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Godfrey Pembroke Outlook

In this edition of Outlook, we look at some of the key components for managing family wealth and consider how laying the foundations now can pave the way for future generations. If you have any questions or would like to review your financial plan, please feel free to contact me.

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Transition of Family Wealth and Values: Preparing the New Generation

The history of long-term wealth preservation in families is often a catalogue of failures epitomised by the American proverb 'shirtsleeves-to-shirtsleeves in three generations'. In fact, the phenomenon of the fleeting family fortune is so well-recognised that there are many variations of this proverb found around the world.

In Japan, there's the expression, 'rice paddies to rice paddies in three generations'. The Scottish say: 'the father buys, the son builds, the grandchild sells, and his son begs.' The Irish variant – 'clogs to clogs in three generations' – implies that, however wealthy a poor man may eventually become, his great-grandson will certainly fall back to poverty and clogs.

There are many more variations on this theme, all used to describe the tendency of the third generation of a family to squander the wealth obtained by the first generation. It's a classic three-stage process: first, a period of creativity and hard-work; second, a period of stasis or maintenance of the status quo; and third, a period of dissipation.

Can a family successfully preserve its wealth for at least four generations, or for more than one hundred years?

Family wealth is not self-perpetuating and managing family wealth can be a complex affair, offering both opportunities and challenges. A solid plan for wealth transition is vital. But, while accumulating and preserving wealth are important in their own right, the 'family factor' must also be carefully considered in order to establish financial goals and values that will span generations.

Prioritising trust and communication

When considering transferring wealth to the next generation, most families will focus on how best to structure and protect their assets and minimise tax. However, unless the next generation is taught why the wealth exists, how to respect and use it wisely and act as good stewards, all the best estate planning won't be enough to escape the 'shirtsleeves-to-shirtsleeves' proverb.

The Williams Group recently published the results of a 25-year survey of 3,250 instances of generational wealth transfer.[1] The survey found that 95% of the failures were attributable to the family itself: due to a lack of a family mission (10%), the inadequate preparation of heirs (25%) or a breakdown of family communication and trust (60%).

The common thread in all these causes is a lack of communication. It is important that all families discuss the legacy they wish to leave to future generations and how best to realise those wishes.

Consistent, effective communication is fundamental to a family's success in the short term and in maintaining wealth momentum through generational transitions. This is especially important for families who work together around shared ownership of family assets.

Setting the foundations

The transfer of capital doesn't begin or end with simply passing it along to the next family member. Rather, the ultimate goal is to preserve your family wealth so it can be passed down through many generations.

This starts with all family members understanding your family's collective vision based on shared values. Like any business, a family 'enterprise' must be built on a foundation of mutual agreement on certain fundamental questions:

- What is our shared vision for the family wealth?
- Is there a plan to grow wealth within the family?
- Is the plan to grow the family wealth aligned with the values of the family?
- Does the next generation understand the importance of wealth?
- Do we have appropriate structures in place to grow wealth for the family?
- How can we continue to adapt and innovate whilst preserving our family values?

By addressing these issues, you can start to put the necessary frameworks in place to ensure your wealth continues to work for what your family believes in. This level of transparency ensures that expectations are aligned and that open discussions can take place around investment and the family's wealth-transfer approach. It is important for the next generation to understand that the decisions they make now can ensure ongoing wealth for future generations.

Consequently, getting 'family governance' right – getting the way in which a family works together and make decisions about their assets – is crucially important.

Family governance

Having a governance structure in place before problems arise will help guide decision-making and ensure open and honest communication. By providing clarity over things like responsibilities, ownership privileges, and involvement in the enterprise, family governance aims to reduce the potential for conflict and poor decision-making. The key to long-term success is keeping the family committed to and capable of carrying on this system of governance, with each successive generation reaffirming and readopting that social compact.

Approaching family governance in the right way is critical. With an inclusive approach, starting with your family objectives, you can create a strong platform for family success that is right for you. It is imperative that family governance is sensitive to the dynamic, culture and objectives of the family in question, and is designed in harmony with the family's unique situation and needs.

To create a successful family governance process:

Make it purposeful: Effective family governance should be designed with reference to the vision of the family. Governance should not be created for its own sake – it is a stepping stone to achieving the family's objectives and goals.

Do it together: Family governance should be inclusive. The whole family needs to be involved and engaged in the process in order to ensure that it facilities family alignment behind a common purpose.

