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# The Business of Family

By Linda Davis Taylor

There are more than nine million households in the United States worth at least $1 million. The biggest concern in the minds of these financially successful people is how to provide for the long-term continuity of their families. Eighty percent say this is even more important to them than their own personal health. In a world where uncertainty is the new normal, we all want to be sure our families are prepared to thrive no matter what life throws at them. We also know from history that over 70% of wealth doesn't last beyond three generations. That means making money isn't the only problem. Keeping it is just as challenging.

Let's be honest: if we already have money, we want to hold onto it. And if we haven't yet made it, we're working hard to achieve financial security. To get there, we need to make sure we have a family plan that's as strong as our financial plan.

Whether we keep our money depends as much on what the family does as what the stock market does. This isn't the "soft stuff" like so many financial experts say, it's the "hard stuff." A family's business is about a whole lot more than money.

As an advisor to families, a college trustee who spends a fair amount of time with teens and young adults, and a mother and wife who's also the primary breadwinner, I know all too well that money will either unite or divide a family. The money doesn't decide. The family members do.

How do savvy families maintain and build their wealth? They run their families the way they run their business. They stay out of debt—both the literal and the emotional kind—by focusing on goals to unite them for long-term profitability. And they keep a close eye on their personal bottom line, which is built on values rather than fortunes.

**"Every family needs its own business plan to ensure the family knows where it's been, where it's headed, and how it's going to get there."**

Billionaires, beginning with the Rockefellers, set up family offices to do nothing but run their affairs. This same principle will work for any family interested in long-term success, even if their version of a corner office is a laptop in the corner of their kitchen. Every family needs its own business plan to ensure the family knows where it's been, where it's headed, and how it's going to get there.

My passion for this topic began fifteen years ago at my dad's 80th birthday. That night, as my siblings and I gathered for a casual dinner to celebrate, our dad spoke for the first time about leaving his southern town on a freight train in search of something better. Suddenly, I realized our family had never talked with our parents—or each other—about what motivated them to do all they had done, and what we, the next generation, wanted to do with that legacy. A year later, both of our parents were gone, and we had missed a priceless opportunity. I realized that the "business of the family" was ignoring the secrets that actual businesses know by heart.

Sooner than we can imagine, we find ourselves as the grownups, with parents aging and passing on. Do we understand what our parents and grandparents stood for? Do our kids have a sense of the family's history? Will our grandkids be connected enough to care?

Most of us find ourselves riding along the highway of life, eyes fixed on the future, occasionally checking our rearview mirror, with money, success, and family security in our sights. Then, suddenly, we're caught off guard when something goes haywire. There has been no warning light that we might be drifting away from values as we earn more and want more. No alarm bells to alert us that we are over-indulging our kids, not until we realize they don't know how much a gallon of gasoline costs. No airbag going off when we women "check out" of the family financial discussion until accidents or illness come crashing down. It's not time to pump the brake or accelerate. It's time to remind ourselves why we got on this route to begin with.

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Though most of us don't have a strategy in mind when we start our families, it's precisely what we need. Any wise entrepreneur would develop a business plan before launching a new venture. Families can use the same approach.

Those who understand wealth invest in their families with as much focus and discipline as they do their businesses. The following five steps offer familiar business concepts to build a family strategy.

1. **A Family on a Mission:** A strong business begins with a thoroughly thought-out mission explaining the purpose of the enterprise. Families can adopt the same strategy, with the awareness that fulfilling their mission hinges on deeply rooted values as well as a shared vision for the future. A business with a written mission statement has double the return on equity as one that doesn't. A business without a clear mission will lose focus and, ultimately, lose money. A family without a mission runs the same risk with even greater consequences than lost profits. That's why starting with a clear mission is the first step for businesses and families alike.

2. **Values Come First:** A healthy enterprise is defined by its values. These are the guiding principles that provide a compass for how people behave. This is true for employees in a business or members of a family. If the principles are clear, the family will not only weather any storm that comes their way—they will grow stronger. Smart businesses make sure their people make decisions with values up front. Families should do the same. The key to this is to open up a dialogue to define the family's principles so members remain connected as well as inspired.

