more sophisticated so do their requirements for the families they serve. Christian Stewart explores the role of a chief learning officer (CLO) and how they can add to family offices and human capital of the families they serve. This article explains the purpose and function of a CLO.

Tsitsi M Mutendi then builds on earlier articles she has written for the Journal on diversity and the challenges raised by more global families. In her latest article, she looks at multigenerational family environments and how these result in constant flux for families and those who advise them. Her article includes an interesting case study for our consideration.

Lastly, Rebecca Eastmond and Peter Goddard draw on their vast experience of working in the philanthropic space to look at how to develop a successful philanthropic strategy. Including a discussion by Peter of his responsibility for a new foundation focusing on mental health.

The Journal closes with the usual highlights from the recent STEP News Digest.

To conclude, I am pleased to report that the third edition of the book *Family Offices: The STEP Handbook for Advisers*, edited by Barbara H Hauser and myself, has just been published by Globe Law and Business. We would like to thank all the contributors.

Building bridges – how finding common ground in responsible investing can unite generations

Shelly Meerovitch

As investors increasingly consider how environmental, social and governance factors can impact their investments, responsible investing has attracted growing attention. However, there is also a growing generational divide when it comes to responsible investing, with younger family members often more engaged than their elders. This divide has the potential to cause family strife, but it can also be an opportunity to come together and engage constructively on the topic. By finding common ground through a more nuanced exploration, families can build bridges across generations and write the script together for responsible investing.

This article will address the importance of a common language and effective governance in facilitating constructive dialogue and decision-making around responsible investing. Ultimately, it will provide practical guidance for family offices and stakeholders looking to navigate the complexities of responsible investing while building stronger, more cohesive families.

Growing pains

Many families have long understood that environmental, social and governance (commonly known as ESG) factors can impact both a company's stock market price as well as society more broadly. But family members can vary significantly in the approach they seek to take when incorporating ESG factors into their investment portfolios.

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Recently, ESG investing has survived a challenging year, with increased regulatory scrutiny and rocky performance providing fodder for fierce debate. For some, the turmoil that comes with rapid change can be unsettling, while others see it as a sign that responsible investing is no longer in its infancy stage.

Despite growing pains, responsible investing is not going away. On the contrary, net zero commitments are expected to drive growth in ESG assets, and shareholder activism around ESG continues to rise. Changing consumer preferences also play a role. Around one-third of millennials often or exclusively use investments that take ESG factors into account – compared to 19% of Gen Z, 16% of Gen X and 2% of baby boomers, according to a recent survey.[1] As millennials enter their fourth decade, the pressure on multi-generational families to integrate ESG in their investments will likely intensify.

As families consider their stance towards responsible investing, it is important to acknowledge that family members may have different expectations for the allocation and use of shared assets. These disparate views can be further complicated by geographic dispersion, among other factors. As a result, family offices and the families they serve need guidance and clarity to navigate potential divides.

Competing perspectives create an opportunity for stakeholders to engage in constructive dialogue early on and work together to develop a playbook for ESG investing. This includes settling on a common nomenclature and terminology, creating diverse ESG-focused return streams designed to enhance long-term return potential, adhering to regulations, and incorporating a governance strategy that instils clarity and transparency around decision-making and implementation. Codifying a clear process in advance will become even more critical for when stakeholders are not aligned in the future. By collectively establishing a shared vision for responsible investing, families can build stronger, more cohesive relationships while ensuring that their investments align with their values and goals.

Stakeholders must speak the same language

To foster a more nuanced discussion of responsible investing, stakeholders must first speak the same language. Indeed, the recent wave of regulation and heightened investor awareness around greenwashing underscores the need for clear definitions and transparent disclosures. As significant asset owners, family offices and the families they serve have an opportunity to work alongside asset managers, regulators and policymakers to help address ambiguity and confusion in defining ESG integration and other responsible investing practices.

There is a spectrum of responsible investing strategies, but we can try to distil them into two major categories – ESG-integrated and ESG-focused. By establishing a common nomenclature and terminology, families can ensure that they are all on the same page when evaluating or engaging with different investment approaches. This will facilitate constructive dialogue and decision-making, and help to build stronger, more unified families.

