Sentinel Trust Company

On Watch

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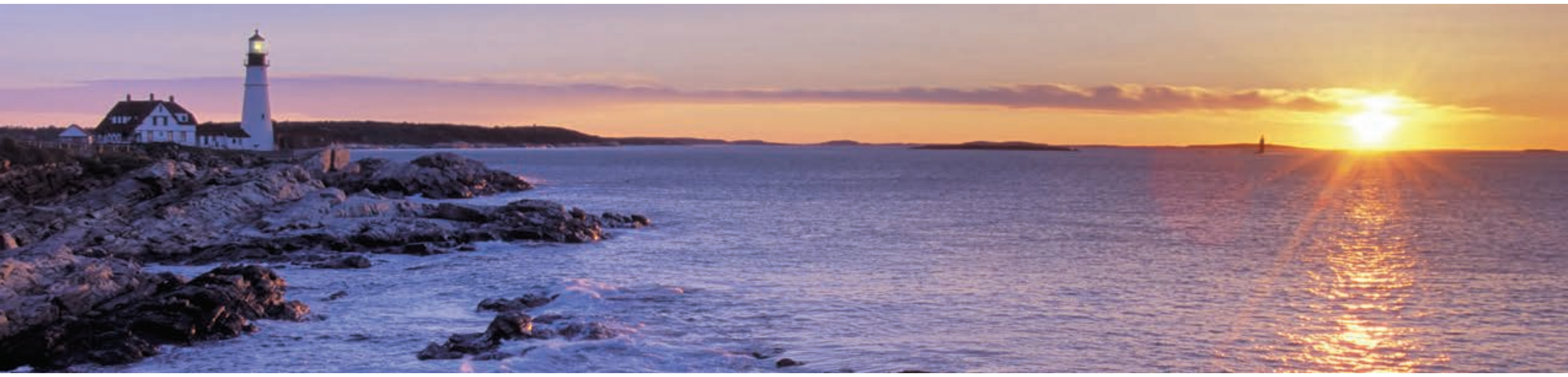

Miscalculating Portfolio Liquidity – A Lesson Learned from 2008

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In This Issue:

Portfolio liquidity - the ability to generate cash to fund distributions, expenses and future investments - was a minor concern for most of the last decade. However, in the Fall of 2008 many sophisticated portfolio managers became greatly distressed as their poor assumptions put them in a liquidity bind. Reviewing how they ended up in this bind provides insight into how one should think about portfolio liquidity.

Divide portfolio assets into three *liquidity buckets*:

1. **Liquid investments:** Investments that can quickly be converted into cash, like domestic and international equities, fixed income and other marketable securities.

2. **Semi-liquid investments:** Hedge funds and other partnerships with stated redemption terms that typically offer monthly, quarterly or annual liquidity.

3. **Illiquid investments:** Private equity (PE), real estate (RE) and other investments that are difficult to sell and only distribute funds if they are able (e.g., if they sell an underlying asset).

Story continued inside ...

Story continued from front ...

Two issues immediately arise. First, although bucket 2 investments may have redemption rights, sponsors typically have the ability to suspend those rights under extraordinary circumstances (more below).

Second, bucket 3 investments often have the right to call on investors for *additional* capital. Investments in PE and RE funds are made by making specific dollar commitments that are paid over time. Funds call cash as they make investments and return cash when investments are sold, all of which happens over periods of years. In order to maintain a target level of exposure in these funds, an investor must maintain large unfunded commitments so that cash distributed from funds will be reinvested. A rule of thumb is that an investor should have unfunded commitments equal to about 50% of its target. For example, if the targeted PE and RE exposure is $30 million, $30 million should actually be invested in funds and an additional $15 million should be committed but not yet called. A common assumption had been that distributions from funds would be more than enough to fund future cash calls.

Chart 1 illustrates a sophisticated investor's $100 million portfolio. This investor was probably comfortable with over half of the portfolio immediately available and only 30% locked up in illiquid investments. If the need arose, the investor could always get a bank line to provide some cash; but with 70% liquidity, he probably didn't bother.

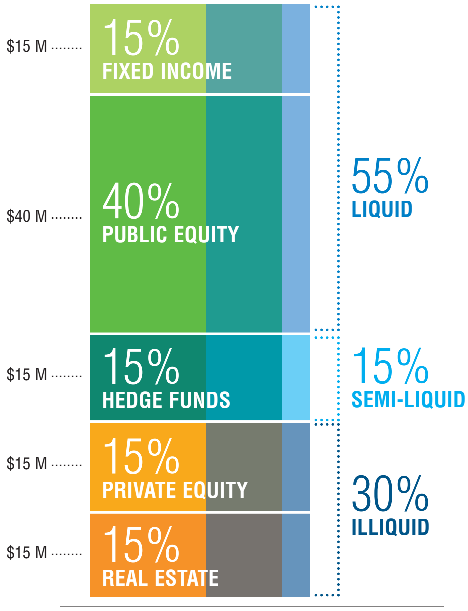

CHART 1

($15 million self-funding PE and RE commitments)

