On The Rise

Family offices cite the established and increasingly important role that hedge funds and hedge funds-of-funds play in their investment strategies.

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Like the alternative investment sector itself, single family offices (SFOs) were first created to address the unique needs and objectives of the ultra-high-net-worth community. Early entrants to the hedge fund space built their reputations on the ability to offer sophisticated investment and wealth preservation strategies that delivered superior returns across all market conditions. Early successes led to a period of rapid proliferation for specialized funds incorporating widely divergent investment philosophies. Today, hedge funds are an investment vehicle of choice for the majority of SFOs and a growing number of institutions. At the heart of this expansion has been the recognition that investors have wide-ranging goals and risk appetites, specific sector expertise and time horizons.

Through expanded due diligence and outside consulting firms, SFOs have the ability to customize their investment portfolios to a greater degree than ever before. Regardless of the investment objectives, there are numerous suitable hedge fund options to consider. However, the task of filtering through the noise in the marketplace to find the best options can become a monumental undertaking. As a result, SFOs are increasingly turning to outside advisers for help in evaluating alternatives.

The SFO industry has prospered alongside the alternative investment sector. Again, the ability to offer tailored solutions to clients is driving sector growth. SFOs, however, manage a much greater portion of the family relationship. While SFOs commonly oversee tasks including advanced estate and tax planning, managing residences, acquiring luxury services and bill paying, they are typically consulted on investment decisions as part of a holistic approach to wealth management. Due to the scope and frequency of their interactions, SFOs hold a position of trust among the families that they represent, establishing these offices as gatekeepers to the family.

To help gain a better understanding of the correlation between SFOs and the alternative investment sector, Rothstein Kass recently commissioned a survey of over 146 family offices. As we have done since our first research on hedge fund industry trends in fall 2007, we teamed with renowned wealth advisers Russ Alan Prince and Hannah Shaw Grove to create a survey that would deliver insightful and compelling results. Our initial findings were then reviewed by our Family Office Group and co-sponsors at G Capital Management to provide additional context. We discovered that, in light of recent market volatility and turbulent economic conditions, SFOs are being asked more frequently to assess investment allocations. Given the hedge fund industry's now-proven ability to generate superior returns amid challenging market conditions, interest in these investments is—as our report suggests—"On the Rise."

Nearly 75% of SFOs indicated that they invest in hedge funds, with some 60% planning new allocations in the coming year. Moreover, nearly half plan to adjust allocations. These figures strongly support the notion of the burgeoning and symbiotic relationship between SFOs and the alternative investment community. The firms that are best-positioned to capitalize on deeper ties to SFOs through increased capital inflows are those that offer enhanced transparency, adhere to stated investment principles and provide a clear marketing strategy.

We hope that you enjoy reading "On the Rise," and think that you will find its conclusions insightful and thought provoking. We look forward to sharing with you the findings of future research reports, and thank you again for your continued support and interest.

Howard Altman
Co-Managing Principal
Rothstein Kass

Key Observations

- The large majority of single-family offices are currently investing in hedge funds and hedge funds-of-funds.

- On average, these organizations have allocated one-third of their total investable assets to such products and hold positions in about six distinct funds.

- Single-family offices identify limited portfolio transparency and continuity of the management teams as their biggest concerns about these investments.

- Over the past 12 to 24 months, the majority of family offices say their hedge funds and hedge funds-of-funds delivered performance that met or exceeded their expectations.

- Substantial assets will be in motion over the coming year, with almost 60 percent of family offices planning to increase their investment in hedge funds and about half expecting to switch some or all of their investment to new funds that better meet their criteria.

- The favor of family offices can translate into new business for the hedge fund firms that can demonstrate strong track records and sensitivity to the requirements of ultra-high-net-worth investors.

Sophisticated strategies and products have long been a part of the investment programs at family offices. For many years, these underlying investments, and the clients for whom they were created, were largely ignored by mainstream asset managers and investors due to their low profile, high cost of entry and relative rarity. The new millennium, however, brought conditions that helped to broaden the awareness and allure of both. Today, hedge funds and family offices are among the fastest growing and most dynamic businesses.

