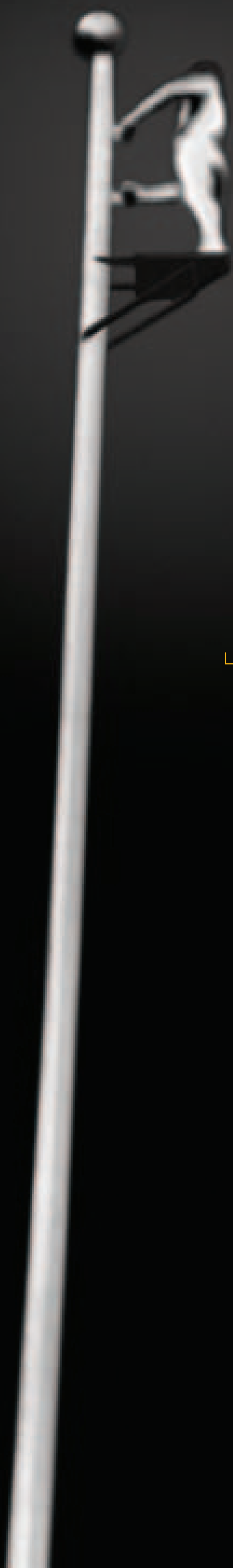
THE CHALLENGES OF WEALTH

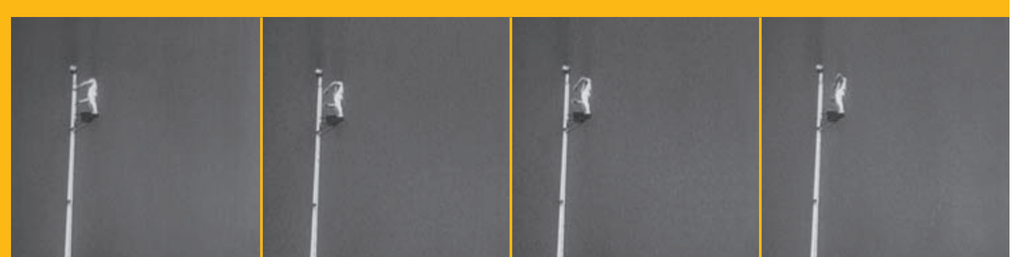


Beating the odds

Improving the 15% probability of staying wealthy

JPMorgan Private Bank

Nothing ventured, nothing gained. But how easy is it to take a risk? Does it come naturally? Or does dicing with danger have to be nurtured?



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Executive summary

Preserving wealth may not be as hard as creating it but it is much harder than most wealthy families would believe. When we examine the names that managed to stay on the Forbes 400 Wealthiest Americans list over a 21-year period, we find that fewer than 15% succeeded.

In this paper, we highlight eight material risks to wealth preservation: concentration, spending, leverage, tax, family dynamics, liability, currency and government action. They are "material" in the sense that they can erode wealth to a point where wealthy families can no longer achieve their goals, whatever they desire to do with their wealth.

Some wealthy families may assume that most of the risks do not apply to them. Others may assume that they will be able to react to an unanticipated event in time and then hedge, adjust ownership structures or buy insurance. The reality, however, is less positive.

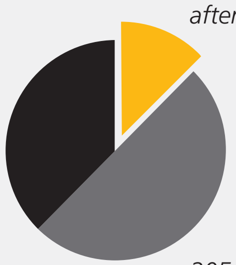
As private bankers, we seek to keep wealthy families wealthy. Through 150 years of working with high-net-worth clients, we have developed a deep understanding of their goals and the risks they face. We have found that when families acknowledge their risks and conscientiously manage them, they have a better chance of preserving wealth across generations.

This article focuses on research which has been carried out using data on US families, as there is a significant amount of readily available information. That being said, we strongly believe that the issues faced by these families are universal and equally apply to wealthy families all over the world.

Reading between the lists

Of the names that appeared on the Forbes 400 Wealthiest Americans list of 1982, we focus on the fates of 259 names. The other 141 need not overly concern us – they disappeared, as the chart shows, for reasons that have little to do with material risks to their fortunes.

So, studying the history of this group of 259, we learn that for an overwhelming number – 205 – wealth did not grow or wealth actually declined. The two most frequently cited reasons were over-concentration in a particular asset and too much leverage. Other important causes were excessive spending and tax. In at least two situations, family discord or liability suits led to deterioration of wealth.



** Forbes accounted for the drop-off thus:*
- *37 had their wealth "realigned" to a wider range of owners – family members, charitable trusts and private foundations*
- *14 were removed from the list after additional research*
- *90 died; their wealth was distributed to family members, foundations and, through taxes, the US Treasury*

JPMorgan Private Bank, with data from Forbes 400 annual editions from 13 September 1982 to 6 October 2003

Will your wealth last beyond a generation?

As difficult as it is to create wealth, it is equally challenging to preserve wealth.

In September 1982, Forbes magazine launched its roll call of the "richest people in America". A generation later, how many of the original "Forbes 400" kept their perch on the elite list? The answer is startling: only 54 remained – fewer than 15%. (See chart on facing page.)

The "Forbes 400" list gives us a convenient prism through which to examine the longevity of wealth, despite three limitations. It focuses on only one country – and a particularly dynamic one at that. It covers a relatively prosperous and peaceful period – unlike the current, more unsettling times. Lastly, it spans only 21 years – most wealthy families we know judge wealth preservation over a period longer than two decades.

Still, the 1982-2003 comparison makes our point. It takes extraordinary energy to create wealth. By the same token, it takes an equally concerted focus to preserve wealth.

This paper focuses on material risks to wealth preservation – risks that can diminish your family's financial wealth to a point where you can no longer meet objectives as you have defined them. (We thus leave out of this discussion the day-to-day portfolio risks that any investor might face – market risk, manager risk, interest rate risk and so on.)

We draw on our own experience of advising high-net-worth families for more than 150 years as well as our own ongoing research into risks and investor behaviour.

Avoiding risk is not possible. Even seemingly safe strategies – like holding gold, property or cash in sterling – introduce risks to preserving wealth over time.

To help you, we devote a section to understanding risks and avoiding common pitfalls. A subsequent section highlights the major risks we found and techniques for managing each. Finally, we offer a practical way to objectively assess the risks you face, prioritise them and manage them.