3. **Service With More Than a Smile:** To last, a business has to provide benefits to its stakeholders. It's why your customers buy from you, why employees want to work for your organization. A family also has stakeholders in the form of family members. It provides benefits to them, both economic and emotional. Shareholders who get a return invest more and stay loyal. Family members will too. Families can determine exactly what benefits and responsibilities their members have, just as businesses do.

4. **Plan the Work and Work the Plan:** Laying out goals and objectives is standard operating procedure with any business plan. The same ought to be true for families. Whether financial or personal, wise families decide jointly what they want to accomplish, then set about doing it as a team.

> **"Just like a successful business, a successful family is all about its people, who require support, training, and commitment to a purpose."**

5. **Strategize to Optimize:** Good strategies are essential to reaching goals. Where should the energy be focused? How should the resources be allocated? What are the barriers? Reaching family success is a campaign of the highest order, so it needs a plan, a staff, a timetable, and markers along the way. This means choosing the things the family wants to focus on and making sure it reaches those goals.

A thriving business or a thriving family is like a jigsaw puzzle—all the pieces must be in place to complete the picture. The mission and values inspire and energize the family by keeping everybody focused on what matters. The goals and objectives establish necessary milestones, and the strategies ensure that everyone is working together.

Just like a successful business, a successful family is all about its people, who require support, training, and commitment to a purpose. Just like a successful business, a successful family deals with unexpected challenges and celebrates its successes. Just as in a successful business, a good family strategic plan demands input from all of the stakeholders—in this case, all of the family members—in order to be optimized. An effective family business plan can be designed at any stage and will grow and change as the family does.

Company directors appreciate that their most important responsibility is succession planning. Leaders of families must be just as intentional about making sure the generations that follow them will be prepared for future roles. In business, we would never rely on one "make it or break it" meeting to communicate everything that our employees need to know to carry out their responsibilities. It's building a culture of ongoing communication and education that gets everyone on the same page.

The combination of families and money can be complicated. They can coexist in the same house, as long as the family leaders are willing to apply their fiscal knowhow to the home front. While there is no silver bullet that ends family problems or financial challenges, the old business adage about working smart rather than hard applies to your family too. Thinking like an owner is just as good for your family as it is for your business.

As when tackling any important project, developing a family strategy might seem overwhelming at the outset. With the right mindset and methodology, however, developing a family plan is quite concrete and prescriptive. Once you build awareness of the possibilities, action can follow. With the summer months and time for family gatherings coming soon, consider starting a conversation about your family's strategy—after all, it's probably your most important business. ◆

# It is Time

By Kevin J. Cavanaugh

We live in an increasingly connected world. A major internet technology company recently predicted that, in just a few years, every person on the planet will be "connected" via six devices at any point in time (see chart on the next page). For investors, this connectedness produces a paradoxical condition. We have a veritable flood of information at our fingertips, from the *Wall Street Journal* or *Financial Times* websites, which are continuously updated with relevant financial news stories, to 24-hour financial news coverage on television (CNBC or Bloomberg) to numerous financial weblogs (Zero Hedge or Seeking Alpha) generating original research insights. Our connectedness is pervasive, and the investment opportunities appear endless. Many investors find it increasingly difficult to differentiate between the signal and the noise.

> **"Orientation towards price changes has produced an exaggerated fear of market volatility, and this misplaced fear has worked to the detriment of many market participants."**

### Speed Kills

The default option for the financial media is to tell us how the markets have done in the past few hours and to ask a few pundits the reasons for the price swings. The advocates argue that investors are best off by attempting to minimize portfolio volatility over the short term by proactive and reactive shifting of assets between classes and individual securities.

In our opinion, any theory of portfolio tinkering that emphasizes the reduction of short-term portfolio volatility as a primary investment objective is sub-optimal, at best, and, at worst, will lead investors in the wrong direction. These approaches tend to orient investor attention exclusively to prices, while ignoring the value of the underlying securities or investments. In recent years, this orientation towards price changes has produced an exaggerated fear of market volatility, and this misplaced fear has worked to the detriment of many market participants. To the contrary, we believe that investors should view price volatility as their friend—one that occasionally offers the potential to enhance investment returns.

