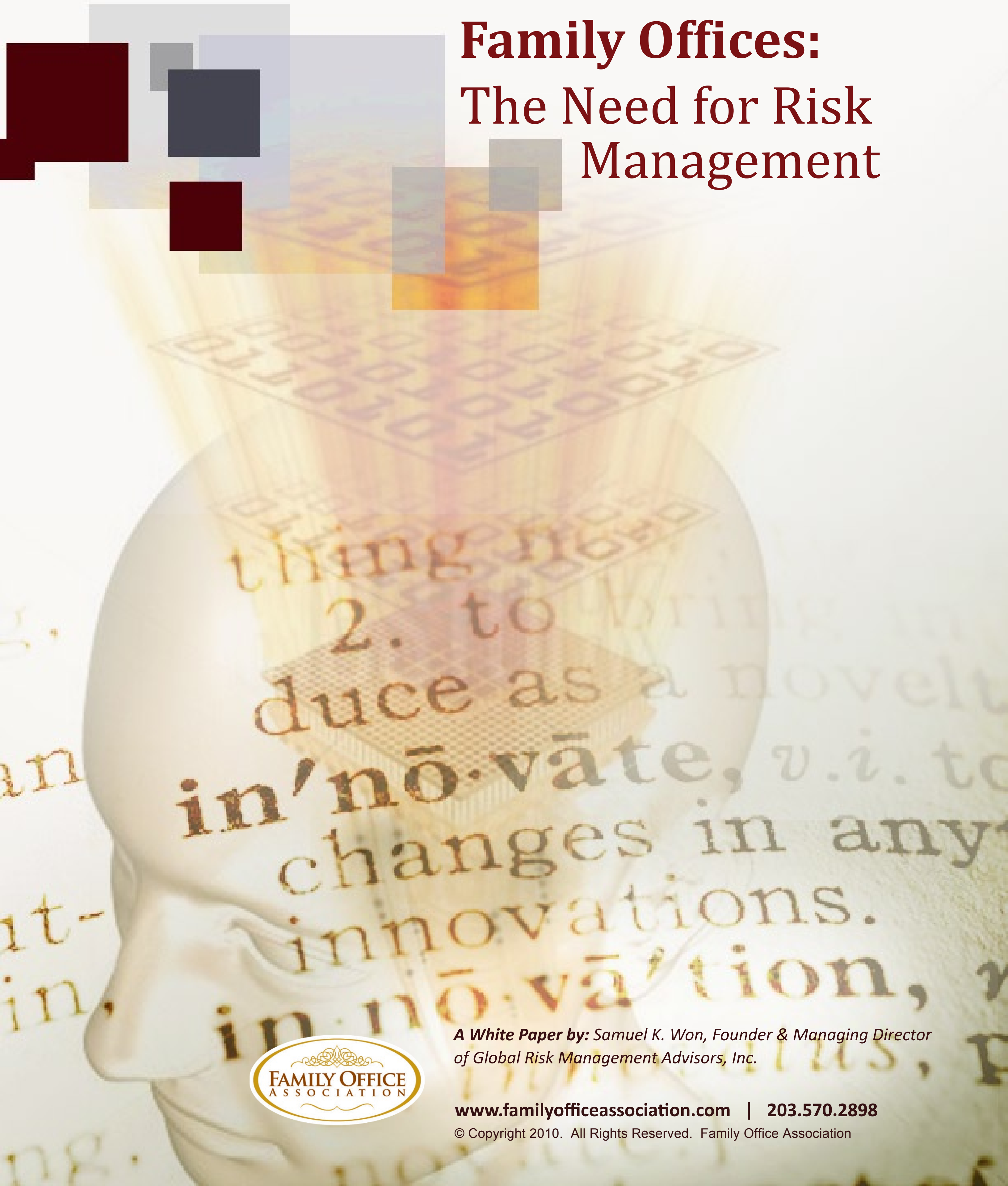
WHITE PAPER

Family Offices:
The Need for Risk Management



A White Paper by: Samuel K. Won, Founder & Managing Director of Global Risk Management Advisors, Inc.