What is risk in the context of preserving wealth?

We can broadly divide risks into:
• those you take for an expected gain
• those you are exposed to given what you do and where you live

Opportunistic risks

The risks you take for expected gain can be thought of as opportunistic risks. Since risk and return are linked, the returns you enjoy over time are commensurate with the risks you have taken.

This concept is often hard for many successful people to truly accept. Most wealthy families have created their fortunes through some degree of risk-taking. The human tendency, however, is to attribute positive outcomes to skill while relegating negative results to bad luck. Such a natural bias (which we will explore later in behavioural finance on page 9) limits our ability to believe in the risk-return connection.

Of course, there will be situations in which the chances are significantly in one's favour. But these tend to be short lived. Markets or investment opportunities where one set of participants tends to win and another set tends to lose will shift with time. The losers leave (or go broke), the pool of winners becomes larger and winnings drop.

Environmental risks

You are exposed to environmental risks because of who you are, what you and your family do or where you live. For example, the risk of deteriorating health is clearly one to which we are all exposed. Other environmental risks are less generic – for example, earthquakes, civil unrest, terrorism or kidnapping.

While you seek to take opportunistic risks to earn returns, you are given environmental risks that you will try to avoid, insure against or accept. Another way of thinking about the difference is to look at it through the basic human motivations of greed and fear. Greed drives us to take opportunistic risks; fear forces us to protect ourselves from environmental risks.

Regardless of the category, risk has an emotional aspect and a statistical one. To understand the risks to wealth preservation, we must weigh what is quantifiable as well as what is not.

Two people can look at the same risk differently. For example, a Chinese entrepreneur invests in Argentina opportunistically but an Argentinean views his or her country risk as an environmental risk. These two investors will view the risk differently given their knowledge of the local market. Importantly though, while the investors' perceptions may differ, the likelihood of returns will be the same (assuming that foreign and local investors are permitted to invest in the same instruments at the same price).

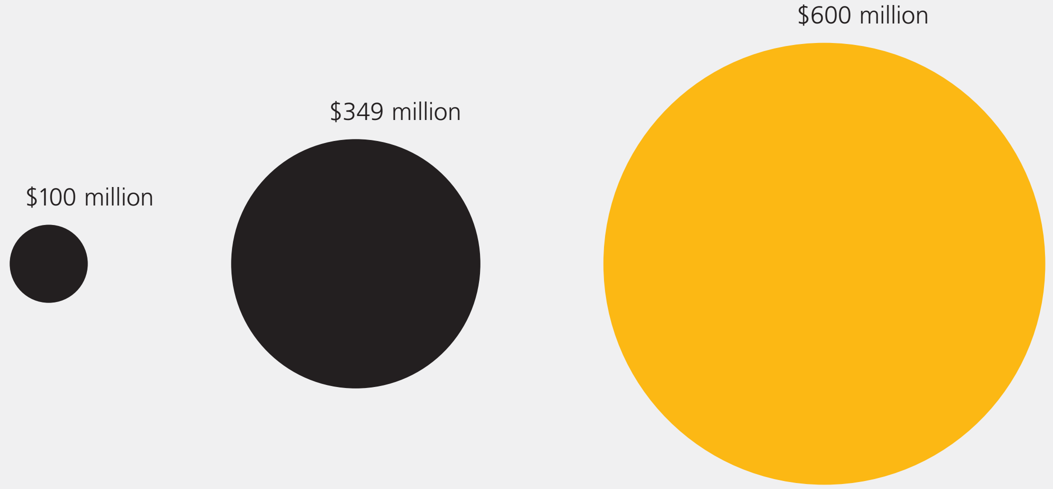
Staying wealthy – the bottom line

Most families have become wealthy by taking risk opportunistically. However, the concentrated risk that families took to create wealth is also the very risk that may erode their wealth. Families stay wealthy in one of two ways: by managing risks or by beating the odds. We strongly believe that, since risk and return are linked over time, the best way to preserve wealth is to avoid unnecessary opportunistic risks and manage carefully the key environmental risks.

While it is important to avoid unnecessary risks, risk should not be totally eliminated. Excessive risk aversion can be as dangerous to long-term wealth preservation as excessive risk-taking. For the majority of families, wealth must grow to accommodate the almost inevitable expansion of the family community as well as any rise in living costs. When you take a risk-averse stance by over-allocating to cash, gold or prime property, you are simply exchanging one type of risk (investment risk) for another (the risk of not keeping up in the long term).

Play it safe

If you had been on the Forbes 400 list in 1982, will a risk-averse stance keep you wealthy enough to remain on the list in 2002?



To qualify for the Forbes 400 in 1982, you had to have at least $100 million.

If you had taken your entire $100 million and put it all in cash, it would have grown to $349 million by 2002, assuming an average interest rate of 5.8%.

But in 2002, the Forbes 400 threshold was $600 million. With a risk-averse approach, you would have fallen far short.

Families have remained wealthy by taking risks efficiently.

Source: JPMorgan Private Bank

What's your risk tolerance?

To consider how much risk you are willing to take, find the balance between achieving all your goals and staying above your minimum wealth level.

Most families can easily list their chief goals. The first, usually, is to maintain the family's current lifestyle. Secondary aims may include the financial security of future generations, a charitable legacy or continued standing amongst the world's richest families.

To achieve these objectives, a family must take risk. On the other hand, the family should not take so much risk that it finds itself in danger of falling below its minimum wealth level.

What is this minimum level? For some, it is what they started with – zero possibly or the proceeds from the sale of their parents' land holdings. For others, it may be the sum necessary for a reasonable standard of living. A client once described his minimum as "the amount I need so that I don't have to start from scratch".

To understand a risk, you must understand both its probability of occurrence and its impact. The same event can have very different outcomes for different families.

Probability of occurrence

There are risks that occur with some frequency – for example, a company losing significant value or the next generation being unable to manage its legacy effectively. Other risks are less frequent – expropriation of a family's assets or accidental death. Unlikely risks should not be dismissed; rare events, when they do occur, can have a devastating impact.

We will not discuss in this paper those risks that are unlikely to have a long-term impact on your total wealth – for example, market fluctuations of 10-20%. Unless a family is highly leveraged or very illiquid, this level of market risk should not permanently damage wealth preservation.