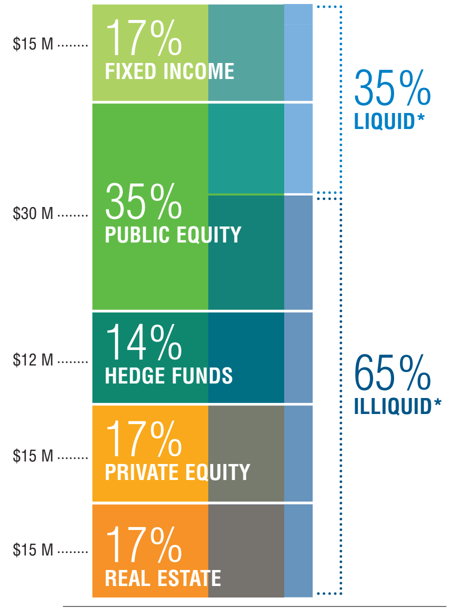

CHART 2

($15 million PE and RE commitments expected payable from liquid portfolio results in 35% effective liquid)*

So what went wrong? Just about everything

After markets fell in the second half of 2008, this investor's portfolio looked very different. Equities had fallen 25% (to $30 million) and hedge funds 20% (to $12 million). While the value of the PE and RE undoubtedly fell, the lack of timely pricing prevented quantification. Chart 2 shows the new look of the portfolio.

RE and PE increased slightly as a percentage of the total portfolio, but the real problem was the compounding factors:

- Many hedge funds suspended redemptions due to extraordinary circumstances, rendering 14% more of the portfolio effectively illiquid. Actual liquidity declined from 65% to 52% of the portfolio.
- With public offerings and lender financing effectively shut down, our sophisticated investor could not count on sales/refinancings within PE and RE vehicles to fund his $15 million of commitments. Further, investors feared the commitments would be called much more rapidly as the managers' other sources of cash (e.g., borrowing) disappeared. With unfunded commitments of 17% appearing imminently due, perceived liquidity dropped to 35%.
- Banks ceased to offer new loans and lines of credit to investors to help carry illiquid investments, taking away a possible backstop.
- With uncommitted liquid assets at only 35%, rebalancing the portfolio (to return to strategic targets) became virtually impossible.

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Huge concerns developed about being able to make distributions to owners, pay expenses and meet other commitments. Lack of liquidity led to loss of flexibility, loss of control and fear.

Our clients were fortunate not to suffer the liquidity traumas beginning in the Fall of 2008, in part because our tactical views had us positioned conservatively in anticipation of potential market declines. But, there are additional lessons that many seasoned, professional investors failed to anticipate and learned the hard way including:

1. You cannot count on liquidity from alternative investments (e.g., hedge funds) when you need it most. *Liquidity is only important when you need it.*

2. Liquidity (redemption) terms of hedge funds should be examined to make sure they are aligned with the liquidity of the underlying assets. Many hedge funds were pursuing illiquid strategies that even in normal times would have trouble fulfilling their stated redemption terms.

3. Private equity cash flows should be modeled using stressed conditions as downside moves in markets can lead to unfunded commitments being much larger than desired at the same time that distributions slow.

4. Bank lines of credit should be sized based upon this modeling and put in place before they are needed.

5. Hedge funds and especially funds of funds should be reviewed for their past liquidity issues.

UNDERSTANDING ROLES & *Responsibilities* IN FAMILY BUSINESSES

ROSS W. NAGER, CPA
Of Counsel

Confusion over the roles of key positions in business and family structures leads to many of the typical problems experienced by wealthy families. Family and business are complex. But, building your family's understanding of basic governance concepts is a great first step in preventing or solving problems.

Although business and investment structures come in various forms, I'll use corporations as the example. These concepts can apply whether or not there is an operating business.

Shareholder Roles

At the top of the corporate structure are the shareholders. Yes, shareholders are the owners. But they actually have very few rights and responsibilities. Here are the primary ones:

> Elect directors
> Receive dividends if and to the extent any are declared by the directors
> Vote on major corporate matters like mergers, sale of the business and liquidation
> Receive financial statements
> Sell their stock.

Shareholders do not have the right to manage day-to-day operations or tell the officers what to do. They do not have a right to work for the company or to receive salary, company cars or other perks. In fact, they don't even have the right to determine operating philosophies, except by their selection of directors.

Directors Give Direction

As the elected representatives of the shareholders, directors have some critical responsibilities, including:

> Represent the interests of all shareholders as a group, not individual shareholder's (or family line's) interests
> Elect officers (and fire them if appropriate) and determine their compensation
> Determine general business strategies and philosophies, usually in consultation with the officers
> Oversee the officers to assure that the board's strategies and policies are being implemented
> Vote on significant matters, such as major property acquisitions/sales, incurring debt and mergers
> Declare dividends if and to the extent the board believes funds are available after considering future operating and growth needs.

Directors do not manage the day-to-day operations of the business. Their functions are broad policy determination and oversight. They typically meet with the officers several times per year and are entitled to reasonable fees for their services.