Scholarly studies have shown that individuals, whether investing in stocks or mutual funds, fail to earn the returns available in the markets. Virtually every study found that the level of underperformance has been dramatic. Why? In brief, most investors tend to trade too much and are overly confident in their ability to make (short-term) predictions. Notably, the studies found that the more the trading, the worse the returns. Investors, by nature, it seems, are susceptible to the dreaded malady of *short-termism*.

In addition to poor investment returns, the consequences of short-termism are exacerbated by high trading costs (many of which are not explicit), paying too many taxes, and getting caught up in investment fads. This last propensity almost always results in the very unpleasant buy-high, sell-low syndrome. With the increasing connectedness already discussed, a number of market participants are becoming even more vulnerable to the fever, while others are working hard to feed it.

Obviously, the financial media and much of Wall Street benefit financially from the average investor's susceptibility to short-termism. This has always been the case. It appears, however, that the paydays for the trading facilitators have improved considerably. Recent advances in network technology have opened the door to a whole new group of profiteers. The esteemed financial writer Michael Lewis has just released a very entertaining book, *Flash Boys*, about a particularly parasitic subsector of Wall Street, the high frequency trading firms (HFT). These traders are the consummate short-termers, trading in and out of stocks in just milliseconds, many times with advanced information on other investors' trades. The book is worth reading for anyone interested in learning more about the underbelly of Wall Street. These "flash boys" have been reaping huge profits in recent years by trading upwards of 65 to

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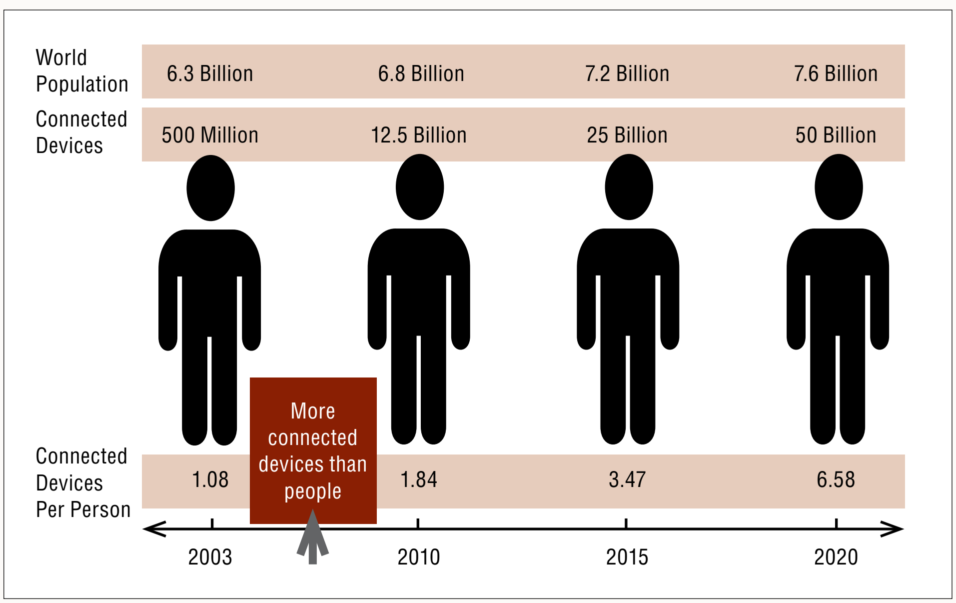
70% of the average daily volume on the public stock market exchanges. Additionally, even with rock-bottom commission levels, the stock exchanges have benefitted nicely from these trends.

With so much attention, and billions of dollars speculating nowadays on short-term price changes in a wide-ranging set of asset markets, many individuals and a handful of astute institutional investors have decided, with good reasons, to stop playing the game. Trading volume on the large domestic public stock exchanges is down considerably (-40%) from a decade and a half ago. This is an amazing statistic, considering all the short-term trading that has been going on. Both individual and institution investors have been net sellers of stocks over that same period and appear, to us, under-allocated to stocks relative to their investing histories. With the increasing focus on and fear of short-term price volatility, many investors have lost confidence in the markets. We believe this disorientation (short-termism) has fostered an excessive level of risk aversion in many investors, while improving the probabilities of success for a different class of investor.