This raises the importance of time frame. Some events evolve slowly (the loss of competitiveness of the US steel industry) while others occur almost overnight (the devaluation of the Russian rouble). Both are equally challenging to wealth preservation.

The reason has to do with human behaviour. We optimistically assume we will be able to sell out in time. But more likely, human nature being what it is, another 5% drop makes the new price even more attractive to us. The field of behavioural finance calls this the disposition effect – people holding onto losses too long. When the loss becomes almost certain, a number of studies have shown, people actually tend to increase risk-taking, hoping to beat the odds and avoid the loss. Such an act is, of course, exactly the wrong behaviour. For as we approach our true minimum wealth level, we should reduce risk-taking.

Impact on your wealth

The impact of some risks can be objectively measured. If 80% of your wealth is in a company and its value decreases by half, your wealth has dropped by 40%. The impact of other risk cannot be so precisely quantified. Say your grandchildren do not get along with one another. How will that affect the company that you will bequeath to them and therefore their financial security? Whether measured objectively or subjectively, the impact of each risk must be assessed.

The biases we all have

"Behavioural finance" is a term used to explain the common biases we exhibit when we make decisions about money – an emotional subject – with uncertain information. The field of study, with its rapidly expanding applications, received international attention when founding father Daniel Kahneman won the 2002 Nobel Prize for Economics. Some key behavioural financial concepts that are relevant to this paper are discussed below.

- Optimistic bias

  The majority of people think that the odds are in their favour. They also believe they possess above-average skills. In behavioural finance, this is known as an optimistic bias. Such confidence may be a useful trait in entrepreneurs and CEOs; it can be dangerous in an investor.

- Narrow framing

  We are influenced by narrow framing – how an opportunity or risk is presented. In an example often cited, food sounds more enticing when it is described as "90% fat free" rather than "10% fat". The point to remember: when analysing decisions, do so in the context of overall wealth. At JPMorgan Private Bank, we constantly look at our clients' total wealth picture – what is held at Morgan and what is held elsewhere, based on information from our clients. In fact, to ensure the proper framing of the asset allocation discussions, our Advice Lab has pioneered the application of wealth projection in the context of a family's goals.

- Disposition effect

  Most of us are averse to losses. This leads us either to hold on to losses too long – the disposition effect mentioned on page 8 – or increase our willingness to take bets to avoid a loss. Further complicating the situation, many investment decisions have an emotional component in addition to the obvious financial one. Keeping these two aspects distinct is vital, though not always easy. For instance, when a particular investment is a large part of a family's wealth, we must not let the human aversion to realising a small loss cause us to end up with a larger loss.

- Illusion of control

  We look for patterns in random events; we perceive we have control, even when we do not. Behavioural finance calls this the illusion of control. In a common example, most of us think that driving is safer than flying, thanks to the illusion that we control our cars. We give little thought to whether other drivers are in equal command of their vehicles. Similarly, most entrepreneurs view their company as less risky than investing in someone else's business. Yet much of what affects a company is beyond management's direct control – consumer preferences, competitors, suppliers, interest rates, etc.

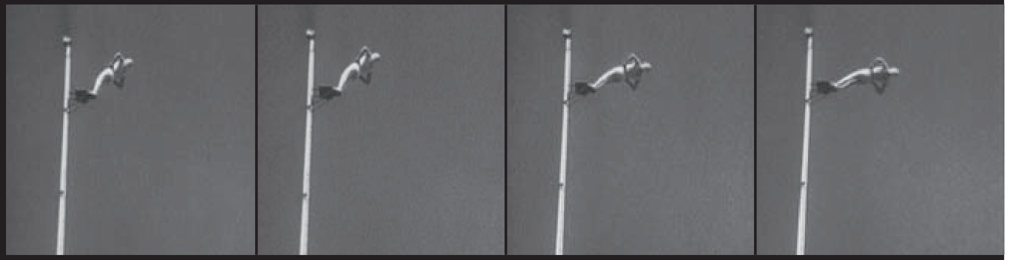
- Bias for the familiar

  We tend to be anchored in our past, overly emphasising former experiences and decisions. Combine this tendency with our aversion to losses and our illusion of control and you have a bias for the familiar or the proven. This may circumscribe what and where we invest in and prevent us from spreading our opportunistic risk-taking to new arenas that may improve the overall risk/return profile of our portfolio.

D Kahneman and A Tversky, editors, 'Choices, Values and Frames', Russell Sage Foundation, Cambridge University Press, 2000

What are the material risks to your wealth?

You do have to take risk to preserve wealth. It is therefore vital that you develop an overall picture of the risks you are taking.



We do not propose to catalogue every risk. Rather, we will focus on eight major sources of risk that can endanger a family's ability to preserve wealth. We want this paper to provoke you to assess your own set of risks. And through specific risk management measures, we also want to move you to act.

A growing number of techniques are available for managing the risks that we highlight. Inevitably, risk protection comes at a cost that must be considered against the value of the protection.

Some risk management ideas carry no explicit price tag. Instead, their cost comes in the form of increased complexity, reduced flexibility or diminished liquidity. In these cases, it will be crucial to evaluate the trade-offs.

1 Concentration

2 Spending

3 Leverage

4 Tax

5 Family dynamics

6 Liability

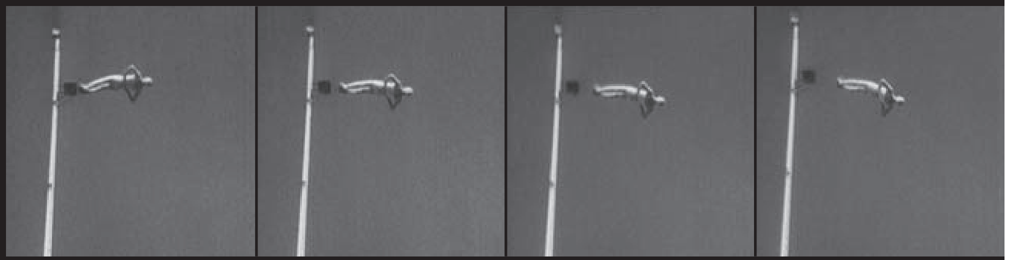
7 Currency

8 Government action

1

Concentration

Most wealthy families have at some point channelled their resources into one area – a company, an industry, property or an art collection, for example – which has become the source of their increased financial wealth. But a concentrated position is risky.



