Exchanges at Goldman Sachs
Where Are Family Offices Seeking Higher Returns?
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Allison Nathan: This is Exchanges at Goldman Sachs and I'm Allison Nathan, a senior strategist in Goldman Sachs Research. Today, we're going to look at the world of family offices, which manage the personal and financial needs of wealthy families. Family offices serve a small and select client base, but they're exerting a greater force on Wall Street and in the investing community.

For today's podcast, I'm delighted to be joined by four of my colleagues -- Sara Naison-Tarajano and Meena Flynn from our Consumer Wealth Management Division; Tony Pasquariello from our Global Markets Division, and Ken Hirsch from our Investment Banking Division. Sara, Meena, Tony, and Ken, welcome to the program.

Sara, let's start with you. You and your team collaborated with Ken, Tony, and Meena and others across the firm to publish new research on family offices called "Widening the Aperture." Set the stage for us. What exactly are family offices?

Sara Naison-Tarajano: Sure. Family offices are a really unique investor base. They're institutions that manage the wealth of an individual or a group of individuals really with the goal of delivering on that family's missions, values, protecting their wealth today and for generations to come. And at a high level, they create a whole lot of organization and structure around how families really think about their long-term wealth.

And what that means in a day-to-day practice is that they perform oversight of investment activities, right? So they make investment decisions. But they also take care of families' trust and estate, tax issues, distributions, governance, and a wide range of both investment and non-investment responsibilities.

Allison Nathan: And why did you decide to survey them?

Sara Naison-Tarajano: So the reason we decided to survey family offices is they've really grown in size and scope and scale on vision last decade. And that's due to a lot of different reasons. It's the macroeconomic backdrop we've seen. It's an increase in M&A activity. It's increase in valuations that has led to more significant wealth in the family office community.

That's led family offices to hire more professionalized teams and begin to look a bit more like what a classic institution looks like -- a fund or an endowment -- but with some key differences. You know, at the end of the day, family offices are looking after a group of individuals and really require that expertise. And they tend to be a bit smaller in size in terms of investment team structure than your classic institution.

And all of this brings together that they're a pretty unique client base that has been very opaque to most of the world. And given the relationships that we have with family offices around the world, we took this opportunity to really dig in and work with our wonderful family office clients and our colleagues throughout the firm to try to find out more about how these family offices operate and invest with the idea that this could be valuable to the lessons of investors around the globe, family offices and non-family offices alike.

Allison Nathan: What can the broader investing community discover and learn by looking at family offices?

Sara Naison-Tarajano: There’s a whole lot that investors can learn from how family offices invest and operate. They typically have a disciplined investment mission, and much less focus on mark to market than your typical institutional client, and they're comfortable with large allocations to illiquid assets. And you know this is in part because they think about their wealth and mission with a very long term perspective at night. And one of the most interesting things that came out of our report was that family offices have a much more barbelled approach to investing. They have very high cash balances to complement the heavy allocation to liquids and alternatives, and the results and we really saw this in March 2020, is that when markets are volatile family offices can acquire assets when other investors are sometimes forced sellers. The broad investor community can learn a lot about what it means to have a small and agile investment team when you look at family offices, because 50% of the family offices we surveyed have less than five investment professionals. And that's pretty lean for the asset levels that we're talking about, and that makes them nimble, they can be quick decision makers, and they have typically a pretty streamlined approach for approving investments. And they benefit from not typically reporting to a board of directors or outside investors. And they're aren't subject to investor outflows, and that means they can take on more risk and generally be a lot more flexible. I'll also add that many families are comfortable holding assets for generations, and they can be patient on timing, they're not typically as focused on exits, which makes them a very attractive partner for those seeking capital. You know, the last point I'll make is that family offices generally have resources and a value statement related to governance and mission. And what this does is it keeps family offices really disciplined with a lot of controls and guardrails, around how their funds are distributed to family members, and ultimately, this leads to asset protection and growth of capital. The family offices focus on next generation and creating process and education and systems around this next generation is an important takeaway for high net worth clients to consider.