Defining ESG integration

Integrating ESG involves identifying financially material ESG issues and then researching and assessing their impact on business and financial measures, such as revenues, margins, cash flows, valuations and cost of capital. Investors must then determine whether the associated risks and opportunities have been priced into the issuer's valuation.

For example, if a portfolio is considering investing in an industrial company whose factories emit a lot of carbon, what will it mean for the business and the return to investors? The investment team must research and consider the impact on the company of potential carbon taxes or pollution regulation on future capital expenditure requirements, or the market share impact of a competitor developing a lower-carbon substitute.

In other words, an investor integrating ESG considerations may identify an ESG issue as financially material because it highlights a future financial risk for the company (eg, a fine or lawsuit) or because it may put the company at a financial advantage (eg, if the company outperforms its peers in managing the issue by creating industry-leading practices). Ultimately, the investor evaluates a company's ESG-related performance *in conjunction with* traditional financial metrics and valuations before deciding whether the inclusion of the specific security will enhance the overall financial performance of a portfolio.

Notably, ESG integration does not prohibit ownership of issuers or industries. The goal of ESG integration is to make better-informed financial decisions rather than to exclude investments.

From climate change to forced labour to discrimination and diversity, ESG factors represent material investment risks and opportunities that can inhibit or encourage the creation of long-term shareholder or bondholder value. Effective ESG-integrated portfolios require a rigorous approach to documenting how ESG issues are considered throughout the investment process. Though third-party ESG research providers like MSCI or Sustainalytics might provide useful data and assessments to inform ESG discussions, they have limitations. Investors should supplement third-party rating tools with proprietary research to develop a broader understanding of ESG risk characteristics and opportunities. This approach allows portfolio managers to be forward-looking and less reliant on historical performance.

Defining ESG-focused strategies

While ESG integration is essentially a security selection tool without regard to an investee company's underlying mandates (ie, the company does not need to pursue a social or environmental objective), ESG-focused strategies are different. They have specific ESG themes, such as focusing on issuers with improving ESG practices or investing in companies that are providing climate solutions, in addition to their ultimate goal of optimising risk and return. The various approaches to ESG-focused strategies can be organised into a common taxonomy, for example exclusion, best-of-breed tilting, thematic investing and impact investing.

Exclusion

The practice of excluding certain issuers or sectors from an investment portfolio, which investors may choose to do for a variety of reasons, such as regulatory restrictions, or to meet specific investment criteria. For example, an investor may choose to exclude investments in certain industries such as

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alcohol, tobacco, weapons or fossil fuels. This may also be referred to as a negative screening approach.

Best-in-class
As adapted within responsible investing over the recent past, best-in-class is a term used to describe a company that is a leader in its sector. Within the context of an ESG-themed portfolio, adopting a best-in-class approach typically includes or overweights issuers that are highly rated in terms of their ESG risk profile, credentials and ratings.

Thematic investing
This is a top-down investment approach that focuses on investments in one or more themes chosen by the investment manager to target returns. ESG thematic investing typically revolves around specific social or environmental categories – such as health, climate change or empowerment – that the manager believes will deliver financial returns. Sub-themes can further hone investment opportunities. For instance, sub-themes within climate change might include cleaner energy generation or resource efficiency.

At times, themes may align with frameworks such as the UN Sustainable Development Goals (SDGs), which aim to address areas of critical importance to humanity.

Impact investing
Impact investing identifies and measures both financial return/risk objectives and social and/or environmental impact objectives. Impact investment strategies may be private or public, for example, funding specific projects – such as schools or hospitals – or aligned with a specific theme, such as clean water. A key tenet of this approach is the ability to both demonstrate and measure impact.

Moving beyond controversy
Many believe that ESG integration is simply good investing. However, while few investors would oppose ESG-integrated strategies, not everyone shares the desire for ESG-focused strategies. And just as investors do not have to own every style box, they don't need to own every – or any – segment of the ESG-focused investment spectrum.

Families who are considering ESG-focused strategies want to ensure they will not sacrifice return potential. Indeed, the historical link between ESG-focused investing and alpha generation is relatively short and has been erratic. ESG-themed portfolios generally outperformed the broader market in recent years, especially as many were overweight large-cap growth stocks. But in 2022, as tech stocks slumped and fossil fuels rallied, many ESG-focused portfolios underperformed.