The Three Types of Family Office

The Single-Family Office

The "classic" structure is one created exclusively for or by a single exceptionally wealthy family to provide control, negotiating leverage and a defense for family members. The families with these types of operations are comfortably situated at the financial apex.

The Multifamily Office

As the term suggests, these structures serve the needs of several families. In some cases, a single-family office has brought in other families to extend its financial reach and share infrastructure costs. Other times, a number of wealthy families with similar goals establish an office together hoping to gain greater influence over key aspects of their personal and financial affairs.

The Commercial Family Office

These businesses share many characteristics with multifamily offices, but are typically owned and managed for profit by corporations or professional advisers that are unaffiliated with their family clients. An array of companies (including private banks, brokerage concerns and investment managers) has moved into the realm of family offices as a way to attract wealthier clients.

Note: Many financial services providers that fit the description of commercial family offices (such as boutique investment advisers, wealth management firms and the examples listed above) identify themselves with the adopted term "multifamily office."

Source: *Inside the Family Office: Managing the Fortunes of the Exceptionally Wealthy*, Russ Alan Prince & Hannah Shaw Grove, Wealth Management Press, Penton Media, 2004.

Some Background on Family Offices

The driving rationale of every family office is to achieve higher levels of wealth management and maximization by pooling the resources of an extended family unit under the oversight of a single, dedicated organization. Armed with a detailed and comprehensive understanding of the family's financial affairs and tax obligations, the office can be structured in a way that meets the needs and desires of the family and the individual members through a combination of in-house and outsourced capabilities. Often, this customized support allows for the pursuit of a family's nonfinancial agenda as well, which may include such things as strategic philanthropy or family cohesion.

The rise in personal wealth has helped boost the appeal of family offices and family office-style services, and as the financial community has responded to this demand, the family office has become a theme with many variations. Despite the escalating number and types of organizations entering what was once an exclusive and private arena, most still adhere to one of three primary business models. (See sidebar on page two.)

Family offices can provide a wide range of services – from administrative tasks such as bill paying and tax preparation to lifestyle services like recruiting key household staff members – but the vast majority of family offices are organized around an investment function with responsibility for the family's collective fortune.

Over the past five years, family offices have increased their use of alternative investments. In particular, hedge funds and hedge funds-of-funds now represent a much larger part of many portfolios due to their non-correlated nature and strong performance results. Our research shows that most family offices have sourced hedge funds from third-party managers in the past; given the sustained interest in these products and the difficulty retaining high-quality investment talent, it's likely that family offices will continue to rely on outside advisers for these types of capabilities.

To understand how family offices use hedge funds and related investments today, and to establish a benchmark for their future application, we conducted a study with single-family offices.

The Research

The term “family office” is now used to describe everything from businesses to service philosophies and product suites. Given its repeated adaptation, we set the following screening criteria for our survey participants:

–An organization that provides investment management and administrative services to one family unit

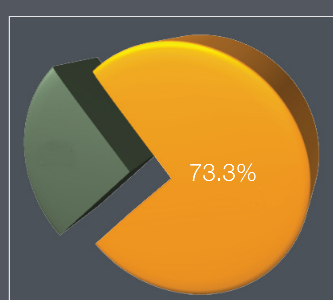
–Services can be delivered by employees of the office, through an outsourcing partner or through a combination

–Size and composition of the families may vary from immediate (i.e., parents and children) to extended and multigenerational (i.e., nieces, cousins, in-laws)

In May 2008, we contacted 146 organizations that met these standards and found that nearly three-quarters of them were currently invested in one or more hedge funds or hedge funds-of-funds. The following survey results are from only those 107 single-family offices with allocations to such products. **(Exhibit 1)**

“A majority of hedge funds significantly outperformed other asset classes in the past few years. For SFOs, the goal is simple—to participate in the most promising investment opportunities and hedge funds that have been a critical part of the mix,” said Peter Gerhard CEO of G Capital Management.