Allison Nathan: Tony, let me turn to you. Family offices are increasingly transacting and operating more like institutional investors. From your seat in Global Markets, how are family offices positioning their portfolios for the current market environment?

Tony Pasquariello: So just to level set, the past 15 or 16 months have been a truly extraordinary period with respect to the macro backdrop. So last year saw the greatest economic collapse since the Great Depression, only to be followed by the fastest economic recovery in American history. And despite all that volatility, what followed from there has been a truly spectacular period for asset market returns in most any form -- public equity, private equity, hedge funds, real estate, art, wine, on and on.

So referencing a recent survey of 150 of the world's most complex and largest family offices, as family office investors look ahead, there are three main macro themes that emerge. The first is growing focus on the potential for an increase in inflation. That's perhaps not a surprise just given the extraordinary policy we've seen in the COVID era on both the monetary side and the fiscal side. And it's also dynamic that family offices with operating businesses observe in real time, be it higher prices for goods or rising wage pressures.

The second, which also I think logically follows from there, is there's a focus on currency debasement. Again, that's a reasonable observation given what global central banks have been up to and results in increased client interest in hard assets, digital assets and commodities.

And then the third topic that certain family office clients are thinking about is a prolonged low interest rate environment. As distinct from those investors who were worried about inflation, we think this is really a reflection of other investors who have observed a multi-decade trend now of ever-lower interest rates across yield curves and across global bond markets, which obviously makes cash management and traditional fixed income investing more difficult.

And then just to kind of jump off those areas of focus, there are a few clear asset allocation trends that emerge. The first is an increased allocation to public equities. Perhaps this comes as no surprise just given the truly superb cumulative returns over the past 12 years in particular. And of course the long-term track record, particularly in the US market.

And the second is hard assets, demand for hard assets. Again, we think this reflects those concerns around inflation and currency debasement. It could be traditional plays such as real estate, precious metals and art. It also includes increased direct investment in operating companies. And as we'll discuss later, it's also resulted in heightened investor focus on digital assets and cryptocurrencies.

Allison Nathan: A key finding from this survey is that, among respondents who are thinking about the rise in inflation that Tony just talked about, roughly half are investing in hard assets such as real estate. Meena, how do family offices approach real estate investing?

Meena Flynn: Absolutely, Allison. Real estate definitely plays a significant role in families' broader asset allocation. And this is because, for decades if not centuries, it's proven to be an effective store of value and inflation hedge. And sometimes it also has tax benefits and is cash flowing.

Most of the families that we surveyed invest directly in real estate, especially if it's a market or it supports an underlying business that they know well. To the extent they don't or to the extent the business actually requires a lot of scale, they will invest through a local operator or through a manager.

Families definitely look at real estate credit as well, but it tends to be a smaller portion of their overall real estate exposure. And here they might look to buy first mortgage bonds and are fine earning a moderate return because, to the extent that that asset turns south, they're happy to own it in perpetuity.

And then they would probably use a manager from a credit perspective if they wanted to have exposure to the space but with more portfolio diversification at a lower risk point and of course with a lower LTV.

As it relates to families, by and large, in real estate, I would say that this group has really been ahead of the investing curve. And that's because they've been positioned for trends that have really been amplified by COVID. And so for years they've been using the fact that they don't have to report to an investment committee, as Sara just mentioned, to garner support to do things like investing in a non-tier-one market or a niche market. And so they've really been able to take advantage of opportunities where there's not as much institutional capital.

And to that end, they've really been focused on some of the demographic shifts of population growth of highly skilled workers to states where there's lower cost of living and lower taxes. And here, they've been buying office buildings and also multi-family assets, where these rent resets as well as cash flow, it makes an attractive investment opportunity in both an inflationary market as well as in a low rate end market.

And then from a niche perspective, they've been focused on industrial real estate, given the secular trends in ecommerce and logistics. But I would say, on the margin, families aren't necessarily really looking to add to their real estate exposure right now, just given where current valuations are. They're of course opportunistic and engaged, but, to the extent that there was investment opportunities in other asset classes, they would be more inclined to look there.