If an event significantly affects a family's one principal asset, the impact on its wealth will be material. For such families, therefore, when to reduce concentration is one of the most important decisions. Yet this is often the asset to which they have strong emotional ties, so the move to diversify is also one of the most difficult.

But diversify they must. While some assets do maintain their value over time, many do not. Quality, in and of itself, is no guarantee of continuing value. Over the long term, once-prime property locations can turn undesirable and even well-managed companies fail.

Historic evidence

A look at some successful companies of the past demonstrates just how great a risk concentration poses. Of the 500 large, publicly traded US companies that were in the Standard & Poor's Index in 1990, only half remained in the index a decade later. Our analysis shows that most of the substantial stock price declines resulted primarily from external factors beyond the control of management – regulatory changes, declining demand, sovereign risk, obsolescence and litigation.* No market segment stood immune. Even large pharmaceutical companies, which for two decades seemed to be insulated against downside risk, proved vulnerable to consolidation in their industry.

The longer the time perspective, the more compelling the evidence that concentration is dangerous to wealth preservation. Of the 30 blue chip companies in the Dow Jones Industrial Average in June 1959, only 11 remain today. Scanning the Dow's benchmark companies of the early 1900s, we recognise even fewer names.

For wealthy families, a century is not an excessively long time frame for planning. No one knows which industries will be valued in 2104. But we do know that, over time, obsolescence is inevitable and, therefore, concentration risk should be reduced.

** For a more in-depth analysis, see "An update on our concentrated stock research", On My Mind, JPMorgan Private Bank, Nov/Dec 2003.*

1 Concentration

Managing the risk

Families exposed to the risk of a concentrated position in a publicly traded company have a number of diversification strategies to consider. The optimal solution varies depending on the size of the family's holding compared with the capitalisation of the company, the liquidity of the stock, the market in which it trades, the applicable local regulations and the family's desires regarding control and charitable donations.

- Strategies for highly liquid stock

Outright sale This is the simplest solution but it is sometimes overlooked. Some families hesitate to sell on account of the capital gains tax they will have to pay. Unfortunately, delaying a sale may expose them to losses far greater than the taxes that would have been due. Others worry about the impact on the market of a founding family selling shares. In many countries, this concern can be mitigated through proper timing, specific procedures or pre-established periodic selling programmes.

Forward sale Rather than paying capital gains tax now, families in certain countries can, within specific guidelines, use a number of techniques to execute a future sale. Often, the seller must retain some risk in order to delay realising the sale and triggering taxes. While these forward sale agreements do not eliminate concentration risk, they can mitigate it appreciably.

Collars In the case of some shares, a family can enter into a series of derivative contracts that will limit the risk of a large drop in value while capping participation in some of the share's upside potential. A pair of derivatives structured to achieve this purpose is called a collar because it places upper and lower limits around the value of the position.

- Strategies for illiquid or non-public assets

Several potential strategies are emerging to help families whose wealth is largely tied up in corporate deferred compensation plans. If the assets are exposed to default risk and the family is no longer actively involved in running the company, then credit default insurance may make sense.

Other new solutions for diversifying compensatory share options include JPMorgan's tradable share option strategy. When adopted by a corporation (as Microsoft recently did), it can help achieve greater diversification for employees who receive compensatory share options and elect to sell them.

For private or illiquid positions, techniques may include a sale, a change in capital structure or a merger. Clients with large holdings in property could soon consider property investment funds (PIF).

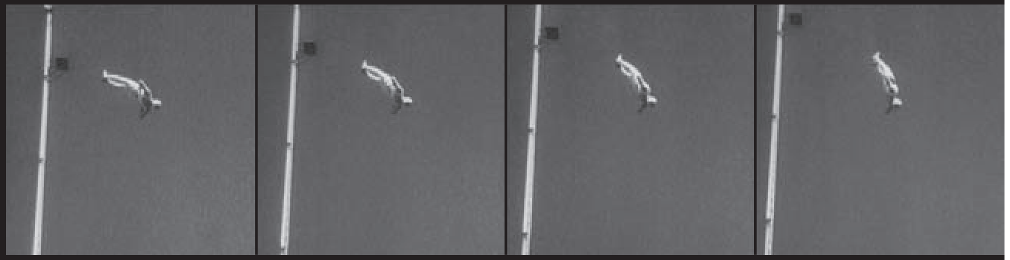
- Keep the trade-offs in mind

Many of the above solutions entail exchanging one form of risk for another. In evaluating potential solutions, families should pay careful attention to the trade-offs. Is the new risk truly more acceptable than the one they are trying to reduce?

2

Spending

It comes as a surprise to many people that to sustain wealth, they may spend no more than 4% annually of their investable assets.



After all, most investors remember equity markets that returned more than 20% a year and bonds that yielded over 10%. But in an environment of low inflation, neither of these levels is sustainable over the long term. Based on both historical analysis and forward projections, we estimate the following relationship between a family's spending level and the likelihood that its wealth will decline.

Of your investable assets, if you spend	*the probability that your wealth will decline more than 20% over 20 years is…*
3%	***less than 10%***
5%	***35-40%***
7%	***70-90%***

2 Spending

Spending has such a powerful impact on wealth in part because it is hard to reduce spending in absolute terms. Whether our goal is to maintain a certain lifestyle, buy a company or transfer wealth, we think of our spending in absolute numbers – not as percentages of our wealth. If the value of our investable assets declines but we spend the same absolute amount, then consumption as a percentage of assets increases. And that will accelerate the depletion of wealth.

A spending strategy is crucial

Some families hope that their investment strategy will save them from their spending strategy. It will not. We have seen people whose current portfolio returns lag behind their spending needs and who addressed the shortfall by taking on more risk. Some bought bonds of longer duration or lower credit quality or bonds with hidden currency risks. Others made higher allocations to more volatile assets, such as equities and concentrated positions. Over time, none of these strategies is likely to be sustainable.

Another aspect of spending risk is that the costs of achieving your goals may increase much more than the returns on your financial assets. For long-term investors, this is not a common risk. For, in general, shares and bonds provide returns in excess of inflation if measured over at least a decade. However, there have been exceptions – during the 1970s in the US, the 80s in many Latin American markets and the 90s in Japan, Eastern Europe and Ukraine.

