Family Wealth
Keeping It in the Family
by James E. Hughes Jr.

The largest intergenerational transfer of wealth in history will occur over the next five decades and much of it will happen in the next twenty years. This fact naturally brings about many questions about how we can safeguard and grow our own family wealth.

Since the 1970s, James E. Hughes Jr., a prominent expert on family governance and on estate and trust planning, has been helping families preserve and grow their hard-earned assets. In Family Wealth: Keeping It in the Family, Hughes shares his years of experience, shows us how we can avoid some of the most crushing mistakes people make, and helps place our future generations firmly on the path of enduring wealth.

Hughes tells us that families need to realize that their wealth is not self-perpetuating and without careful planning and stewardship, a hard-earned fortune can easily be dissipated within a generation or two.

The phenomenon of the fleeting family fortune is so well recognized that it inspired a proverb, "Shirtsleeves to shirtsleeves in three generations," which describes this cycle:

- The first generation starts out working manual labour, receives no formal education, and through very hard work, creates a fortune while maintaining a frugal lifestyle.
- The second generation attends university, wears fashionable clothes, has a mansion in town and an estate in the country, and eventually enters high society.
- The third generation’s numerous members grow up in luxury, do little or no work, spend the money, and fate the fourth generation to finding itself back doing manual labour again.

It's a classic three-stage process: first, a period of creation; second, a period of stasis or maintenance of the status quo; and third, a period of dissipation.

In Family Wealth: Keeping It in the Family, you will learn how a family can successfully avoid the shirtsleeves proverb by keeping and growing its wealth over generations by:

1. Creating and maintaining solid family values;
2. Growing the family's human and intellectual capital;
3. Increasing the family's financial wealth; and
4. Effectively managing itself through proper governance.
James E. Hughes Jr., a retired sixth-generation counsellor-at-law, has spent his lifetime analyzing the factors that contribute to the shirtsleeves proverb and the past three decades personally guiding multiple generations of families in creating strategies to preserve their wealth. He is the author of many influential articles on family governance and wealth preservation, is renowned for facilitating multi-generational family meetings, has spoken frequently at symposia on estate and trust planning, and helped found a new learning institute called the Family Capital Institute.

Examples of Success

For a family to learn how to be successful at preserving family wealth (regardless of current assets), it is helpful to look at wealthy families who have successfully overcome the odds and prospered over several generations. Hughes uses the Rothschilds and the Rockefellers as such examples.

The Rothschilds

In the mid-eighteenth century, Mayer Amschel Rothschild founded the House of Rothschild. This creator of the Rothschild fortune had five sons and set up each of them in the banking business in one of the era’s five principal European financial capitals: Frankfurt, Vienna, London, Paris, and Naples.

He lent each of them money to get started, with the proviso that they pay him back so that the “family bank” could make further loans to other family members. He maintained that each son could keep the profits of his individual bank once the original loan had been repaid with interest (although the interest rate was below market rates). Rothschild also requested that each of his sons relay to him every bit of financial information gained in the city so that he could share that knowledge with the other siblings.

Not all of the banks were successful. The branches of the family business in Frankfurt, Vienna, and Naples failed because of historical events while the branches in London and Paris survived and prospered. But the family bank concept proved very useful for providing a financial education, a sense of community, character building and financial mistake-making in a safe environment, all the while increasing the family's financial and intellectual balance sheets through the cumulative successes and failures of the individual borrowers.

Before finishing the Rothschild story it is important to note the family's extraordinary philanthropic generosity. According to Hughes, families learn more about long-term wealth preservation through giving than they do through spending or accumulating because value discussions grow easily out of giving to others, and positive and successful mission statements grow out of these discussions. As a result of all this, some 250 years later, the name of Rothschild is still synonymous with wealth.

The Rockefellers
In the mid-nineteenth century, John Davison Rockefeller Sr. amassed a large fortune in oil and created the Rockefeller family fortune. He had only one son, John D. Rockefeller Jr., who decided at an early age that he was not interested in a business career and, with the blessing of his father, devoted the rest of his life to family governance and philanthropy.

Hughes believes that the father's willingness to free his son to follow his individual pursuit of happiness is one of the best long-term wealth preservation strategies he made.