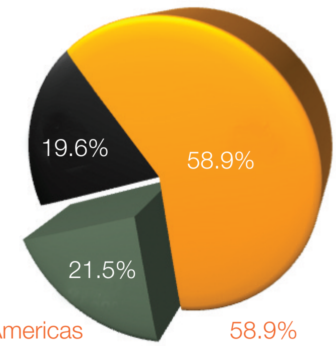
Exhibit 1: Hedge Fund Usage



Using hedge funds or fund-of-funds 73.3%
N = 147 single-family offices

We constructed a global sample of single-family offices, with about 60 percent located in the Americas and the other 40 percent fairly split between Europe and the Far East. (Exhibit 2) The total investable assets of these firms ranged from roughly $300 million to more than $1 billion, with an average of $775 million and a median of nearly a half-billion dollars. (Exhibit 3)

Exhibit 2: **Geographic Location**



Americas	58.9%
Europe	21.5%
Far East	19.6%

N = 107 single-family offices

Exhibit 3: **Investable Assets**

Mean	$774.8 million
Median	$496.5 million
Range	$312.2 million to $1.3 billion

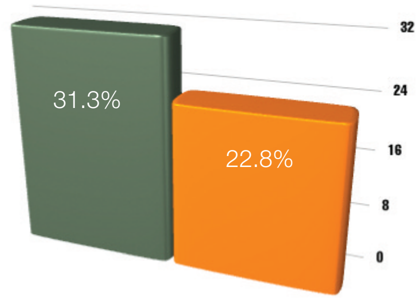
N = 107 single-family offices

Usage

Hedge funds and hedge funds-of-funds play a significant role in the investment strategies of the family offices that participated in our survey. On average, the offices allocate roughly one-third of investable assets to these products. The median allocation is slightly less than one-quarter of investable assets, though both figures represent hefty sums of money when considered in the context of the total investable assets cited above. (Exhibit 4) Those monies are generally spread across more than one product, with offices citing an average of 5.7 and a median of 3.2 individual funds. (Exhibit 5)

"A single product is too limiting. We believe that allocating across several strategies improves the chances of achieving optimal returns. Extensive and ongoing due diligence and monitoring allow firms to be more opportunistic in their approach," Mr. Gerhard explained.

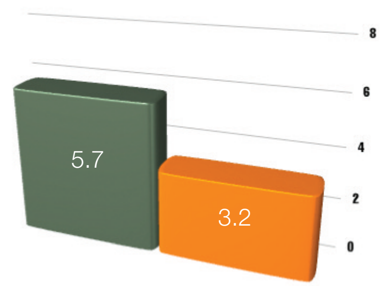
Exhibit 4: **Percentage of Investable Assets in Hedge Funds or Hedge Funds-of-Funds**



Mean	31.3%
Median	22.8%

N = 107 single-family offices

Exhibit 5: **Number of Hedge Funds or Hedge Funds-of-Funds in Portfolio**



Mean	5.7
Median	3.2

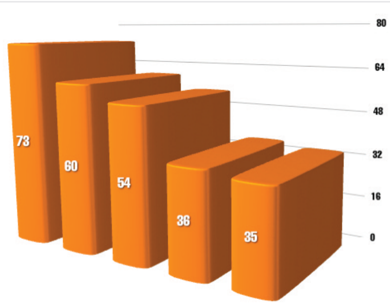
N = 107 single-family offices

Concerns

The greatest concern expressed by single-family offices relative to their hedge fund and hedge fund-of-fund investments was a lack of transparency in the portfolio holdings, as cited by almost three-quarters of respondents. Without a running inventory of the underlying securities and instruments they own, many offices feel their ability to proactively manage assets and risk can be compromised. (Exhibit 6) Almost two-thirds of family offices ranked the length of lock-up periods as a top concern, and about 55 percent say they are wary of style drift as hedge fund managers pursue alpha-generating opportunities. Far fewer, roughly one-third of family offices, say fraudulent activities by fund management companies and the side pocket investments are top-of-mind.