Managing the risk

There are four key techniques for managing spending risk:

- **Monitor the level of spending**
  Each year, families should calculate the level of their current spending and future commitments as a percentage of their financial assets. One year of excessive spending is generally not a problem. But a steady rise in percentage spending will, over time, inevitably expose a family to material risk.

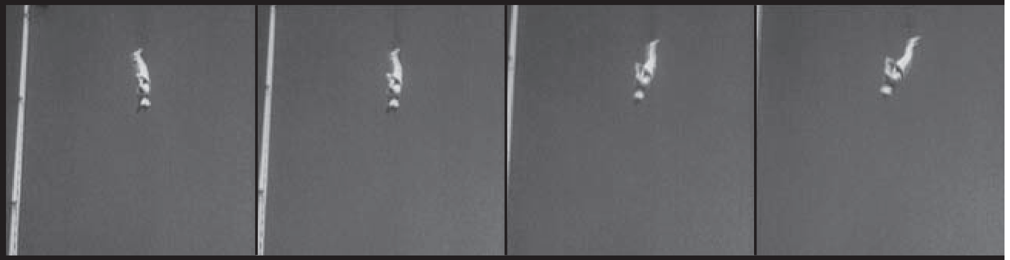
- **Manage inflation risk**
  In some markets, investors can manage inflation risk by purchasing long-maturity, inflation-protected securities.

- **Maintain as much flexibility in spending as possible**
  It may be worthwhile to consider new ways of owning assets such as fractional ownership.

- **Implement a balanced, diversified investment strategy**
  An asset allocation strategy should factor in a family's risk tolerance, time horizon and spending goals. Matching spending to investment returns is more prudent than attempting to accomplish the reverse.

3 Leverage

Leverage is a double-edged sword. It provides an opportunity to enhance returns but it also increases risk.



Leverage – or gearing – magnifies the risk/return at both ends, increasing the potential of positive returns, while exacerbating the implications of a negative outcome. In addition, the cost of debt produces an asymmetric effect, dampening the impact of leverage on positive returns and driving negative returns further down.

The chief risk of debt is that outsized leverage may render a family unable to react and remain in control of its assets should negative events strike. Changes in cash flow or declines in collateral values can force asset sales during inopportune market cycles. This can turn what might otherwise have been a temporary reduction in value into permanent destruction of borrower wealth.

An example

Let's suppose that a family pledges one million shares of a single stock worth £20 million in support of a £10 million loan to make a purchase. If the stock suddenly drops in value by 50%, assuming the lender requires ongoing 2:1 collateral to loan coverage, the family might have to liquidate the entire one million shares to satisfy the £10 million loan obligation. If the family instead liquidated £10 million of the initial share position to make the purchase and the same 50% drop occurred, the family is left with half a million shares worth £5 million.

As important, without leverage, the family is also left with the possibility of future appreciation and recovery of value in half its original stock position. That possibility has been lost in the leverage scenario.

Consider eventualities

Of course, leverage presents a material risk only if the debt carried is large relative to assets or cash flows. But it is not always easy to recognise a debt burden that is too large. With surprising frequency, borrowers believe that debt is manageable because they currently have enough excess cash flow to meet the required payments. Instead, borrowers should rely on a more storm-worthy evaluation. They need to consider the future volatility of collateral values, interest rates and cash flows and measure these potential movements against their own tolerance for certain negative asset and cash flow outcomes.

This kind of careful assessment is all the more important when families leverage concentrated wealth. The unforgiving nature of leverage, combined with the inherent volatility of concentrated share positions, can present a formidable threat to wealth preservation.

In a typical example, a successful entrepreneur sells his business to a publicly traded company for shares in the company. He then borrows a substantial amount against the share position to invest in a high-risk venture. The buying company falls on hard times, eventually going bankrupt. The entrepreneur is left with worthless shares, a portfolio of illiquid investments and no liquidity to service or retire his debt. While the details vary, leveraging a concentrated position leads to disastrous results with shocking regularity.

Know the risks

Frequently, families borrow to reinvest in financial assets and, in that way, enhance portfolio returns. While this can often be a rewarding strategy, the risk/reward dynamics may not be intuitive. Investors need to know how to measure expected returns against the cost of debt and they must understand how levered investing can change the distribution of probable portfolio return outcomes. Without a clear comprehension of these concepts, borrowers can unwittingly overexpose themselves to risk or pursue opportunities that create risk without commensurate returns.

Managing the risk

• Consider leverage against your total portfolio
A family seeking leverage must do so in the context of its overall portfolio, viewing assets, liabilities and the purpose of leverage as a whole. The level of risk introduced by leverage will be influenced by such considerations as overall debt levels, the assets offered as collateral, the use of debt proceeds, the fixed/floating rate decision and sources and term of repayment.

• Keep yourself informed
In our observation, many wealthy families seem to be well attuned to the risks surrounding investing but they are far less aware of the risks and subtleties associated with debt. Yet leverage-related risks can present equal or greater challenges to the preservation of wealth. Stepping up the awareness level can therefore mitigate these risks. Critical topics would include:*

– How to determine a maximum personal debt level based on your view of future market movements and your risk tolerance for undesirable financial outcomes
– The risks of leveraging a concentrated position
– Collateral hedging tools
– Levered investing – factors that may influence returns and risk
– The fixed/floating rate decision and fixed rate choices

• Other tools
In addition, the following specific risk-mitigation tools may help in managing certain leverage-related risks:

Forced liquidation risk The first lines of defence here are moderate leverage levels (based on knowledge of how much debt is too much for you personally) and a diversified collateral base. If you find yourself beyond your comfort zone or if you elect to move beyond it, there are hedging techniques to manage your risk until the debt can be reduced. The hedging of underlying collateral positions to put a floor on collateral value can help minimise the possibility of forced liquidation. Hedging alternatives include cashless collars, puts and prepaid variable forward transactions.

Rising interest costs can thrust borrowers into a cash flow squeeze, which may then require assets to be liquidated. To manage this risk, floating interest obligations can be "swapped" for a fixed interest rate or various interest rate cap or collar solutions may be considered.

Collateral concentration risk
Mitigation techniques are numerous – starting with the obvious solution of relying on a more diverse set of securities for collateral. Unfortunately, many borrowers' entire asset bases are concentrated. These borrowers should refer to the ideas described earlier, such as outright sale to purchase a more diverse asset and collateral base, exchange funds or hedging (see pages 14/15).