> **“Short-termism has fostered an excessive level of risk aversion in many investors, while improving the probabilities of success for a different class of investor.”**

### The Internet of Things “Born” between 2008 and 2009




SOURCE: CISCO IBSG, APRIL 2011

### Survival of the Fittest

So, then, what does it take to be a successful investor? One would think this is a relatively easy question to answer. It is not. If you asked ten different professional money managers this question, you would likely get ten different answers. Is the key to success knowledge? Is it skill or technique? Or, does successful investment require a unique sort of temperament? Newer investment professionals might answer that information and knowledge is the key to success, saying that the investor with the quickest access to the best information always wins. After a few years of successes and failures, the serious professionals who remain will likely say that it makes more sense to rely upon a refined investment process, which, if followed with conviction, should ultimately lead to success. Years go by, and those humble few who have endured, chastened by yet more successes and failures, may find that, yes, comprehensive knowledge is an advantage, and an effective investment technique can improve one’s chances. However, they may add, financial market history has shown that even those possessing adequate information and/or the most elegant investment techniques have come to ruin in periods of extremes. Even the most experienced may lack the temperament to deal with the disorder of manic markets and could, ultimately, be undermined by one of two human frailties—hubris or irresolution. It takes a distinctive wisdom, acquired by few and over time, to be a successful investor.

For the students of history, fortunately, there are a handful of positive paradigms to enlighten the way. Investors such as Warren Buffett, Charlie Munger, and Sir John Templeton have displayed the proper knowledge, skill, and temperament to react effectively during periods of strain and, as a result, have flourished

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over time. Analyzing their idiosyncratic investment histories, we find a common characteristic in the investment styles, which each would later profess as key to their success. Whether markets were calm or manic, these investors were able to make effective investment decisions by maintaining a longer-term time horizon than their peers. The wise ones might say that, with an understanding of human nature and history as well as a proper investment perspective (longer-term), one can successfully avoid the common pitfalls of professional money managers: dogmatism (hubris), and trend-following (irresolution).

We actively attempt to emulate these positive paradigms. Like them, as conservative investors, our primary objective is to reduce the probability of the permanent loss of our client's capital. We hope to accomplish this by making decisions based, primarily, on the attractiveness of long-term investments; this is one of the key reasons our firm has lasted almost 100 years and flourished through so many market phases, including the current one. With most market participants now overly concerned and disoriented toward the short-term, the competition for attractive longer-term investment ideas has been greatly diminished, enhancing the probabilities for our success. In periods of calm or excess, our distinctive longer-term perspective endows us with the necessary confidence to invest effectively. We are fortunate that our clients have understood the benefits of such a perspective, which allows us to operative effectively to meet their needs.

> **"Making decisions based, primarily, on the attractiveness of long-term investments...is one of the key reasons our firm has lasted almost 100 years and flourished through so many market phases."**

We define our long-term approach to investment as follows:

1. Our client portfolios are constructed on a security-by-security basis. We are bottom-up, fundamental investors and attend very closely to underlying equity values and credits. To reduce the risk of loss, we are careful to pay attractive prices for these securities. Adequate portfolio diversification, while not an over-riding objective, is a beneficial outcome of our investment style and process. For those clients for whom it is appropriate, we employ the same investment philosophy for a range of alternative investments.

2. We seek to invest only in high-quality businesses. These kinds of firms generate superior profitability, possess clean balance sheets, and are managed by teams that have shown a track record of making sound, shareholder-oriented decisions. We look for businesses that are regarded as the best in their field and/or dominate an industry or market niche. We require that the management teams are oriented toward making long-term commitments with shareholder capital, with the goal of growing the intrinsic value of the company well into the future.

3. We come to know these companies well; we gain valuable knowledge through perseverance and patience. Our focus on, and knowledge of, a relatively small universe of high-quality businesses enhances our ability to make predictions about the future long-term sales and earnings growth. We seek to avoid investing in companies susceptible to short-term fads and concentrate investment in those companies benefitting from longer-term trends. In this regard, we seek investment in companies with not only the financial wherewithal to grow, but with clearly defined opportunities in which to invest and grow.