"By definition, every investment carries some risk. SFOs must communicate regularly with sub-advisers and expect them to address their concerns expeditiously. Sub-advisers that fail in this regard will be replaced by those that can," Mr. Gerhard added.

Exhibit 6: Key Concerns

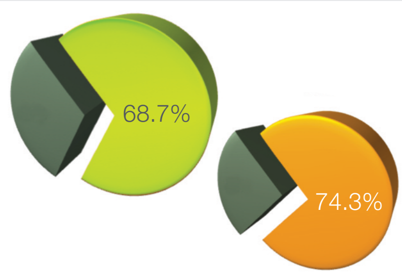


Lack of transparency	72.9%
Length of lock-up periods	59.8%
Style drift	54.2%
Fraud	36.4%
Side pocket investments	34.6%

N = 107 single-family offices

We identified a noteworthy increase in the level of concern about two specific issues when we compared these responses to the findings of a similar study conducted in 2007 of 167 single-family offices. Last year, 69 percent of offices cited apprehension about the continuity of fund management. One year later, the number of respondents with similar fears increased to 74 percent, indicating heightened concern about many firms' ability to seamlessly manage the variety of planned and unplanned succession scenarios that can impact a fund's operation, such as death, termination or defection. (Exhibit 7)

Exhibit 7: The Increasing Importance of Business Continuity



2007 | 68.7% | 167 single-family offices
2008 | 74.3% | 107 single-family offices

Year

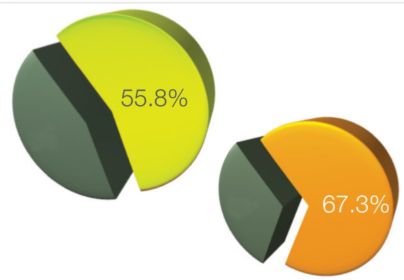
Importance of business continuity

Sample size

"Contrasting our findings against earlier research efforts demonstrated that despite growing SFO participation in the alternative investment space, persistent concerns will need to be addressed if this interest is to continue unabated. Survey respondents were particularly wary of lengthy lock-up periods and a perceived lack of transparency," said Rick Flynn, the head of the Family Office Group at Rothstein Kass. "SFOs are typically intimately involved in multiple aspects of their clients' lives and have a keen understanding of how these interrelation components comprise a unified plan. SFOs will be averse to allocating resources to funds that limit their ability to customize client portfolios or create uncertainty. SFOs that invest in a fund that delivers excellent returns but is at odds with overarching objectives do their clients a disservice by exposing them to risks that can undermine their long-term goals."

In a similar vein, we found that concern about the risk management controls in place at each investment firm had increased from 56 percent to 67 percent in the same period of time. (Exhibit 8)

Exhibit 8: **The Increasing Importance of Risk Controls**



2007 | 55.8% | 167 single-family offices
2008 | 67.3% | 107 single-family offices

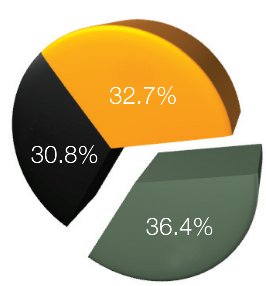
Year | Importance of risk controls | Sample size

Performance

Performance is critical to hedge fund investors, and a portfolio management team's results can heavily influence a family office's satisfaction, willingness to remain invested or likelihood of seeking other products.

When the survey respondents were asked how their hedge fund and hedge fund-of-fund portfolios had performed in the previous 12-month period relative to expectations, we found that the large majority of family offices realized investment returns that met or exceeded their expectations. (Exhibit 9) When we extended the timeframe to 24 months, more than 80 percent of family offices reported performance that was in line with or better than projections. (Exhibit 10) It's worth noting that fully half of family offices said that their performance was better than they anticipated over the 24-month period, an extraordinarily large percentage relative to normal circumstances but reflective of the volatile markets and economic climate in recent years, which presented numerous occasions for hedge funds to outperform their benchmarks and other types of investment products.