Allison Nathan: These historically low interest rates and family offices' higher return hurdles have spurred broad investor interest in alternatives and private markets. The survey actually showed that family offices have an outsized allocation to alternatives. What's driving this interest in alternatives? And how are family offices investing in that space?

Meena Flynn: Sure. The survey suggested that institutional family offices have 45% of their assets allocated to alternatives. Some may be including their operating business exposure here, but either way it's significant. Investing in alternatives plays to the strengths of the family office structure that Sara just mentioned. There's a lot of benefit of staying invested in markets over the long term.

For example, in public equities, over the last ten years, if you had stayed invested the entire time in the S&P 500, you would have earned roughly a 16% annualized return or a 469% total return. But if you were out of the market on the 50 best days, you would have basically been flat. So take that and apply it to private markets where there's an illiquidity premium. And in private equity, even a median manager has been able to add incremental return to the extent of 2.5% a year. And top quartile managers, that number goes to roughly 7.5%.

Lastly, the other attractive part of private markets is how much value is being created before companies go public. The private ecosystem is now in excess of $7 trillion. And just in the first half of 2021, there was 6 billion invested in more than 3,500 seed-stage startups. This amount of capital provides these companies the ability to stay private for longer and focusing on growing their company versus having to think about the public scrutiny of quarterly changes.

Families really see this as a significant opportunity to grow their capital. And 80% of the families in our survey suggested that capital appreciation was their primary mission. Investing in alternatives and directs definitely provides an attractive way for them to be able to participate in growth-oriented and higher return opportunities. Because of this, they've been increasing the amount of dedicated resources to their investment teams for diligence, and we see that trend accelerating.

Allison Nathan: Ken, let me bring you into the conversation. How do family offices partner with private equity firms in direct asset investing?

Ken Hirsch: Private equity firms and family offices are fairly compatible, and they tend to work quite well together. Many family offices do not have the team, the infrastructure, or the processes in place to properly evaluate, execute, or manage control deals. So they're natural partners for private equity firms, whether that's as LPs or co-investors in specific companies. On the other hand, private equity firms themselves generally want to maintain control, and that makes family offices natural partners for them as well.

Allison Nathan: So what makes family offices attractive to companies raising capital or selling their businesses?

Ken Hirsch: Family offices are very attractive investment partners or buyers of companies that are selling minority or control positions, Allison. And this is for a number of reasons.

First, most are investing over a longer time horizon than other institutional investors, given their focus on multi-generational wealth transfer and the fact that they tend to have less pressure to underwrite to a predetermined time frame because they have fewer outside LPs to answer to.

Second, family offices tend to have more flexible capital. They can invest across the capital structure. And their investment mandates typically have fewer constraints, which allows them to consider different strategies and different geographies. And they're also able to invest across a wide range of sizes. So we might, for example, be speaking on one day to a family office about a $25 million minority position in a high-growth company. And later that same week, speak to them about a $100 million to $500 million-plus position in a control deal. And so this range of flexibility makes them extremely attractive.

Family offices also bring strategic value that's unique, sometimes deriving from their own experience in building and running related businesses. And for family-owned businesses, we also see family offices bringing the added benefits of greater privacy when that's desire and sometimes a sense of legacy in that family-owned businesses take comfort in knowing that the business would be owned by families on an ongoing basis.

Finally, during the pandemic, we saw an interesting phenomenon appear in the merger and acquisition market where certain family offices were able to provide 100% deal certainty by showing a willingness to backstop the entire deal and therefore eliminate any financing risk which other institutional investors were requiring. And this allowed family offices to emerge as the preferred buyer in a number of multi-billion dollar deals during that time frame.

Allison Nathan: Another finding in the report is that more than 90% of respondents indicated they invest in venture capital. What things have you been seeing across family offices investing in that space?