John D. Rockefeller Jr. had six children — one daughter and five sons. He set up a family office to serve the wealth management needs of each family member. The office's mission was (and continues to be) to grow the human and intellectual capital of the family. That mission is confirmed each and every year at the Rockefeller's annual family meeting. These meetings also address individual, generational, as well as family-wide concerns. Today, more than 120 years since the founding of this great fortune, the third-generation Rockefellers have made remarkable contributions to philanthropy, government, international banking, and investment in new industries and continue to grow their wealth.

**Requirements for Success**

So what can one learn from these successful families that have overcome the shirtsleeves proverb? There are various factors that contributed to their success:

**Create and Maintain Solid Family Values**

According to Hughes, every family that he has observed that is successfully preserving its wealth is a reflection of five virtues: truth; beauty; goodness; community; and compassion. Families who preserve their wealth successfully reflect these virtues in their relationships both with their family and with all persons outside the family. Hughes is convinced that without these core virtues and a solid value system, a family cannot succeed in preserving itself.

Another important value is the desire to create wealth rather than simply consume it. Every generation of a family should consider itself to be the first generation and believe that it has the same power to create and accumulate wealth as the one that preceded it. It is only when a family fails to think of itself as the first generation that it runs the risk of maintaining the status quo of a second generation or the decay of the third.

Families must remember that the preservation of family wealth over long periods of time is very hard work — work with a tremendous risk of failure balanced by a magnificent but distant reward. To embark on long-term wealth preservation is an act of courage for a family. Like planting a copper beech tree (which takes 150 years to mature) the family members who initiate the process will never know whether or not they were ultimately successful.
Also critical is the family members' ability to think vertically rather than horizontally and collectively rather than individually. The ability of siblings and cousins to learn to work together is critical to long-term wealth preservation. Every family that Hughes has studied that is still thriving past its fourth generation has committed to the family's shared values and a method of governance to practice those values. This is done through either frequent oral recitation or written documents.

It’s the value and belief system that is reflected in the acts of the family — not just the successful management of their individual financial wealth — that is critical to successfully maintaining or growing the family's wealth.

Grow the Family’s Human and Intellectual Capital

A family needs to understand that its wealth consists of three forms of capital: human (defined as all the individuals who make up a family), intellectual (defined as everything that each individual family member knows), and financial. In Hughes opinion, the issue that can cause a family to lose its wealth is concentrating on the family's financial capital and paying only lip service to its human and intellectual capital.

Without active stewardship of its human and intellectual capital a family cannot preserve its financial capital; with growth of human and intellectual capital comes a high probability of growth in financial capital. In fact, concentrating on financial capital may even cause a family to go out of business in just one generation.

Examples of ways that a family can maximize the return on its human capital include:

- Providing only the best medical care for each individual family member;
- Delivering the highest education possible for each member;
- Assisting each member in finding the work that most enhances that individual's pursuit of happiness; and
- Encouraging the geographic diversification of the family members.

With respect to its intellectual capital, examples of ways that families can maximize it include:

- Creating and employing a system for the collection and dissemination of the accumulated knowledge of all family members;
- Using incentives for the family's highest achievers to take representative and leadership roles within the family governance structure;
- Providing tools for the younger members to learn the family stories and business;
- Appreciating and harnessing the knowledge of the family's oldest members; and
- Encouraging all of the family members to study the world’s cultures and languages.
Not every member of a family will directly increase the family's financial capital, but if each individual achieves their highest intellectual and emotional capacity the family's overall wealth will be enhanced.

Increase the Family's Financial Wealth

Another important factor for success is applying the appropriate time frames for successful wealth preservation. Time should be measured by the generation. When twenty-, fifty-, and one-hundred-year terms of measurement are imposed on the family's investment strategy, the disciplines of patience and value investing (i.e. the methods used by such great investors as Warren Buffet) shine forth. For families setting their long-term strategies for preserving financial wealth, time is a friend in a way it is not for most investors.

Seventy to eighty percent of the family management's time must be spent on asset growth and twenty to thirty percent of its time on liability management. In Hughes experience, almost every family gets this formula reversed. Hughes recommends that those who want to understand portfolio theory and the reasoning behind it (as well as studying how to best leverage the theory) should read Charles D. Ellis's book *Winning the Loser's Game – Timeless Strategies for Successful Investing*.