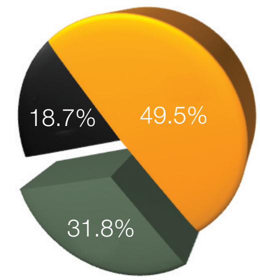
Exhibit 9:
Performance in Last 12 Months



Better than expected	32.7%
As expected	36.4%
Worse than expected	30.8%

N = 107 single-family offices

Exhibit 10:
Performance in Last 24 Months



Better than expected	49.5%
As expected	31.8%
Worse than expected	18.7%

N = 107 single-family offices

"Hedge fund investments have been accretive to overall performance. However, long-only strategies simply cannot deliver the desired results in this type of market environment. As a result, some firms are adopting institutional-quality techniques and specialized products that bring quantifiable value to their portfolios," Mr. Gerhard said.

"The success of the alternative investment space is directly tied to its ability to offer superior returns regardless of underlying market conditions. This is especially true during periods of extreme volatility and uncertainty. From our results, we can see that the industry as a whole has continued to deliver on that potential," said Mr. Flynn. "Because of the plethora of investment options available to them, however, SFOs are beginning to look beyond performance in evaluating funds. In evaluating these funds, SFOs must also consider risk tolerances, long-term investment objectives and, often, sector focus to structure portfolios that meet the individualized needs of their clients."

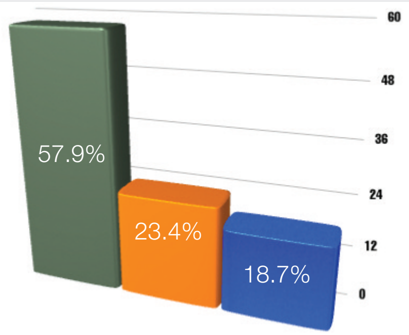
Intentions

In recent years, pension plans, foundations, endowments and other institutional investors have gradually increased their allocation to alternative vehicles, and, according to our research, many single-family offices will follow suit. When asked about their intentions over the coming 12-month period, almost 60 percent of offices plan to increase the percentage of assets invested in hedge funds and hedge funds-of-funds, about one-quarter expect to maintain their current level of investment, and slightly less than 20 percent say they will decrease their allocation. (Exhibit 11)

"Nearly 60% of SFOs indicate that they plan to increase allocations to hedge funds over the next 12 months. However, competition for these assets will be intense. SFOs will immediately rule out investing in funds that do not offer a clearly defined strategy and exceptional transparency," said Alan Kufeld, Principal at Rothstein Kass. "The hedge funds that will enjoy the greatest benefit from increased allocations from SFOs are those that recognize the need for enhanced marketing and communication efforts targeted to this constituency."

"While it's important to avoid trading for its own sake, firms should be conscious not to limit their options either. Managing substantial assets effectively calls for flexibility and agility, and an ability to aggressively pursue the opportunities that meet established selection criteria and make the most sense," said Mr. Gerhard.

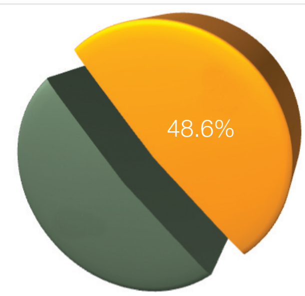
Exhibit 11:
Plans Over the Next 12 Months



Increase the allocation to hedge funds 57.9%
Keep the same hedge fund allocation 23.4%
Decrease the allocation to hedge funds 18.7%
N = 107 single-family offices

Despite the overwhelming sentiment among single-family offices to have hedge funds and related products become a bigger part of their portfolios, there is a good chance that a meaningful amount of money will be moved between competing products during that time. Almost half of family offices indicated a high probability of switching funds within the coming six months, revealing a desire to find funds that can better meet their objectives or have the ability to temper some of the concerns cited previously without conceding on performance. (Exhibit 12)

Exhibit 12: Highly Likely to Switch Funds in the Next Six Months



Highly likely to switch 48.6%
N = 107 single-family offices

"Investment styles cycle in and out of favor, so it's imperative to stay on top of holdings and make needed changes. Our own portfolio looked different six to twelve months ago. If I had to guess, I would predict that it will probably look different six or twelve months from now. It's incumbent on firms to manage market fluctuations and capture upside whenever possible," observed Mr. Gerhard.

