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ILLIQUID ASSETS

The Hidden Half of Client Wealth

By Brad Davidson

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Consider this proposition: Your wealthy clients own twice as much as you think. Three recent studies cited below validate this assertion. Their liquid assets (the stocks, bonds, and cash that advisors tend to focus on) represent less than half (45 percent) of a typical millionaire's portfolio. The other 55 percent consists of illiquid assets such as real estate, stock in privately owned companies, artwork, etc.

It takes specialized skills to preserve the value of illiquid assets, skills their owners often lack. Most owners need help and know it. They are more apt to worry about their illiquid assets than, say, their mutual funds. Yet most advisors offer no help. When it comes to this half of the portfolio, clients hear nothing but crickets.

Advisors routinely ignore this "hidden half." This must change. This article (1) argues that illiquid assets are important so advisors should not ignore them; and (2) suggests how even advisors with limited illiquid asset experience can provide assistance their clients will value.

MORE IMPORTANT THAN LIQUID ASSETS

Some recent studies document the importance of illiquid assets. TIGER 21 is an association with more than 500 extremely wealthy members who collectively manage more than $50 billion in personal assets.[1] Each member is required to present his or her personal investment portfolio annually. The association publishes quarterly reports detailing the holdings, which form a fascinating insight into how ultra-affluent families invest their money. The TIGER 21 Member Allocation Report details how in Q3 2017 55 percent of the TIGER 21 household investments were in illiquid assets; just 45 percent consisted of liquid assets (see figure 1).[2]

TIGER 21 has been tracking portfolios for decades (see figure 2). Note the growth over time of dark orange (real estate) and light gray (private equity). Particularly since the Great Recession, the clear trend is that illiquid assets are growing in importance and liquid assets are becoming less so.[3]

PricewaterhouseCoopers issued a 2015 report confirming the growth in this segment and predicting that illiquid assets will continue to grow by double digits annually.[4] "Between [2015] and 2020," the report states, illiquid assets "are expected to grow to $13.6 trillion in our base case scenario and to $15.3 trillion in our high case scenario" (see figure 3).

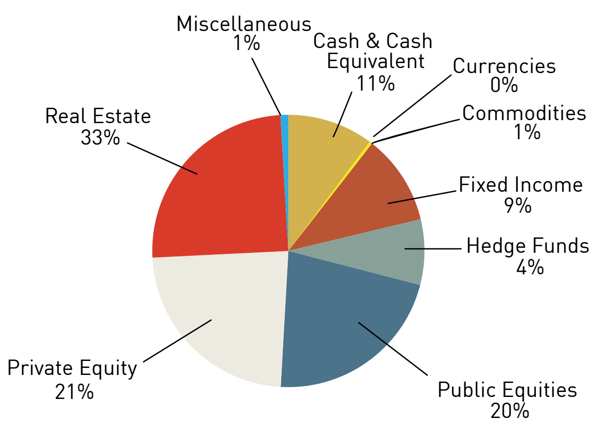
A third study of note is an Internal Revenue Service (IRS) analysis of estate tax returns filed in 2016.[5] Because only estates worth more than $5.4 million file, the study sheds light on what the wealthy own. In 2016 more than one-third of the assets listed on estate tax returns were real estate, interests in small businesses, and other. That is, illiquid assets (see figure 4).

As suggested by the TIGER 21, PwC, and IRS studies, illiquid assets are important. Therefore, advisors should treat them with respect. Yet in my experience advisors think that if they don't directly manage the assets, they are not responsible for them. In other words, "not my problem." To the contrary, helping owners address their illiquid asset challenges is good for any advisor's business.

Consider registered investment advisory firm AdvicePeriod,[6] recently featured in *Financial Advisor* magazine.[7] President

Figure 1

TIGER 21 MEMBER ALLOCATION, Q3 2016–Q2 2017



Source: https://d2zmiui5l338ap.cloudfront.net/s3fs-public/Asset%20Allocation%20q3%202017.pdf

Larry Miles ascribed his firm's phenomenal growth in part to its willingness to advise clients on all their assets, not just the ones it directly manages:

> *"Oftentimes, we're able to advise clients on assets that are managed elsewhere, assets that are in the form of a business or real estate," said Larry. "We found over the years that clients were really seeking an advisor who could offer them advice on their entire balance sheet, and all of their liabilities, regardless of where they were custodied. We believe the best advisors are able to do just that."*

To summarize, there are many reasons for advisors to stop thinking of illiquid assets as being someone else's problem. For advisors willing to help, happier clients and more referrals await.