> **"In periods of calm or excess, our distinctive longer-term perspective endows us with the necessary confidence to invest effectively."**

4. We assess the strength/resilience of a company's franchise and attempt to predict the company's long-term competitive position. We then calculate a conservative value for the company, using long-term sales and earnings growth estimates.

5. We seek to buy these investments at a reasonable discount to their intrinsic values, with the goal of holding the investments for as long as they remain superior growing businesses. If an investment comes to trade at a substantial premium to our assessment of the intrinsic value, we may decide to sell all or part of the investment.

6. We continually reassess our assumptions from a long-term perspective. As G.K. Chesterton perhaps put it best, "Wisdom should reckon on the unforeseen." ◆

# Market Outlook

By Ralph E. Weil, CFA

The first quarter of 2014 was mixed in terms of performance, with the Dow Jones Industrial Average down 0.7% and the S&P 500 up 1.3%. Fixed income also had a modest gain in value during the quarter. The second quarter has not started off on solid footing, and some investors and traders are questioning whether this is the beginning of the next bear market.

Additionally, we have just entered earnings season for first-quarter reports, and general expectations are for first-quarter corporate earnings to be down about 1%. That would be the first down quarter year over year since 2012's third quarter. The down quarter and fear of some negative Federal Reserve actions have raised the specter of a 10% or more decline in the equity market.

So, what do we expect for the balance of the year and perhaps into 2015?

Let's address first the actions of the Federal Reserve. The Federal Reserve has stated that they are reducing their buying program of government bonds. This program has been the main vehicle for the Fed's expansion program. The key word here is "reduce," not eliminate. The Fed normally takes action to slow an overheated economy when inflation is high and some sectors of the economy are overheated. It is clear that inflation is not a problem currently; as a matter of fact, certain groups are raising concerns about deflation. Also, we are not seeing overheated segments in the economy such as those we saw before previous significant market declines, like the 2007-2008 housing bubble and the tech bubble in 2000. Add the fact that the new head of the Federal Reserve, Janet Yellen, has recently made statements reflecting that her number-one priority is reducing unemployment. We do not believe that the Fed is a threat to the economy or the equity market at this time.

Should the expected 1% decline in corporate earnings in the first quarter be of major concern? We don't think so, because we can identify events in the quarter that impacted earnings negatively and were more or less one-time occurrences.

The number-one item is the weather. This year's first quarter had some of the most severe weather conditions in many years. When we talk to companies or read reports about current business conditions, the subject of weather comes up often. This is especially pronounced for companies that deal directly with the general public. Retailers are a good example of a sector of the market that was impacted significantly by these weather conditions. While we can't predict the weather with certainty (nor can weathermen), we can expect that conditions will return to normal for most of the balance of the year.

Our expectations for the economy, corporate cash flow, and earnings for the full year show some improvement from the first quarter. Full-year inflation-adjusted Gross Domestic Product (Real GDP) should increase about 2.5%. That kind of domestic growth, along with moderate international growth, should enable U.S. corporate profits to rise in the mid-single-digit range.

The above factors suggest that we will see equity markets up moderately for the full year. Unlike in 2013, when we saw a significant move-up in price earnings ratios (P/E's), we would expect in this environment those ratios to hold steady at current levels for this year. We also believe that this year will have more volatility (first quarter being a good example) in the major equity indexes. We may even get what we would classify as a market correction, with indexes down 10% or more, but less than 20%.

So, we do not believe we are in for another bear market at this time, for the reasons given above. The Federal Reserve's actions for the balance of the year should cause interest rates to rise moderately, but not enough to bring down the economy.

There is an old saying in the investment business that "a rising tide raises all boats." That would be more like what we saw last year with the rise in P/E's pretty much across the board. Again, we do not expect that to happen this year, which leads us to focus on companies that should perform better than the overall economy and are of higher quality (see Kevin Cavanaugh's article in this newsletter). In the fixed income arena, due to the shape of the yield curve favoring slightly longer maturities, we have gone from purchases in the range of four-to-five-year maturities to eight to nine years; this trend should continue. We will maintain our emphasis on quality in the fixed-income portions of the portfolios. ◆



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