Looking Ahead

Our research findings all point to a strengthening relationship between hedge funds and family offices. If approached and managed effectively, these ultra-affluent investors can be long-term, profitable clients for firms with top-performing products. It will, however, take more than consistently above-average investment results to reach, cultivate and retain single-family offices. These are unique organizations that share qualities with both institutional and individual investors; they have explicit requirements, high standards, and the freedom and authority to do exactly as they choose without fear of repercussions. Hedge funds and hedge funds-of-funds will need to recognize and accommodate the distinct aspects of family offices to capture their share of this expected growth.

"Few investments can rival the appeal that hedge funds hold for the high-net-worth investor. For that reason alone, I believe that they'll continue to occupy a meaningful place in the investment strategies of family offices," concluded Mr. Gerhard.

About the Authors

Russ Alan Prince is the world's leading authority on private wealth, the author of more than three dozen books on the topic, and a highly-sought counselor to families with significant global resources, and their advisers. He is co-author of *Fortune's Fortress: A Primer on Wealth Preservation for Hedge Fund Professionals* and *Beyond Performance*: *How Hedge Funds Can Strengthen and Build Their Affluent Client Base.*

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About the Sponsors

Rothstein Kass

Rothstein Kass provides audit, tax, accounting and consulting services to hedge funds, fund-of-funds, private equity funds, broker-dealers and registered investment advisors. The Firm is recognized nationally as a top service provider to the industry through its Financial Services Group. The Financial Services Group consults on a wide range of organizational, operational and regulatory issues. The Firm also advises on fund structure, both inside and outside the US, compliance and financial reporting, as well as tax issues from federal, state, local and international compliance perspectives.

The Rothstein Kass Family Office Group offers a wide range of financial, wealth planning and lifestyle management services to management companies, family offices and high-net-worth individuals, including family members, business owners and members of the financial services, entertainment and sports industries. Comprising seasoned financial professionals and Certified Public Accountants, the Family Office Group applies proven expertise with the utmost discretion and attention.

Rothstein Kass has offices in New York, New Jersey, California, Colorado, Texas and the Cayman Islands.

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G Capital Management LLC

By leveraging state-of-the-art capital markets expertise and select advanced planning concepts, G Capital has raised the bar for the next generation of family offices. In addition to the highly effective and sophisticated solutions its family members require, the organization's structure and capabilities create an efficient, scalable and profitable operating environment that can be readily adapted to capture new business opportunities.

Publications

Beyond Performance: How Hedge Funds Can Strengthen and Build Their Affluent Client Base

As competition in the hedge fund sector intensifies, it will be more important than ever for hedge fund professionals to complement strong investment results with a thorough recognition of the priorities and expectations of their client base. Authors Russ Alan Prince and Hannah Shaw Grove share the research they have conducted with wealthy individuals and families that invest regularly, and significantly, in hedge funds and funds-of-funds. Their findings will help hedge fund firms understand the most effective ways to reach, cultivate and retain high-net-worth investors.

Fame & Fortune: Maximizing Celebrity Wealth

Wealthy celebrities have the world at their feet – but the unique circumstances of their professions often present financial and legal challenges that require special handling. The leading authorities on affluence and celebrity wealth management—Russ Alan Prince, Hannah Shaw Grove and Richard J. Flynn—deliver the first data-based insights on the world of high-profile wealth in this invaluable resource for celebrities and their closest advisors on how to enhance, protect and pass along their hard-earned assets.

Copies of both publications are available upon request.

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