Officers Manage the Business

Key officers, like the president and vice-presidents, are responsible for implementing the strategies and policies of the board through the day-to-day management of business operations. They report to the board and provide financial information to it and the shareholders. Officers do not have any rights of ownership, so they are not entitled to dividends or any growth in stock value. Their only economic rights are reasonable compensation and perks for their services, all as determined by the board.

Things become murky when a family member has more than one role. Actually, it's not multiple roles that are the problem...It's forgetting the responsibilities inherent in the roles you have. For example, if one or a small group of shareholders have a majority vote, they can "stack" the board with directors (usually themselves). They then elect themselves as officers and determine their own salaries. As directors, they may forget that they have a responsibility to all the shareholders. They rarely ever consider dividends. They may not provide financial information and may ignore the minority owners' input. Not surprisingly, the minority shareholders then perceive that the majority favors its own interests to the detriment of the rest and mistrust begins to smolder.

The minority family members get increasingly frustrated. A public company shareholder can at least sell if he or she is disenchanted with management. But family business shareholders don't have the realistic ability to sell their stock because there is no market for it. Whether or not they have any relevant skills or meaningful knowledge of the business, their only outlet is to try to get involved in management. Of course, the majority calls this "harassment."

These are some of the reasons I recommend including independent directors on the board. Properly selected, independent directors bring objectivity, impartiality and wisdom to the board. Their views are respected by majority and minority shareholders alike. Minority owners gain comfort in the knowledge that their interests are considered and that management is overseen and held accountable. But the power inherent in being able to stack the board to suit the controlling shareholder(s)' wishes is also the reason that so few family businesses give any serious consideration to my recommendation.

The solution to family business issues is not necessarily to prevent family members from having multiple roles. And, many family businesses do quite well without independent directors. The key to the success of these businesses is the family's ability to reduce the emphasis on the rights inherent in their roles and instead to focus on the responsibilities of each role.

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HOW TO BE A GREAT TRUSTEE

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Senior Vice President – Lead Fiduciary Officer

The trustee relationship is surprisingly intimate; requires a high degree of prudence and judgment; and like most relationships, is better if you work on it. You may already be a wonderful friend or loving parent to the beneficiary of a trust, but you need additional skills to be a great trustee.

A GREAT TRUSTEE IS:

Loyal | The trustee must be absolutely loyal to the beneficiaries, which requires faithfulness and adherence to the requirements of fiduciary duty. In any decision the trustee makes, the interests of the beneficiaries (current and future) come first.

Communicative | A trustee must gather information from the beneficiaries and keep them fully informed despite the fact that some subjects may be uncomfortable. The trustee must listen carefully to the beneficiaries before and explain patiently after making a decision.

Reasonable | A great trustee must be able to put aside personal bias, remain even-tempered and patient, and avoid emotional responses to any issues that arise. The ability to step back from a problem and try to understand another perspective is also important.

Humble | Trust administration requires legal, accounting and investing expertise that is, in many ways, very different from the skills needed to manage one's own affairs. A trustee may not be an expert in these areas but may still be a great trustee if he is humble enough to ask for professional advice and wise enough to follow it.

Prudent | A great trustee must not take either too much or too little risk. He must assess the beneficiaries' risk tolerance and establish prudent policies in line with the specific circumstances of the trust.

Studious | The rules governing a trust come from the document and state law; the trustee must understand and follow them carefully. The trustee also must learn the beneficiaries' individual circumstances and use skill and care in the decision-making process. Even when delegating functions to a professional, the trustee must study and digest the information received before acting.

Meticulous | Trust assets must be segregated from the trustee's personal assets. The trustee must keep careful and detailed records of what is in the trust, where and how assets are held, and details of income and expenses. The Trustee also must make accurate reports to the beneficiaries and all appropriate tax authorities.

Proactive | The trustee should take the initiative to open lines of communication with the beneficiaries and encourage frequent interaction.

Discrete | The trustee should keep the affairs of the trust confidential and guard the confidentiality of the trust and beneficiaries with the same zeal applied to safeguard the assets. Personal information must be obtained from the beneficiaries in the process of administering the trust, but it must be kept completely confidential.

Responsive | A great trustee must respond quickly and with candor to beneficiaries' questions or requests.

In addition to all the characteristics noted above, it may also help to have patience and a sense of humor. Of course, even the trustee who strives for perfection may fall short from time to time. But a trustee with these character traits will have an excellent foundation upon which to build a strong fiduciary relationship.

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Sentinel Trust Company provides custom integrated planning, investment, fiduciary and administrative solutions to affluent families and their closely held businesses and entities.

Founded in 1997 as the successor to two 40-year old, investment-focused family offices, today Sentinel offers the stability of an institutional firm, the entrepreneurial spirit of a young firm, the personal feel of a family office and the in-house technical skills of independent planning and investment management firms.

For further information, please contact Anthony DeToto, Senior Vice President, at adetoto@sentineltrust.com or 713.559.9578.

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