



## In assessing risk, consider financial and operating assets

*A total wealth management approach measures risks and rewards separately for the two types of assets—and considers emotions.*

**M**OST FAMILY BUSINESSES and single family offices around the world are still dealing with the aftermath of the financial crisis. Many are confronting an interesting problem: a significant shift in allocation of the family's total wealth between operating assets (the business or other mostly illiquid investments) and financial assets (the family's liquid investment portfolio).

Most likely, both the operating assets and the financial assets suffered a major devaluation during the crisis. However, the speed and magnitude of the devaluation were not

stakeholders consider the different risks and rewards involved for the two types of assets.

The return on financial assets is primarily tangible, and their risk is measured by volatility. The rewards that come with operating assets, on the other hand, are not just financial; they include the emotional connection that many owners feel to their company, their control over management and their desire to perpetuate family values. Operating assets are long-term in nature; they are measured by discounting the present value of long-term future earnings.

Risks associated with operating

of its value since the financial crisis began. Although it continues to return about 3% a year, he's feeling a cash-flow squeeze; his customers have been taking longer to pay and his bank has refused to extend his lines of credit.

It seems as though Daniel is just throwing good money after bad. But Daniel views his company as a family legacy asset. In his decision making, he factors in his emotional connection to the company and his track record of navigating the business through previous economic storms.

Most family business owners react to a downturn in one of two ways:

- **The patient capital perspective.** People like Daniel who are emotionally attached to their company want to keep it in the family at almost any cost. Because Daniel's family business retained more value than liquid assets during the downturn, he can rationalize his decision to invest heavily in it.

- **The modern portfolio theory perspective.** At the opposite pole are those who assess the family company's risk-and-reward equation as they would calculate risks related to financial assets to which they have no emotional tie. Business owners who take this approach might consider the company's return too low in relation to the risk involved. They would argue that this is a great time to sell some stake in the company.

Is Daniel so focused on preserving the legacy company that he's ignoring the short-term threats that may jeopardize the future of his ail-

**Sometimes patient capital can be a liability. Emotional attachment may overshadow external market risks.**

equal for the two asset categories. A portfolio that was balanced before 2008 may now look very imbalanced, with an over-concentration of wealth in illiquid operating assets.

During down cycles, operating assets tend to hold more value than other investments. The value of financial assets—investments in hedge funds, private equity, bonds or other types of securities—is defined by short-term market factors. In contrast, the value of operating assets is determined by long-term external and internal factors.

It may seem wise to try to rebalance such a portfolio. But when deciding what to hold and what to relinquish, few family business

assets include fluctuations in value as well as business risks, such as product or market obsolescence, availability of working capital to meet cash flow needs and access to funding for future growth. For example, an operating company faces the risk that banks might cut off credit, especially if the company's customers and suppliers are also under stress.

### **Patient capital vs. modern portfolio theory**

A family business owner whom I'll call Daniel recently told me, "I plan to sell all my toys—my cars, my boat, everything—and pour the money into my company to keep it afloat." His company has lost about 20%

ing business? Are portfolio managers who recommend against over-concentration in any one asset—even the family business—being shortsighted?

Often, family business owners are well served by their patient capital. While public company investors put pressure on CEOs to produce short-term returns, a family's patient capital allows family business managers to pursue long-range goals and produce sustainable, long-term returns.

Sometimes, though, patient capital can be a liability. Emotional attachment may overshadow external market risks, such as access to capital, or more fundamental risks, like product obsolescence.

No single perspective fits all situations. The decision to keep or sell an asset depends on family members' needs for liquidity and their attitude toward long-term stewardship. As the economy improves, there will be new opportunities to create wealth. In order for the family to capitalize on these opportunities, they must agree on why they own a particular asset, where future capital should be invested and how family liquidity will be generated.

### Total wealth management

In assessing a business owner's portfolio, many wealth managers ignore the largest portion of the client's assets—the family business—because the tools used to evaluate a financial portfolio do not apply to most operating assets.

A total wealth management (TWM) approach, by contrast, measures the risks and rewards of operating and financial assets separately. Along with the financial attributes of those assets, it evaluates the emotional components.

Traditionally, family business owners think of themselves as stewards of the family business. In a TWM approach, they would regard themselves as stewards of all the assets: financial, operating and emotional.

Daniel's patient capital has turned into a desperate attempt to save his depreciating asset (the company) by selling other assets that are also devalued in today's market. TWM might help him uncover other opportunities, such as ways to diversify his financial securities as well as his company's concentration of customers (geographically and by sector).

A sound family governance system that separates management of the family business from management of the family wealth can help implement TWM. While the board of the operating company focuses on business risks and opportunities, a family office or other family governance structure can evaluate the risks and rewards related to the family wealth, and how best to transmit the family assets and family values to future generations. FB

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