THE HELP THAT ILLIQUID ASSET OWNERS NEED

Earlier I said that illiquid asset owners need help. What kind of help, exactly? My answer is, "They need the services you might want if you owned the illiquid asset," which vary depending on the type of illiquid asset in question. There are seven major types:

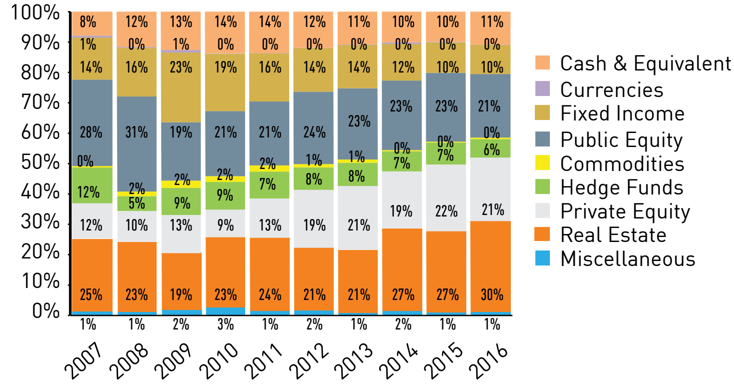
1. Real estate
2. Closely held businesses
3. Life insurance
4. Loans and notes
5. Minerals, oil, and gas
6. Intellectual property
7. Tangible assets and collectibles

Each of these seven has subcategories. Real estate, for example, has six subcategories:

1. Owner-occupied home
2. Vacation home (including hunting, fishing)
3. Income-producing (multi-family residential, commercial, retail, industrial)
4. Agricultural (farm, ranch, orchard)
5. Timber
6. Raw land

Figure 2

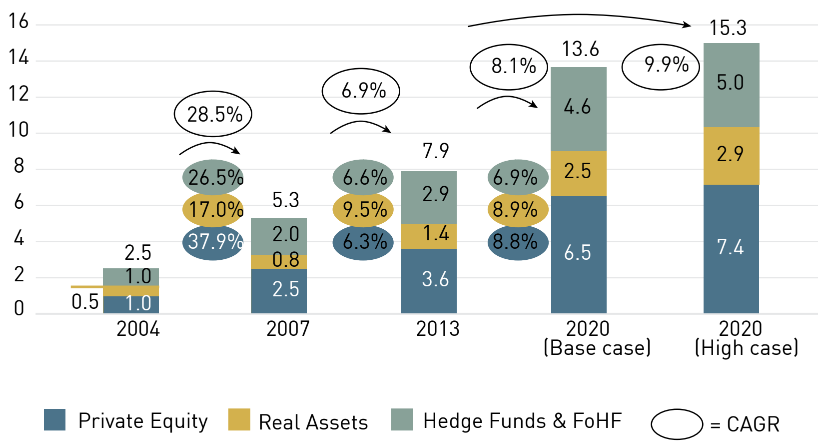
TIGER 21 MEMBER AVERAGE ALLOCATIONS YEAR OVER YEAR DATA



Source: https://d2zmiui5l338ap.cloudfront.net/s3fs-public/Asset%20Allocation%20q3%202017.pdf

Figure 3

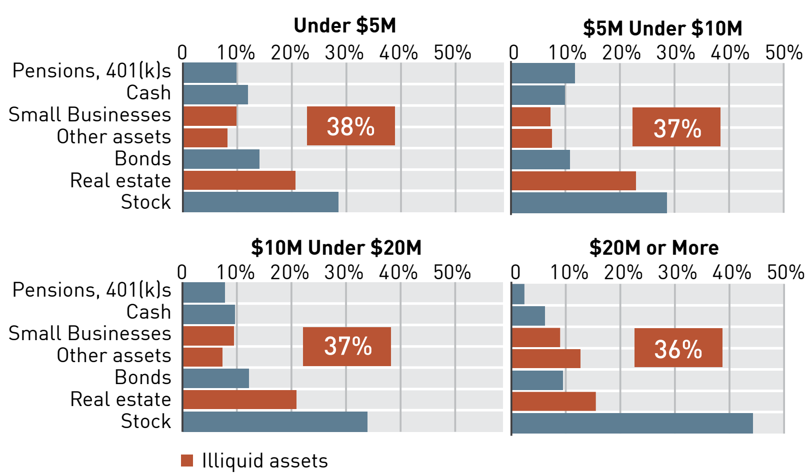
ALTERNATIVE ASSETS (IN USD TRILLION)