Ken Hirsch: With the massive amount of wealth creation, Allison, and venture-backed companies, alongside the macro-driven focus on growth, we've seen capital flows into the venture capital asset class at record levels. In fact, in the first half of 2021 alone, more than $155 billion was invested in North America into this asset class.

As part of this trend, we've seen a number of nontraditional investors come into venture capital, including family offices, who are aggressively pursuing opportunities to dedicate more resources and capital to the strategy. One of the big challenges for family offices seeking greater exposure to the venture market has been limited access to the top managers. So family offices are having to get creative and are often using their own networks to find access to attractive venture capital opportunities.

One effective strategy that we've seen family offices employ is to position themselves as an attractive, complementary partner to the fund and its portfolio companies, perhaps bringing unique skills or capabilities or access that they find to be of value. And for some family offices who have significant experience in hot areas for venture investing, including biotech or artificial intelligence or other areas, we're seeing them make direct investments into venture-backed companies because they have the ability to evaluate and manage and monitor those types of investments. And even less commonly, we've seen family offices manage their own venture funds.

For most others, the norm has been to invest in venture capital as family offices through venture funds or fund to funds because the disruptive nature of those markets is beyond the expertise of the family office team.

One final way that we're seeing family offices participate in venture capital is through venture debt, which is inherently a smaller opportunity given many early stage companies really cannot support much debt. But one way we are seeing venture debt play a role for family offices is through pre-IPO convertibles for later stage growth companies.

Allison Nathan: So a big investing theme that's growing in importance really for all investors is ESG. Sara, coming back to you, can you provide some insight into this growth trend in the family office space?

Sara Naison-Tarajano: Sure. And Allison, I think I'll start by defining ESG because it's used all the time. It stands for environmental, social and governance investing. And it's certainly been on the rise for quite some time now. But I think recent events around climate issues, social unrest, and the pandemic have really amplified investor focus on ESG. And family office interest in this space is really a combination of mission and value driven as well as a search for innovation and outsized returns.

And if we look at this year, 2021 has been the strongest year on record for flows into ESG investments. And global ESG funds have generally outperformed their category peers over the last ten years on a risk-adjusted basis. This is according to Morningstar and Goldman Sachs Zone Investment Research.

And I think regulatory tailwinds are a really key factor here and have reinvigorated ESG focus from family offices. Currently, we see EMEA leading the ESG charge to date with more than 80% of survey respondents in the region who reported they are moderately to extremely focused on ESG. We expect to see other regions follow suit as local regulations evolve. And when we really think about this on a global scale, we've got the Biden administration's commitment to cut US emissions in half by 2030. You have the European Union's commitment to reach net zero emissions by 2050. China has pledged to be carbon neutral by 2060. And finally, the United Nations' Sustainable Development Goals.

Allison Nathan: So how are family offices integrating ESG strategies into their portfolio decisions?

Sara Naison-Tarajano: When we think about how this is integrated into the family office world, it really cuts into three main areas. There's workplace policies, there's philanthropy, and there's investing strategies. On the workplace front -- and I think this is similar to what we've seen from a lot of corporations and institutions -- the emphasis on diversity of all forms within investment teams and within portfolio companies that families own is increasingly important to our family office clients. Family offices often view this as a critical place to enhance their perspectives, reflect the communities in which they engage, and attractive and retain the best talent.

And I think historically there's been a clear delineation between philanthropic efforts and investing strategy, but we're really seeing greater alignment between the values and frameworks applied to both pools of capital today. More and more, we're seeing family offices focus on ESG as a source of outsized returns versus being solely mission driven.

Family offices execute across a variety of channels for investments in ESG, but they generally have a similar approach to how they implement this. And this includes direct investing into companies that are solving environmental or social challenges, selecting private market impact managers, and then allocation to public market ESG portfolios or managers. And within these investment buckets, we see that clean energy has been top of mind in light of emerging global regulation geared toward combating climate challenges as well as sustainable practices. And that's particularly related from our family office clients to agriculture and food. I think that's partly because family offices really think and individuals think and care about what they put in their bodies. And so we've seen food and agriculture will be really top of mind for our family offices on the investing side.