Without any of these risk-amelioration tools, the borrower must be especially careful that the overall level of debt is appropriate to the substantial risk created when leverage combines with a concentrated asset base.

** To help in this regard, JPMorgan Private Bank's Capital Advisory group has created a broad series of leverage education and advice primers aimed at clarifying leverage risks, minimising leverage surprises and positioning individuals to employ debt in an intelligent, informed way. These materials cover each of the topics outlined above as well as a recently developed framework we call "Maximum Prudent Leverage", which helps clients to develop their own personalised view of the amount of debt they can be comfortable with.*

4 Tax

Tax poses a significant risk to families that do not implement effective strategies on a timely basis.

Tax on wealth takes a variety of forms across jurisdictions – the typical types being capital gain tax and tax on the transfer of wealth. Many governments combine several of these levies.

In the UK, for example, taxes on the transfer of an estate from one generation to the next can be as high as 40% (in the US it is even worse). In the case of some estates, this has made for very large tax bills, as shown in the table below.

Less room to manoeuvre

Generally speaking, fiscal authorities around the world, driven by a growing need to raise revenues, are increasing their ability to tax wealth. They have become increasingly adept at tightening the rules. As a result, some long-familiar strategies for minimising taxes – such as siting assets in tax havens or translating deduction allowances liberally – are no longer effective.

The new environment has prompted some advisors to develop a variety of new tax-minimisation techniques for wealthy families. Many of these proposed tax "shelters" require increasingly complex ownership structures operated by independent third parties in a variety of legal jurisdictions. The very complexity of these structures magnifies certain risks such as:

- the difficulty of identifying an error or a poorly performing investment
- the inability to respond to emerging events because of insufficient liquidity or flexibility
- disallowance of the entire technique by a taxing authority.

A large tax bite

	Year of death	*Gross estate*	*Estate taxes paid*
Charles Woolworth	***1947***	***$17 million***	***$10 million***
Conrad Hilton	***1979***	***$199 million***	***$105 million***
Jessica Savitch	***1983***	***$2 million***	***$1 million***

"Estate Planning Works Already", Forum for Financial Planning, Spring 2001, Ashland University.
Table: Margaret M Holman, Holman Consulting, Inc., New York, NY.

4 Tax

We urge clients to view new varieties of tax shelters with scepticism. Risk and return are linked in tax-minimisation strategies, just as they are in the capital markets. If a technique is intended to permit you to avoid or postpone paying significant tax, there is always a trade-off. Many proposed techniques simply exchange tax cost for some form of risk that may be hard to perceive. If a scheme sounds too good to be true, it probably is.

Since tax systems evolve and the line between aggressive and abusive practices shifts over time, it is also important to keep any strategy current. If not reviewed objectively from time to time, a strategy that was acceptable in one decade may become a target for litigation in the next.

Fortunately, there are strategies – often quite simple – that are well accepted by the fiscal authorities.

Managing the risk

When family members and assets occupy multiple jurisdictions, complexity increases – but so does the opportunity to develop effective strategies. Around the world, a multitude of tax-minimisation possibilities exists, applicable to specific tax jurisdictions and specific types of assets. Families should keep a number of general principles in mind when evaluating any plan with tax and other advisors.

- Remember to consider simple strategies
  Sometimes the obvious can be overlooked. Before executing a major decision, do you first consider its tax implications? Do you have a valid will that is consistent with your current situation? Are your life insurance policies owned appropriately and do they name the correct beneficiaries? Are your trusts properly funded and maintained so they will work as intended when required?

- Turn complexity to your advantage
  Wealthy families, by their very nature, have complex situations. They may have many types of ownership vehicles – personal holding companies, operating companies, partnerships or trusts – in multiple jurisdictions, where they are subject to multiple tax and regulatory authorities. This can create opportunities to reduce the overall tax burden. Sophisticated global advisors, if given access to the whole picture, can help avoid unnecessary double taxation. They can also find opportunities to use tax-advantaged vehicles or jurisdictions to their fullest.

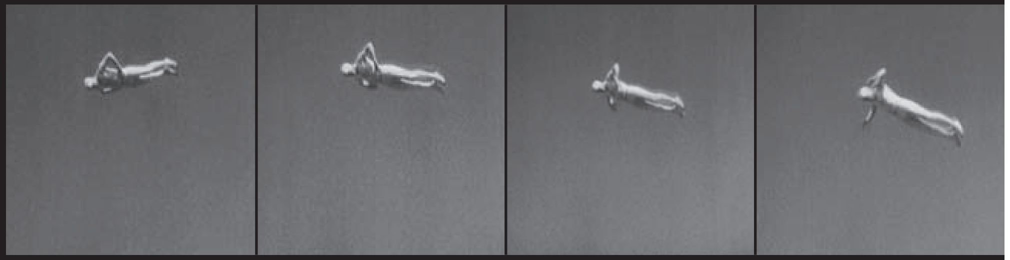
- Understand the trade-offs
  Tax-minimisation strategies should be scrutinised carefully. What risks are you taking on in order to reduce your tax risk? Are the tax savings truly more valuable to you than the flexibility you will forego? Are you willing to relinquish partial or total control over specific assets for the sake of reduced tax? Are you willing to face a possible audit? Are you sure that you or your heirs will never need access to principal that will henceforth be unavailable?

- Be sure that a strategy makes economic sense
  Many overly aggressive strategies are disallowed by tax authorities because they serve no economic rationale. To avoid this, make sure that your tax-planning strategy is founded on substantive legal precedent – for example, life insurance, trusts and companies are all well-recognised vehicles.

5

Family dynamics

This risk encompasses a great deal – the actions of family members or the interactions amongst family members – that can result in a material diminution of the family's wealth.



Many fortunes do not survive to the third generation, often because the relatives find it hard to manage their assets together effectively. A family with no clear decision-making process may be unable to cope with changes, whether gradual or sudden, in its environment. A patriarch with his wealth held in complex structures to minimise tax may end up leaving a picture so opaque as to cause suspicion and strife among his heirs. In a recent well-publicised case, a young member of a wealthy American family brought a suit against others in the family in order to understand changes in the family's wealth.