One of the most powerful tools available to families in managing their financial wealth — both in terms of assets and liabilities — is the family bank. The family bank is not a formal institution (i.e. it is not a bank in the normal corporate sense); rather it is set up like a business (with officers and directors), with a mission statement (explaining its philosophy and its reason for being), and formal procedures for receiving and processing loan applications (including providing all family members who agree to participate in the family bank with copies of all loan applications).

Through its lending, the family bank enables families to effectively allocate financial assets across its human assets to maximize returns while minimizing liabilities (such as taxes).

Hughes cites the admonition of modern portfolio theory that ninety percent of successful long-term investing lies in correct asset allocation. Families who are successful investors have elaborate asset allocation plans that often include equities, bonds, real estate, collectibles, venture capital, and alternative investments, including hedge funds.

All too often the family members holding onto these investments are chosen by "who has the money" when the investment opportunity arose. Effective allocation across family members can reduce the taxes paid year after year by determining the investment's long-term growth rate and allocating based on estate tax implications.

Normally, this means the oldest member buys the investments offering the lowest
growth (as they are usually in the highest tax bracket, are most risk averse, and have the least time for growth in principal), and the youngest family member buys the investments offering the highest growth (as they are in the reverse situation of the oldest members).

To illustrate this, suppose a family wants to invest $1000 in bonds (to be held until maturity) and $1000 in venture capital (with the goal to double in five years). The grandmother should buy the bonds and use them as collateral for borrowing by a grandchild who, without the loan, could not afford to make the venture capital investment. The result is that taxes are minimized and the grandmother's estate remains the same even though the family's financial balance sheet grew by $1000.

The point of investor allocation is to manage risk by maximizing the overall family financial balance sheet while minimizing the growth of individual portfolios more likely to be subject to estate tax.

Family bank loans made for opportunities can provide returns much higher than average loans made by commercial lenders. For these loans, the family member who is borrowing should prepare a business plan and loan application equivalent to that required by a commercial lender, the borrower should present and discuss the project's feasibility with the family bank and advisors, the borrower should provide proper business reports on the investment when the loan is granted, and the borrower should ultimately repay the loan. If financial knowledge along with capital are both part of the repayment plan, as Mayer Rothschild requested of his children, the returns to the family will be very exceptional.

Effectively Manage Through Proper Governance

The governance system oversees the “family business.” A proper system of governance and management is critical in growing the family's human, intellectual, and financial wealth. In terms of best practices, Hughes believes that every family should:

- Have a constitution, which expresses the family’s values and goals and their voluntary decision to govern themselves according to those values and goals.
- The family constitution should be renewed and reaffirmed yearly through elections. Without reaffirmation, the system will gradually lose its vitality and each successive family generation — by its decision to be governed by the chosen system — revitalizes the system.
- Each member should have the right to participate in the choice of family representatives.
- Each member should have the freedom to leave without restraint if they no longer wish to participate.
- The system should adopt a formal set of checks and balances (similar to those placed on a government's executive, legislative, and judicial branches), to ensure that representatives are held accountable to a standard of excellence.

- There should be a judicial branch or council of elders that provides for effective dispute resolution.

- There should also be a process to amend the family governance system's practices (flexible enough to deal with new issues but not too easy to change so that it does not change constantly). Hughes points to the process used in the US for amendments to the Constitution for changing rules that voters originally adopted.

**Measuring Success**

A family must understand that the fundamental issues of wealth preservation are qualitative, not quantitative. The qualitative questions critical to measuring whether or not a family is actively preserving its wealth are:

- Is each individual member thriving?

- Is the social compact among the members of each family generation providing incentive to the leaders of each generation to stay in the family and listen to the individual issues of those they lead?

- Are the selected representatives of the family meeting their responsibilities? If the above answers are positive, the family balance sheet — human, intellectual, and financial — will grow.

**Conclusion**

By following Hughes simple steps — creating and maintaining solid family values, growing human, intellectual, and financial capital, and effectively managing itself through proper governance — any family can successfully avoid the dire warning of the shirtsleeves proverb, and instead grow its wealth and prosper over many generations to come.