Source: PwC Market Research Center analysis based on Prequin, HFR, and Lipper data (https://www.pwc.com/us/en/industries/asset-wealth-management/alternative-asset-management-2020.html)

Figure 4

PORTFOLIO COMPOSITION OF ESTATES, BY SIZE OF TOTAL ASSETS, FILING YEAR 2016



Source: https://www.irs.gov/pub/irs-soi/2016estatetaxonesheet.pdf

To illustrate what help looks like, consider the example of a lakeside cottage that has been owned by one family for generations. Advisors with experience working with multi-generational families know that by the second or third generation, such properties likely have many owners and certain issues such as the following are sure to arise:

- Who is responsible for keeping critters and others outside during the off-season and between family visits?
- Who referees disputes if two family members want to use the cottage at the same time?
- Who decides if a repair is needed, and who pays for it (remembering that not all family members have an equal ability to pay)?
- What happens (and who decides) if an owner doesn't plan to use the cottage or can't afford to pay his or her fair share of the costs?

Therefore, help with respect to a vacation cottage requires the following:

1. someone with diplomatic skills to help develop a governance plan for the property;
2. someone to pay property taxes, insurance, and other routine bills;
3. someone to inspect the property periodically to ensure it is being kept up;
4. (if the owners so decide) someone to rent out the cottage during vacant periods;
5. someone to supervise the contractors maintaining the property;
6. (if the owners so decide) someone to handle the property's sale;
7. someone to prepare the property's financial statements every year; and
8. someone to appraise the property from time to time.

HOW TO HELP (IF ADVISOR IS NOT A FIDUCIARY)

Often owners cannot or will not skillfully administer their illiquid assets. In such cases advisors who are simply giving advice (i.e., not acting as a fiduciary) can ride to the rescue by saying, "Would it be helpful if I connected you to firms providing services 1-8?" In my experience the reaction from owners is always the same: a sigh of relief, a smile, and a heartfelt "Thank you, that is exactly what we need." (This is why advisors offering help with illiquid assets win so many referrals.)

Hundreds of firms offer specialized illiquid asset services and each wants your clients to hire it. So when acting in a non-fiduciary capacity, typically the advisor's job is to connect clients to the best of these vendors. Although simply Googling vendors and compiling a list is better than nothing, I recommend against it because not all vendors are competent. Instead I suggest having the client hire an independent due diligence firm to identify the best candidates and vet their competence.

Advisors should adopt sound policies, procedures, and checklists that are succinct and flexible. Otherwise internal auditors, regulators, and plaintiffs' attorneys will have a field day playing "gotcha."

HOW TO HELP (IF ADVISOR IS A FIDUCIARY)

When advisors are acting in a fiduciary capacity (for example, as trustee of a trust that owns the illiquid asset), prudence dictates that steps be taken to ensure the asset is skillfully administered, such as the following:

Adopt policies, procedures, and checklists. Advisors should adopt sound policies, procedures, and checklists that are succinct and flexible. Otherwise internal auditors, regulators, and plaintiffs' attorneys will have a field day playing "gotcha."

Revise onboarding procedures. Owners are never more willing to supply information about their illiquid assets than in the days before getting advice (or transferring the illiquid asset to the advisor in trust). Before taking ownership, robustly gather information to ward off unnecessary future headaches.

Select vendors. Unless your firm has expertise managing that type of illiquid asset (and I would argue not even then), have expert third parties perform the services. Outsourcing limits risk and makes it easier for clients to see what portion of their fee goes to pay the vendor versus paying the advisor for providing oversight.

Obtain valuation(s). Illiquid assets can be hard to value but advisors should always get an appraisal—ideally prepared by an independent subject-matter expert—at the outset. Because beneficiaries often misjudge the worth of their illiquid assets, we recommend sharing the appraisal report with all the owners to help debunk unrealistic notions of value.

Train staff. Do not assume your colleagues understand illiquid assets. Training is essential.