Risk can arise when one person dominates decision-making. This powerful family member must pay attention to grooming future leaders, hiring professional managers and instituting appropriate family governance measures. Otherwise, an unexpected turn of fate – illness, disability or death – will quickly put the family wealth at risk. With effective planning, family members will be prepared for a wide range of possible futures – not just the one they deem most natural or most probable.

Managing the risk

Families can mitigate this risk in a number of ways. The key is to involve younger generations in decision-making sooner rather than later.*

- Provide a basic financial education
  With a basic knowledge of the capital markets, children of wealth can better understand the family's overall strategy and play a more meaningful role in discussions.

- Ensure intra-family communication
  Family members should receive the information they need in a clear and readily understandable form. A simple summary of the family's goals, assets, cash flows and ownership structures will arm members with a fundamental level of information. To convey these facts and facilitate family communication, we have developed a highly effective format known as the Wealth Album.

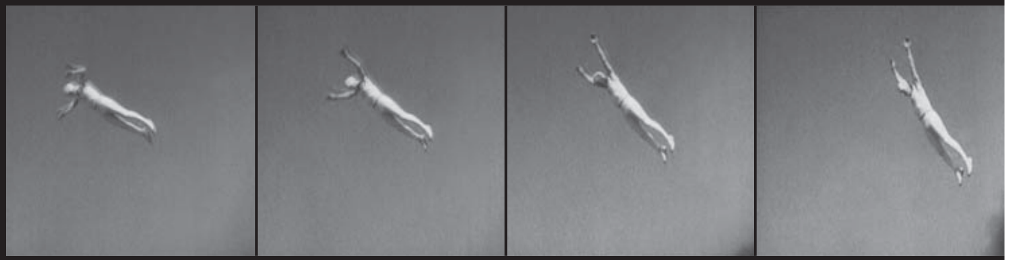
- Create flexible structures
  Flexible ownership structures – family companies, partnerships and trusts – can reduce the family-dynamics risk by permitting some members to take an independent path. Each structure must have an appropriate governance process to ensure that it remains consistent with the family's goals and with the evolving tax and regulatory environment.

- Get appropriate insurance coverage
  If the premature disability or death of a key person would put the family's wealth at risk, life and health insurance may be advisable.

* *See Effective governance: The eight proactive practices of successful families, The Challenges of Wealth series, JPMorgan Private Bank, 2003.*

6 Liability

By this term, we refer to a two-fold threat: litigation and theft. Wealthy families are often obvious targets.



In our increasingly litigious world, the wealthy are vulnerable to risks such as class action suits for employee discrimination, malpractice, insider dealing or negligence – justifiably or not. Theft remains an equally strong concern. Given today's technology, forgeries and other crimes seem easier than ever.

Managing the risk

It is difficult to manage a risk characterised by infrequent and unique events. There are, however, two broad approaches:

- Insure against liability suits
  Liability insurance is widely available to protect you against broad risks as well as specific events. Consider engaging a risk expert to evaluate your environment and identify high-risk activities.

- Institute good controls
  There are a number of steps you can take to reduce the risk of theft. Exercise great care in granting powers of attorney. Review who has access to your account information, cheques and passwords. Determine who has signing authority as well as the accounts and transaction size involved. Maintain tight control of documents.

  While delegation can simplify your life, it also exposes you to increased risk that something may happen that is not in your best interest. Make changes where necessary. A separation of duties can help to safeguard your assets. For example, in some family offices, the person who initiates wire transfers should not also be the approver.

7 Currency

Wealth can be defined in local terms or global terms. Currency risk comes into play when there is a mismatch between a family's assets and its financial goals.

Families may be wealthy on their home turf without ever worrying about being considered wealthy on the wider world stage. As long as the monetary and fiscal policies at home provide stability, families such as these need not expose themselves to currency risk to any significant degree. Any opportunistic investments outside their stable home currency should be limited, in most cases, to no more than 20% of the family's wealth.

Other families define their wealth in global terms because the majority of their interests lie abroad. Some family members may live overseas. Or they may want to pursue such passions as private yachts, personal jets or exclusive residential properties – assets with prices driven by global, rather than local, wealth thresholds. So these families must establish a reference currency for their wealth that is broader than their home currency.

The downside of being multinational

Currency risk arises when a family's assets are not denominated in the same currency as its liabilities and expenditures. Over time, if the currency of the former depreciates against the currency of the latter, the family's wealth will gradually erode. Such long-term erosion may be driven by inflation differentials, differences in productivity or other macroeconomic factors. Short-term fluctuations in currency values may mask a long-term decline.

There is a second form of currency risk that is harder to recognise but may be even more damaging. Currencies that are pegged to one another may induce in wealthy families a dangerous and false sense of stability. Currencies that are linked in value are not, in fact, identical; removal of the pegs or bands may precipitate a dramatic shift in exchange rates. This is precisely what happened to both the Hong Kong dollar and the Mexican peso in relation to the US dollar.

7 Currency

Managing the risk

There are two techniques for managing currency risk. The first, strategic asset allocation, is generally used to manage environmental risks – those the family will be exposed to in the long run.

The second technique, combining derivatives and forward transactions, should generally be used to manage opportunistic risks – those the family takes in order to profit from a particular view of the relative value of two markets.

- Invest in assets that mirror the currency mix of the family's goals
  In view of a family's obligations and spending plans, what are the most appropriate currencies for managing its wealth? One simple answer is to divide the family's wealth into a local portion for its local interests and a global portion for its other interests. The global pool also serves as a safety net in case the family has an unexpected need to relocate.

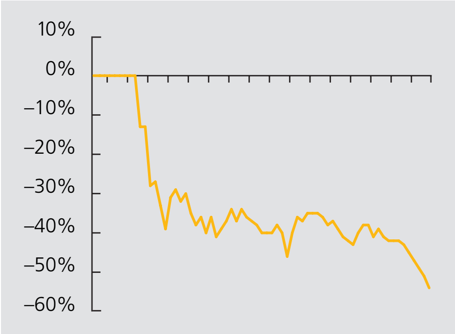
  A more complex approach is to combine the family's entire needs and set an overall strategic currency mix. This creates a currency benchmark that can then be used to measure the family's wealth. Once this benchmark is set, currency risk can be minimised by investing the family's assets appropriately. For example, a family whose interests are equally divided between Europe and the US should consider a currency benchmark that is 50% euro and 50% US dollar. The family's investment policy statement should indicate a strategic asset allocation consistent with this currency allocation.

