Derivatives and the Family Office

How Derivatives Have Transformed Asset Allocation for Multi-Generational Families

Investors and institutions have used derivatives for many years to hedge stock market risks and currency fluctuations. Recently, their use has expanded beyond these traditional applications. This white paper examines how multi-generational families can use derivatives to customize their access to alternative investments, minimize investment risk and gain exposure to international markets.

SOME FAMILIAR USES OF DERIVATIVES

As you may know, a derivative is a financial instrument that mirrors the value of an underlying asset. Rather than trade in the asset itself, investors enter into a contract to exchange funds, assets or some other value at a future point in time—based on the value of the underlying asset.

Derivatives can be based on many types of assets including stocks, bonds, commodities, interest rates, exchange rates, or indices (such as stock market indices). Typically, they have been used to protect investors from dramatic fluctuations in the value of an asset.

COMMON USES OF DERIVATIVES

- **Diversifying a concentrated stock holding that has a low tax basis.** Derivative products such as equity collars and variable share forward contracts can help investors diversify these holdings without triggering what is deemed to be a taxable sale of the asset;
- **Managing interest rate risk in real estate investments.** Derivatives can be used to hedge floating interest rate exposure when you are directly involved or are developing real estate;
- **Offsetting volatility in energy prices.** Derivatives have been used to create a more predictable stream of income for investors involved in oil and gas exploration limited partnerships;
- **Protecting the value of export sales, import orders and outstanding loans.** Institutions and governments use swaps, currency forwards, futures and options to protect against interest-rate risks that arise from normal commercial activity, and to help reduce their financing costs.

THE NEW ROLE OF DERIVATIVES

CUSTOMIZED ACCESS TO VOLATILE ASSET CLASSES WHILE MINIMIZING RISK

In addition to these traditional uses as a hedging instrument, derivatives can now provide access to alternative asset classes that you might not otherwise consider for your portfolio. This can lead to a more broad-based asset allocation.

Within the family office, however, you have the added complexity of multi-generational wealth and therefore multi-generational needs. Derivatives give you the ability to customize exposure to a volatile asset class in a way that serves the needs of each generation in the family. Let's look at how this might be structured for a particular family.

Generation One is the founding patriarch of the family, and of the corporate enterprise that has recently been sold to generate a liquidity event. For illustrative purposes, let's assume he is 70 years old, seeks preservation of wealth with some growth, and has a 10-year investment horizon. He is happy to have some exposure to commodities, for example, in a portion of his portfolio, but needs this exposure to be delivered in a way that guarantees protection of principal.

This generation might consider using a structured derivative product such as a principal protected note. This product contains a combination of a zero coupon bond that guarantees return of principal upon maturity, together with a call option that's tied to the performance of a more volatile asset class, such as stocks or commodities.

If the asset goes down in value over time, the option that is embedded in the structured product expires worthless. But the zero coupon bond accrues to par and therefore returns the original capital investment. If the volatile asset appreciates, the investor gets the return of principal plus the performance of the option.

Generation Two seeks to build wealth, is willing to accept greater volatility and is looking for tax efficiency. Let's assume Generation Two could be a 40-year-old individual who has a leadership role in the family business but is looking to build wealth and potentially engage in new entrepreneurial activity. As such, he may be willing to accept greater day-to-day volatility, but would like his returns to be delivered in a tax efficient way.

There are straight call options offered by major financial institutions — either based on a single hedge fund or a basket of hedge funds — that can serve the needs of Generation Two.

Although this option references the performance of a hedge fund or group of funds, it is actually a contract between the investor and a counter-party, a major financial institution. Therefore the timing of the maturity of the investment can be specifically set for 53 weeks or longer — to qualify for long-term capital gains and therefore potentially receive favorable tax treatment.

Generation Three, the youngest generation in the family, has a much longer investment time horizon and may therefore have a greater comfort level with risk.

Generation Three can introduce volatile assets into their portfolio and actually gain the benefits of diversification. This may sound counter-intuitive, but because this generation is often relatively concentrated in a single asset and does not have a great deal of liquidity, they can use the leverage of a derivative to increase their diversification and potentially improve long-term returns.

OTHER BENEFITS OF DERIVATIVES - PART 1

As we have seen, various derivative products enable you to take exposure to a core underlying asset, whether it is stocks, commodities or hedge funds, and tailor it to the needs of each individual generation, relative to risk and return.