Beyond these, other steps worth considering include optimizing accounting systems, creating useful management reports, optimizing organizational charts, reviewing service offerings, analyzing costs, beefing up annual reviews and examination preparation, and revising fee schedules.

WHAT ARE THE RISKS?

When acting in a fiduciary capacity, what risks should advisors keep in mind? The United States Treasury Office of the Comptroller of the Currency's *Unique and Hard-to-Value Assets Handbook,*[8] published in August 2012, provides an excellent overview of illiquid asset-related risk. Its observations are relevant for any advisor acting as a fiduciary, not just those working at national banks:

> *Asset management risks are inherent in individually managed portfolios, but the inclusion of illiquid assets further increases a bank's risk. Risk increases because these assets often require special expertise to manage, are sometimes subject to special ownership rules, and are frequently hard to value. Some assets present liability concerns that may extend the risk of loss beyond the amount invested. A bank fiduciary may face liability from secondary beneficiaries when holding a nonproductive asset, such as property occupied by a primary beneficiary. Other beneficiaries might question why the property was not made more productive. A bank's failure to properly manage illiquid assets prudently and legally can increase the bank's risks, particularly its operational, compliance, reputation, and strategic risks.*

The four main types of risk are described below.

STRATEGIC RISK

A good example of strategic risk is the risk that your employer will pursue the wrong growth strategy. As the *Handbook* notes:

> *[A] bank fiduciary assumes strategic risk when taking on new product lines without having the expertise and systems to properly manage and control risks associated with the line of business. ... Because the management of illiquid assets falls outside the more traditional equity and fixed-income strategies, management must ensure that personnel are qualified to manage these assets.*

Given how important illiquid assets are to affluent investors, it is (in my view) strategically risky for advisors to ignore them. The right strategy is to offer a list of competent vendors (if acting strictly as an advice-giver) or by taking the steps described in the "How to Help" section (if acting as a fiduciary).

REPUTATION RISK

Reputation risk may be thought of as the risk of appearing on the front page of the local paper at the wrong end of a jury award. The *Handbook* says, "a bank fiduciary's lack of expertise or oversight of illiquid assets can subject the bank to significant losses, potential litigation, and reputation risk."

To limit reputation risk, if acting strictly as an advice-giver, offer a list of competent vendors; or if acting as a fiduciary, take the steps described in the "How to Help" section.

COMPLIANCE RISK

Compliance risk is the risk of violating governmental laws, rules and regulations, or the organization's internal policies and procedures. The *Handbook* says that "a bank fiduciary can expose itself to compliance risk if it fails to adhere to the bank's policies and procedures or fails to secure needed expertise."

Again, to limit compliance risk, if acting strictly as an advice-giver, offer a list of competent vendors; or if acting as a fiduciary, take the steps described in "How to Help."

OPERATIONAL RISK

In my experience, most illiquid asset risks arise when day-to-day tasks are mishandled. As the *Handbook* points out:

> *Operational risk is the risk to current or anticipated earnings or capital arising from inadequate or failed internal processes or systems, the misconduct or errors of people, and adverse external events. This risk manifests itself in several ways. First, safeguarding illiquid assets owned by an account for which the bank is a fiduciary or custodian poses unique risks. This involves the physical upkeep and securing of the asset as well as maintaining the account's legal ownership of the asset. Real estate or collectibles are in this asset type. Secondly, a bank fiduciary holding illiquid assets such as mineral interests, real estate, or interests in closely held companies generally requires specialized accounting and control systems. Without these systems, the bank risks not properly monitoring and accounting for the various income streams and related taxes associated with these assets.*

As before, to limit operational risk, if acting strictly as an advice-giver, offer a list of competent vendors; or if acting as a fiduciary, take the steps described in "How to Help."

CONCLUSION

To sum up, it takes specialized skills to preserve the value of illiquid assets, skills their owners often lack. Advisors willing to help can meet their clients' pressing needs and win referrals while prudently managing the associated risks.

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ENDNOTES

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2. See https://tiger21.com/2017-3rd-quarter.
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7. Steve Sandusky, "How One RIA Got to $1.6 Billion from Zero in Four Years," *Financial Advisor* magazine (November 30, 2017), https://www.fa-mag.com/news/seven-strategies-to-rapidly-grow-your-business-35947.html?section=40.
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