Be flexible: It is also important to conduct a governance 'review' every few years to ensure that it still supports your family's vision and goals, and is appropriate for the environment you are operating in.

Make it fit: Every family is different, and family governance should reflect the needs of the family that sits at the heart of it - there is no 'one-size-fits-all' governance structure solution. As James E Hughes notes in his book Family Wealth: Keeping it in the Family, the 'capacity of the family governance system to acclimate to the ebbs and flows of energy is critical to successful wealth preservation. The life of a family is dynamic; the governance system it develops must be just as dynamic'.[2]

Interests shift over time; new members join the family through marriage – and sometimes exit through divorce – and family members will pass on. Each of these events will affect the energy of the family, and the governance structure in place. The system of governance your family decides upon must be able to manage these fluxes over the long-term.

Family governance isn't about deeds and charters so much as good communication, a shared vision and clear decision-making. To thrive, the family must learn how to work together, and how to equip succeeding generations to deal with the responsibilities and opportunities of inherited wealth.

Independent directors can be helpful in developing a formal family governance plan. With family governance, the biggest challenge is often following through on the plan and setting up the model you choose to work with. Your financial adviser can help your family create a governance plan and work to ensure it's followed and respected over time.

Mentoring the next generation

What about the 25% of failures in Williams' study that were due to inadequately prepared heirs? Along with understanding the family's values and mission, it is equally important that the next generation has a working knowledge of the fundamentals of the family's financial position – this doesn't mean that the children need to be investment professionals, but they should be able to make informed decisions.

Focusing on financial education at an early age can be a key part of setting younger generations up for success. It is important that heirs gain an understanding of how the family governance system works, what the responsibilities are that come with being a beneficiary and even where an investment adviser or independent director fits in. So, if the inevitable happens sooner than expected, you know the next generation has some level of education around finances, and who to turn to for advice.

Charitable giving, or philanthropy, is also another way to educate the younger generations. Philanthropy can act as a platform for discussing family values while allowing the younger generation to communicate their own values and put them into action. It offers an opportunity for the next generation to learn the technical skills of wealth management by learning how portfolios work, how to manage for risk and how to ensure they act as good stewards of the funds with which they are entrusted.

When it comes to educating the next generation, the examples that the older generations set are the best lessons, but financial advisors are also a valuable resource in this journey as well. Beyond having the technical knowledge of asset allocation, portfolio construction, investment selection, trust structures and tax planning, advisors have the experience of working with multiple families and seeing firsthand how wealth transitions succeed or fail.

Engaging the next generation

We are on the verge of the largest intergenerational wealth transfer in Australian history. Over the next 20 years, an estimated $3.5 trillion is expected to transfer to the next generation.[3]

However, the sheer volume of wealth moving between generations has overshadowed the dynamics surrounding that transfer. The challenge many families face is that wealth is not self-perpetuating, with both statistics and anecdotes (like the many behind the universal proverb of shirtsleeves-to-shirtsleeves in three generations) suggesting that most families fail to sustain wealth across multiple generations.

The largest cause of failure in Williams' study was a breakdown of family communication and trust. And a lack of trust almost guarantees the failure of wealth transition. Ongoing communication is key to strengthening family relationships and facilitating the continuation of your values into future generations. But, it also requires a commitment from the entire family.

Successful wealth transfer is a long-term process that does not end with a technically effective estate plan – it begins there. Wealth preservation is a dynamic process of group activity that must be successfully re-energised in each successive generation.

Successful families are communicating all the time – sharing stories, imparting values and asking questions. Wealth should be a part of these natural conversations. With the right communication and governance approach, your family finances can be a source of unity, not division, and can continue to last for many generations. If you are not sure where to start, having a conversation with your financial adviser can be a good step in helping you and your family work out a plan.

Taking the time now to prepare the next generation can help ensure they have a concrete understanding of the values underpinning your family wealth goals. The ultimate goal for all parties involved in the process is the protection of hard-earned wealth, and bringing everyone along on that journey to help secure a family legacy.

[1] Vic Preisser and Roy Orville Williams, Preparing Heirs: Five Steps to a Successful Transition of Family Wealth and Values (2003).

[2] James E Hughes, Family Wealth: Keeping it in the Family – how family members and their advisers preserve human, intellectual and financial assets for generations (2004).

[3] McCrindle, Wealth Transfer Report: A Report of No More Practice (September 2016).

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