However, there are benefits that go beyond this customized exposure. Investors who might otherwise avoid investing directly in volatile assets such as hedge funds — either due to the risk factors or the availability of certain funds — can gain access to them through structured derivative contracts with major financial institutions. These structured products can offer greater transparency, better oversight and risk management, lower fees and favorable tax treatment.

Providing an added level of risk management

With many derivative products, you are entering into a contract with a major financial institution with a solid credit rating. This institution will be the conduit by which you receive returns on either a single hedge fund or group of funds.

Therefore the institution becomes, in a sense, an "outsourced risk manager" because, ultimately, the institution is responsible for delivering the returns via the derivative contract. As such, the institution will demand a higher level of transparency, level of risk management, and level of communication from the hedge fund managers that is often beyond what is possible even with a large family office.

They will carefully monitor the hedge fund for deviations from the fund's strategy, such as style drift or over-concentration. They have in-house experts and technology to understand the complexity of the fund. Because of its large position in the fund, the institution has the clout to demand a greater level of transparency than any individual investor may receive. The institution becomes your advocate, your outsourced added value risk manager.

Reducing value at risk

It is possible to use derivatives to lower your exposure to a volatile asset class while still fully benefiting from the performance of that asset. For example, if you have $1 million invested in a hedge fund, you have $1 million of exposure. However, you can purchase a levered warrant or call option for $200,000 that replicates the performance of that $1 million hedge fund investment. As such, you have actually lowered your allocation to that hedge fund by $800,000, and therefore your funds at risk, and can reinvest that $800,000 in some other asset for greater diversification.

OTHER BENEFITS OF DERIVATIVES - PART 2

Access to restricted funds

Many successful hedge funds carry high minimum investment levels. Investing directly in such a fund could greatly skew the asset allocation and change the risk metrics of your portfolio. In addition, some of these funds are simply closed to new investors and not available at any price.

Major institutions are able to offer access to these funds through structured derivative products. In addition, these derivatives are often structured in a way that offers access to a basket of hedge funds without having to pay for additional layers of management fees.

Likewise, derivatives can help family office investors gain access to emerging growth markets and currencies that would otherwise be difficult to reach and inordinately risky. An institutionally-sponsored derivative that references the market in India, for example, could provide access without the risks of currency fluctuations and the complexity of that market.

Favorable tax treatment

With derivatives, you are buying a contract from an institution that promises to deliver value based on the performance of that asset at some point in the future. Therefore it is possible to structure the derivative to deliver value at a point in time that qualifies for long-term capital gains. When one considers that many of the underlying hedge funds could be engaged in high turnover trading, this ability to tailor the investment for favorable tax treatment is an especially attractive element.

In addition, the ability to customize the language that governs a derivative can be an opportunity to enhance discounting capabilities for estate planning purposes. The more you can make relative to an unknown, the more you can discount. And the more you can discount, the more assets you can pass in an estate plan tax-effectively.

For example, if you have $1 million in each of five hedge funds, the government could value that as a total of $5 million, for gifting purposes. However, if you have derivatives based on underlying hedge funds that pay off in unique ways, such as 100% of the best performance, 20% of the worst performance, and a linear scale for performance in between, it is more difficult to place a finite value on this type of structure for tax purposes. As a result, it is possible that the overall value of this portfolio could be sizably discounted, enabling you to gift securities more tax-efficiently.

OTHER BENEFITS OF DERIVATIVES - PART 3

Broaden your estate planning options

Today, derivatives are being increasingly used for various estate planning applications. For example, there are derivative strategies that allow you to effectively leverage intra-family transfers while minimizing the impact of the Gift Tax on those transfers.

In addition, many trusts have strict provisions that limit the trust's ability to borrow for investment purposes and use leverage. Derivatives can be customized to work within the constraints of a trust entity, while still being able to use leverage and to benefit from the potential of a long-term investment horizon without violating the terms of the trust.

DE-MYSTIFYING DERIVATIVES

Taken at their core value, derivatives have the potential to offer you all the upside benefits of a volatile asset class with few of the downside risks. However, they can be complex investments. They are often not exchange listed, as with other securities, nor do they generally have the transparency and documentation that you expect from other markets. Therefore it extremely important that you proceed with the help of a trusted, professional advisor.

Your advisor will understand your family's particular dynamics and investment needs, and can represent your best interests in negotiating with the institutions that offer these products.

Derivatives have become more popular because of specialized advisors being able to de-mystify the financial engineering behind them, and to deliver outstanding returns with reduced risk to family office clients.

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