- Use forward transactions and hedging techniques
  The second way to manage currency risk is to alter a family's currency exposure by entering into transactions in the currency markets. This may make sense if it is not possible to shift the family's asset allocation to mirror its goals or if the family's strategic currency mix is evolving over time. To manage shorter-term currency risk exposures, the family can sell or buy a certain currency at a pre-set price and date in the future. Such forward transactions can effectively shift the family's overall currency mix for a set period of time. In situations in which a change in the relative value of two currencies would be especially costly, currency derivatives may be available to help manage the risk.

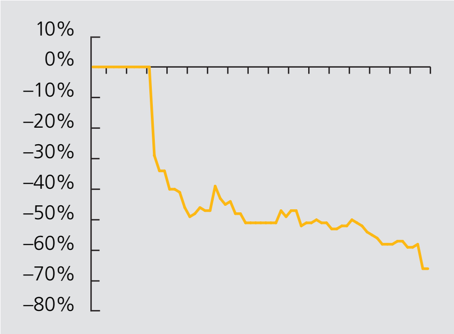
A steep and sudden dive

The value of currencies can drop rapidly and unexpectedly, as seen in the examples below. Over a three-month span and after a fairly stable spell, wealth in Mexico, Argentina, Russia and Indonesia dropped suddenly and significantly in dollar terms.

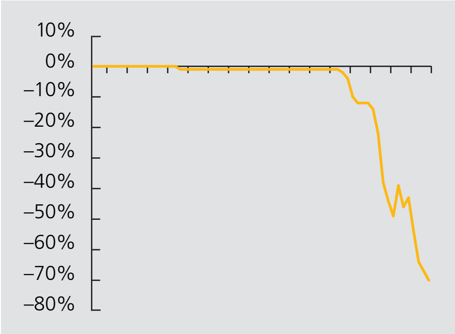
Mexican peso drops 54%
Dec 94-Mar 95



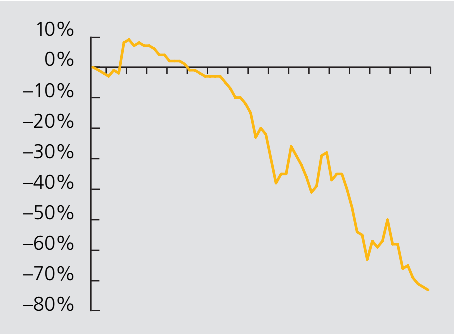
Argentine peso drops 66%
Dec 01-Mar 02



Russian ruble drops 70%
June-Sept 98



Indonesian rupiah drops 73%
Nov 97-Jan 98



JPMorgan Private Bank. Bloomberg

8 Government action

Throughout history, the actions of governments have caused the destruction of wealth owned by individuals. It is possible that wealth may continue to evaporate in this way.

The high dive into a tank of flaming water is the stuff of stunt legend. Captured in this collection of stills taken from a 1940s film, success demands practice, precise timing, nerves of steel, but perhaps, above all, a firm belief in fortune favouring the brave…

Governments, faced with political pressure, have often chosen short-term stability over long-term prosperity.

Such actions as radical tax increases or expropriation of private assets can have a huge impact on the wealth of families. Also, government action, or inaction, with regard to the domestic money supply can contribute to high or hyperinflation.

While government actions may occur in stages, wealthy families may not always be given the opportunity to react. For example, as money supply expands and inflation accelerates, governments may implement exchange controls and other steps that limit a wealthy family's flexibility.

Sometimes, as ideology shifts, families have been taken by surprise again and again – whether it is by ethnic persecution or by the confiscation of financial assets or key industries.

While we would like to think that governments today would not take these actions or would first provide sufficient notice to those who may want to leave the country, experience would indicate otherwise.

Managing the risk

It is impossible to insure directly against government actions such as expropriation or confiscatory taxation – events that occur infrequently but have huge financial impact when they do. The best defence is to recognise what assets are vulnerable and diversify the location of assets as much as possible.

- Identify assets at risk
  These are assets that cannot be moved from their location and thus are exposed to the risk of government action. Examples: property, plant and equipment and the cash, shares and bonds of that country.

- Consider relocating assets through a change of ownership
  These intangible assets can be easily transferred to a company or a trust in another jurisdiction. For example, patents and trademarks could be held by an entity located in a stable country. If a government were to seize the physical assets, the family still has control of its intangible assets and may thus be able to rebuild abroad.

  In managing government action risk, the goal is to limit the physical concentration of assets. In assessing exposure, families must correctly identify the location of financial assets. Local bonds, for instance, carry local country risk even when held in a custody account in another location.

At JPMorgan Private Bank, we have worked long enough with the world's wealthiest families to know that "wealth" is always defined in very personal terms. As John D Rockefeller once remarked of J Pierpont Morgan's $80 million estate, "...to think he wasn't even a rich man!"*

Further, every family prioritises in a different way what it seeks to do with its fortune. But if wealth preservation counts as one of those goals, then an understanding of these eight major risks is critical.

No strategy to preserve wealth is risk free; the best strategy is to understand risk and manage it.

About the author

Alexander ("Lex") Zaharoff, the principal author of this paper, heads JPMorgan Private Bank's Advice Lab, where experts focus on creating solutions to the issues that wealthy families face.

Lex joined JPMorgan as a private banker in 1982. His first assignment involved working with clients from Europe. In 1990, he moved to investment management, becoming co-head four years later. Five years later, he took over as head of product development and advisory services, which evolved into the Advice Lab.

US born, Lex traces his family story through two of history's watershed events. His paternal grandfather, a member of St. Petersburg's elite and a designer of bridges for the Trans-Siberian Railway, escaped from the Russian Revolution, saving his family but losing almost all his possessions. The Zaharoffs created a new life for themselves in Shanghai – only to see what remained of their wealth disappear during China's Communist upheaval. The family eventually found safe haven in Paris, with Lex's father sailing onward to America. Lex holds a Bachelor of Science in Engineering from Princeton University and an MBA from Harvard Business School. He is a Chartered Financial Analyst.

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*Richard Conniff, *The Natural History of the Rich: a Field Guide*, Norton, New York, 2002

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Editor's note

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- Amy Braden – Effective Governance: The Eight Proactive Practices of Successful Families

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