This seems to indicate the need to develop complementary ESG-focused strategies that do not rely on any single source of beta. As with any asset allocation, investors should consider a variety of equity styles, alternatives and fixed income to diversify ESG-focused return streams. Further, investors should not be limited to investing in companies when sovereign debt and real and securitised assets can also pull ESG levers.

Amid shifting regulations, consumer preferences and competitive landscapes, family offices and their stakeholders must continue to engage constructively in conversations around ideas fundamental to responsible investing: regulations, common parlance, robust frameworks, differentiated return streams, and more.

Family governance around responsible investing
Effective communication through shared terminology is vital for reaching a family consensus on an appropriate investment approach. But once an agreement is reached, family governance integrated with the family office can provide a framework for joint decision-making based on shared values and a common mission. Well-crafted investment governance captures the family's financial objectives – including responsible investing preferences – and drives a strategy for their assets. Incorporating family values into the investment strategy can create an impactful experience, strengthening connections and engagement among members and with the overall wealth enterprise.

Creating a governance framework requires accord among family members who may have different expectations for the allocation and use of family assets. These challenges often become more pronounced as family members disperse geographically and generational inclinations toward certain investment approaches emerge. For these reasons, documenting decisions – once agreed upon – becomes even more important.

Families evolve, as do investment opportunities in general and the universe of responsible investing strategies in particular. Families who include rising generations in the investment conversation can better ensure continuity in the stewardship of assets across generations. For example, routinely reassessing shared values allows families to incorporate insights from the rising generation who will lead and manage the family office one day. Through active dialogue, younger generations might suggest incorporating impact investing in the overall strategy, which may not otherwise occur to older generations. Giving next-generation members a voice, working through differences, and finding alignment can ensure more unified decision-making and a more satisfying investment experience.

First steps – effective tools

Setting priorities

Understanding the family's purpose and values – whether preserving long-term wealth, generating risk-adjusted returns, or making an impact – is the first step to fleshing out the governance required to keep both the family and family office intact. By reflecting on 'Who are we as a family?' and 'What is the purpose of our wealth?', families can begin identifying the values that unite them. Family values set the tone for how the unit thinks, feels, assesses and acts.

Establishing family values begins with each member prioritising what is most important – the tenets that motivate and guide personal decisions. A deep understanding of these personal values gives the broader unit a springboard for discussions. When it comes to responsible investing, several questions can help tease out key ideas:

- What environmental, social or governance issues are important to the family?
- What kind of impact does the family want to have and why?
- Does the family want to reduce risk, avoid exposure to specific activities or invest in companies developing solutions to important societal issues?
- What is the geographic scope of the family's concerns? Is the family targeting global themes, or wishing to make a difference closer to home?

Notably, a family's shared values are not meant to replace or overshadow individual ones. They are about finding alignment and establishing a shared family purpose that still honours each member's independence. A shared sense of purpose and values representing both the individual and collective mindset enables more cohesive decision-making.

Investment committee

With the family values guiding the family office operations, the need for more formalised investment decision-making often emerges as families become more complex. In those instances, an investment committee accountable to the board of the family office is usually formed to focus on investments and guide the strategic direction of the family's investment portfolio. The committee aims to synthesise disparate opinions and execute on finalised decisions – including those related to responsible investing.

There are many approaches to forming an investment committee to fit a family's needs. For instance, investment committees often consist of more non-family professionals who lend expertise, objectivity and accountability. Whether through an investment consultant hired by the family office, or reflected through the composition of the investment committee, having an impartial viewpoint and bringing forward expertise in the investment arena can be a key driver in the investment process. Keep in mind, an investment committee may only suit certain families. Other options include delegating investment decisions to the board of directors, trustees or a third-party investment adviser.

This extract from the article 'Building bridges – how finding common ground in responsible investing can unite generations', by Shelly Meerovitch, is taken from the 29th issue of *The International Family Offices Journal*, published by Globe Law and Business.

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ISSN 2398-5402
9 772398 540000

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