FAMILY OFFICE ASSOCIATION

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Family Offices:
The Need for Risk Management

Why do Family Offices Need Risk Management?

Endless debate over the factors that contributed to the financial tsunamis of 2007 and 2008 will persist for years to come. However, one cause seemingly brings no disagreement: most, if not all, of the major financial failures during this period were, at their core, failures in risk management.

Family offices were not spared during these financial meltdowns, and many suffered significant financial losses as a result of inadequate or a complete lack of risk management. Only a select few family offices employed risk defeasance measures to mitigate their financial losses during this time. In addition, many of these family offices suffered major losses due to their large allocations to illiquid alternative investments. As a result, these family offices were also unable to benefit greatly during the snap-back rally in 2009.

What are the Key Considerations and Issues?

When considering what to do about managing investment risk, family offices should first understand what constitutes a sound risk management framework. A complete risk management framework must include robust risk measurement, institutional quality risk management and well functioning risk management governance.

Risk measurement is the process of identifying, estimating and evaluating investment risks, such as market and credit risks. Once these risks have been identified and measured, risk management is managing these investment risks to best meet the stated investment objectives. Risk governance involves creating the proper infrastructure, processes and culture that enable a family office to have an effective and well functioning investment risk management program. Furthermore, proper governance provides the appropriate controls and accountability for managing issues and executing decisions surrounding both investment risk and return.

Before a family office creates its investment risk management framework, it must first have a well thought out risk and investment strategic plan that fully captures the "thinking behind" the family office's risk management infrastructure and processes.

Investment Risk Strategic Plan

A family office's investment risk management strategic plan should outline in clear detail the family office's overall investment objectives and associated risk parameters. This plan should take into account the family office's current investments, prospective investments and the maximum limits for market risk, credit risk and investment drawdown. This risk management strategic plan should define the family office's trigger levels for risk escalation. In addition, the plan should provide risk defeasance measures that the family office would use in the event of meaningful investment performance deterioration or in the case of significant market trends or events that could adversely impact the family office's investment portfolio.

Risk Infrastructure

Family offices cannot have institutional quality risk management without the proper infrastructure. For robust risk measurement and risk management, infrastructure is a major foundational element. Examples of essential infrastructure for a sound family office risk management program include risk analytics, a data warehouse, and connectivity of risk infrastructure to other key systems, e.g., accounting and compliance.

Family offices must also decide whether to hire an experienced risk management advisory firm to develop and build their own infrastructure for risk measurement and risk management or to leverage the risk infrastructure of their risk management advisor.

Risk Processes/Governance

A successful risk management program is not possible without fully integrated and well-functioning risk and investment processes and a sound governance structure. Governance and the appropriate risk processes enable a family office to use and leverage their risk measurement and risk management infrastructure. Without the proper risk processes and governance, a family office will not possess the capabilities to act strategically and decisively about risk issues and to manage risk successfully through various market cycles. Ultimately, these risk and governance processes must be an integral part of the family office's overall risk and investment management approach and culture.

Key risk processes should include a risk evaluation and investment risk management due-diligence process for current and prospective fund investments, a limits process that captures the family office's risk tolerance levels, and an escalation process for risk defeasance. On the governance side, the family office should have a risk and investment Committee that periodically reviews the risk profile of the investment portfolio(s), evaluates and sets overall risk parameters, and reviews and approves the family office's risk and investment management guidelines.

Why Independence Matters?

A family office should retain an independent risk management advisor who has no role or responsibilities for selecting investments or funds for the family office. The family office should not consider risk and reward in isolation, as they are inexorably linked when evaluating or choosing investments. However, a family office should separate the advisors they use for risk management from those they use for investment management. Investment managers have a vested interest in continuing to manage assets and collect fees and, therefore, cannot provide independent risk management counsel to the family office. Furthermore, aside from their lack of objectivity, fund managers and investment advisers typically do not have direct risk management industry experience and subject matter expertise in investment risk management.