Clients are definitely focused on high-growth companies innovating in this space. Direct deals that we've worked on this year include an electric vehicle charging station, a battery manufacturing company, an AgTech company, just to name a few. In all of these examples, while certainly I think families appreciated that overall mission of the companies, the return profile and expected return was really the key factor behind the investment decision for the family offices.

And look, finally, as the next generation we spoke earlier of, how important the next gen is to family offices and as this next gen comes into adulthood and becomes more involved in family offices' infrastructure and operation, we think the focus on ESG, particularly on the investment side, is going to continue to accelerate.

Allison Nathan: Of course, another area that's been top of mind for all investors has been digital assets such as bitcoin and other cryptocurrencies. Your paper found that almost half of family offices are interested in initiating exposure to cryptocurrencies in the future. Meena, what's driving that interest?

Meena Flynn: Like with most investors, the overall price appreciation of the last several years and the social adoption of cryptocurrencies really has more families looking at it. The survey suggested that 15% of institutional family offices have exposure, and another 45% are considering adding it.

While there's thousands of cryptocurrencies outstanding, the majority of these clients are focused on bitcoin and ether, which are also the only two coins that the SEC has said that they will not treat as securities.

The families that own bitcoin, they point to the fact that it's a rules-based global currency that is fungible and open source with a monetary framework that cannot be changed. They see it offering an asymmetric risk-reward given the limited supply. This is the same reason they believe it will be an effective inflation hedge. They also point to more adoption coming from developing countries, given the relative ease and lower transaction cost associated with using the coins.

For those that are considering adding cryptocurrency exposure, the main concern in the survey was how to prove that it's going to be a store of value over time. And it's difficult to predict that given it's challenging to analyze on a fundamental basis as you would any other currency or asset. And without these metrics, it's also unclear how it fits into a portfolio in a complementary way to other exposures.

The other concerns that families noted were around volatility, the safekeeping of the coins, environmental concerns from significant energy usage, and the evolving regulatory environment. Because of these concerns, we do see many families looking at the overall digital asset ecosystem and how they can invest in the innovation of distributed ledger technology and blockchain. Some believe that this technology is going to be as impactful as the Internet, and it's going to offer tremendous productivity gains. So to this end, we see investors looking at early-stage companies that focus on software and infrastructure as well as larger companies that are going to use this technology.

Allison Nathan: And finally, the four of you represent three divisions at Goldman Sachs -- Investment Banking, Global Markets and Consumer and Wealth Management. Why was it necessary to build a multi-divisional perspective in this study? Tony, maybe you can answer that.

Tony Pasquariello: So Allison, a few thoughts. Family offices' set of interests span across asset classes -- public and private markets funds and direct investments, both investment and non-investment-related needs. And as we've discussed today, they can be incredibly opportunistic.

Now, as part of the long-term relationship, the firm works with our family office clients in many different ways to help meet their objectives, whether it's asset management, financing or operating or portfolio companies, trading, philanthropy, the list goes on and on. So in this report, we really wanted to ensure that complexity in that range was fully represented.

And for that reason, it was really important to canvass family offices that interact with different divisions and businesses across the firm. We also drew on the perspectives and thought leadership of our colleagues from across the firm. And in doing so, we were able to contextualize our survey results and subject matter expertise that is as wide ranging as family offices themselves.

Allison Nathan: Thanks so much for joining us today, Sara, Meena, Tony, and Ken.

Ken Hirsch: Thank you, Allison. It's been great to be here.

Sara Naison-Tarajano: Thanks so much, Allison. It's been great to be here spending time with you. And thanks so much to Meena, Tony, and Ken as well for the great work on this project and for the last few years.

Allison Nathan: That concludes this episode of Exchanges at Goldman Sachs. Thanks for listening, and if you enjoyed this show, we hope you subscribe on Apple Podcasts and leave a rating and comment. This podcast was recorded on Thursday, July 15th, 2021.