In sum, akin to utilizing an independent auditor, a family office should use an independent risk management advisor that is distinct from the individuals or firms that it uses to advise upon or manage the family office's investments. An independent risk management advisor is important not only for the risk management of the family office's investments but also to provide objective third party validation of the family office's approach toward risk and investment management.

Risk Management Key Success Factors:

1) Investment Risk Management Strategic Plan—is the critical starting point before a family office should develop and implement its risk management infrastructure and processes.

2) Proper risk infrastructure—is an essential foundation for risk measurement and risk management.

3) Risk processes and governance—are necessary elements in order to have a well functioning and "true" risk management program.

4) Independence matters—a family office should retain an independent risk management advisor that has no direct role or responsibilities in selecting or managing the family office's investments. Only an independent risk management advisor can offer an objective third party validation of the family office's approach towards investment risk management.

About the Author:

Samuel K. Won is the Founder and Managing Director of Global Risk Management Advisors, Inc. a leading and independent risk management advisory firm that provides risk and investment management advisory services to asset managers and asset owners.

Mr. Won has over 20 years of risk management, capital markets, trading and portfolio management experience at major financial institutions in both the public and private sectors. In the investment management industry, Mr. Won was Chief Risk Officer at Brencourt Advisors, Chief Risk Officer at Ospraie Management and he headed up investment risk management of over $44 billion in alternative assets for Citigroup Alternative Investments. On Wall Street, Mr. Won headed up risk management for customer trading, proprietary trading and capital markets for Citigroup Global Markets and also played a similar role as Global Head of Risk Management at Dresdner Kleinwort Benson. In the public sector, Mr. Won was in charge of risk management for the bailout of the S&L industry. Mr. Won played a leading role in creating the Managed Funds Association's 'Sound Practices Guidelines for Risk Management' for the hedge fund industry. He has advised regulatory agencies, such as the SEC, the Federal Reserve Bank, the Office of the Comptroller and the FSA, on major risk management, trading and capital markets issues and policies.

Mr. Won has had extensive experience, with all major asset classes, in investment risk management, risk architecture and analysis, asset allocation, portfolio rebalancing, risk budgeting, and investor relations/marketing for hedge funds, long-only strategies, private equity, real estate private equity. In addition, Mr. Won served on the investment and risk management committees at several major financial institutions where he headed up risk and investment risk management.

Mr. Won completed a BA at Northwestern University, attended the Tuck School of Business at Dartmouth College and received a Masters degree from Columbia University with a concentration in International Finance and Economic Policy Management.

About Family Office Association

The Family Office Association (FOA) is a global membership organization exclusive to single family offices (SFO) and families of wealth. In a world of uneven information, families of wealth need to come together in a confidential setting to share ideas and compare notes. The Family Office Association seeks to provide the combination of privacy and openness where relationships of trust can grow. FOA also provides programs, roundtables, significant summits, research and a secure place online for the exchange of experience and thoughtful advice from such peers and families who may be journeying on the same path. FOA seeks out the best experts and notables in the family office industry to educate our members. FOA establishes the place where families can truly raise social capital.

Family Office Association is the trusted and respected source that families of wealth can turn to for independent resources, education and guidance. For these families, FOA is the advocate for establishing and sustaining a single family office (SFO). With an SFO, these families create their own private company of dedicated professionals exclusively devoted to their investment, legacy and personal needs. An SFO enables a family to customize their own solutions mindful of their values and goals. FOA provides the foundation, insights and encouragement for families to engage with the long-term preservation and conservation of their wealth and family stories.

Family Office Association
500 West Putnam Avenue, Suite 400
Greenwich, Connecticut 06830
Ph: 203-570-2898

Angelo J. Robles, Founder and CEO
angelo@familyofficeassociation.com
www.familyofficeassociation.com