April 2021 | Volume 11, Issue 2

Sentinel Trust
Together, families prosper℠

OnWatch

In This Issue:

SPACs: A PRIMER

SPACs permeated the financial press beginning in 2020 – but what are they?

Dennis A. Montz, MBA, CFA, CAIA
Managing Director, Director of Private Investments

"SPAC" stands for "special purpose acquisition company." An alternate name gives a clue to what they are: "blank check companies." The typical process involves an individual or organization, called a sponsor, raising money through a public stock offering. What's unusual is that the newly public company is an empty shell. The money raised goes into an escrow account to be used to buy one or more as-yet-unidentified companies within about two years.

Why would anyone invest in an empty shell? The appeal is usually in the SPAC sponsor's qualifications and reputation. Although the sponsor may give a sense of what the SPAC might buy, the SPAC can buy any company it wants. These days, the typical SPAC targets fast-growing, venture-backed technology companies. Four of the ten companies in our private equity portfolios that were or are being purchased by SPACs, however, are traditional, not venture-backed, buyouts. Investors have the right to reject proposed acquisitions and get their money back.

About Sentinel Trust Company

Sentinel Trust Company, LBA is an independent wealth management firm and multi-family office that provides comprehensive wealth and succession planning, fiduciary, investment management, philanthropic, and family office services to a select group of affluent families and their closely held entities and foundations. Founded in 1997 as the successor to two 40-plus-year old single-family offices, Sentinel Trust currently serves more than 30 multi-generational families nationwide and is responsible for approximately $5 billion in assets as of December 31, 2020.

Learn more at
www.sentineltrust.com.

Instead of shares, SPACs issue units, typically priced at $10, plus warrants. Hedge funds like this feature as they can trade or hedge the units and warrants separately. SPACs generate excitement by issuing forward-looking projections – something that is not permitted for an initial public offering (IPO) of an existing company. A SPAC usually does not raise enough money to buy the target so it may rely on additional money raised from qualified institutional investors via a "PIPE," which stands for a "private investment in public equity."

Although the end result is similar to the target company "going public," there are some key differences from a traditional IPO. Unlike the pricing uncertainties before and immediately after an IPO, the shareholders of the SPAC's target receive a negotiated price for their stock. The target also avoids the regulatory requirements to issue stock to the public. Another key difference is that the public is able to buy in at the fixed price without experiencing the potential post-issuance volatility of an IPO. Unfortunately for investors, the typical 20% interest received by the sponsor is a much greater cost than the various expenses incurred in an IPO. Below is a list of the pros and cons for various participants in a SPAC.

Investor

PROS

- Potential access to fast-growing technology company he or she might not be able to access otherwise
- Right to veto a deal and receive money back
- Ownership of a unit and a warrant

CONS

- High cost due to sponsor carry (often 20%)
- No certainty of what sponsor might buy
- Potential deviation by sponsor from stated strategy or inability to find a deal within allotted time
- Potential of sponsor's carry incentive to lead to overpaying for a company or buying an inferior company
- Sponsor's potential lack of track record or experience in targeted sector
- Sponsor might not perform as rigorous due diligence as occurs in IPOs

Sponsor

PROS

- Efficient way to raise money for acquisitions
- Receipt of 20% of the value of the merged company as incentive compensation

CONS

- Veto rights by investors
- Rising competition from other SPACs
- Number of potential targets decreasing
- Two years to find a deal

Selling company

PROS

- Cheaper and easier process than IPO for going public
- Greater certainty of transaction closing relative to an IPO
- Potential full valuation today for future growth initiatives
- No "money left on the table" (that is, the company lists at the purchase price, not at an IPO price that might pop, with the value over the IPO price going to IPO investors instead of to the sellers)

PIPE investor

PROS

- Knowledge of target company before SPAC investors know
- Possible discount to IPO price

In the past, SPACs had a dodgy reputation. Recently, investor demand and the improved quality of sponsors – plus the inability to conduct traditional IPO road shows due to pandemic lockdowns – has given new life to SPACs. SPACs raised more money in the first quarter of 2021 than in all of 2020 which, in turn, was greater than that of the entire previous decade. This massive inflow has called the SPAC boom into question. One touted SPAC in the electric vehicle space was hurt by reports of fraud in the acquired company, pointing to inadequate due diligence.

Despite the SPAC publicity, potential investors should be cautious. Some SPACs trade below their $10 price which may indicate a lack of confidence in a target being found at a decent price, even though the investors can reject the deal and receive their entire $10 per unit back. It may also indicate some skepticism about the potential to find targets that can generate sufficient growth and revenue to offset the drag of the sponsor's cut of the deal. ■

Selecting an Effective CORPORATE TRUSTEE

D. Fort Flowers, Jr., CFA
Executive Chairman

Until the late 1980s, families commonly appointed a local bank or trust company as trustee or co-trustee. It was generally accepted that the institution's professionalism, combined with the bank's longstanding relationship with the family, would assure a level of competence and involvement that would serve the family well for generations.

The bank failures in the 1980s, combined with the rapid consolidation of local banks into mega regional and national banks, resulted in significant losses of both competence (as institutions dramatically cut costs in their trust departments) and longstanding local relationships with senior officers (as the mega organizations cut local management to reduce costs). In many cases, families have been relegated to calling an 800 number for services and having no consistent point of contact. Poor-to-nonexistent service appropriately led families to question fee levels. It's no wonder that families began avoiding bureaucratic institutions and naming individuals to serve as trustees.

Unfortunately, individuals as trustees present significant issues as well, with a primary one being continuity. Many trusts are designed to last for generations yet individuals who are appointed to serve often are in their 50s or 60s (or even older), leading to multiple trustee transitions in the life of the trust. Aging trustees can lose touch with family members' needs and become complacent, nonresponsive, and senile. The succession process can be problematic.

Boutique Trust Companies Emerge

Boutique corporate trustees, often formed and owned by one or a few families, arose in the 1990s in response to the poor service of the large institutions. Some of them offer the advantages of individual trustees while overcoming many of the disadvantages, including continuity.

These trustees have regulatory oversight and corporate governance structures that are similar to their bureaucratic brethren. They can be distinguished from their bureaucratic brethren by:

- **Focus –** Do they serve a particular kind of family or situation, or do they try to be everything to everyone? Is serving as trustee a core part of their business, or is it ancillary to a banking or investment operation?
- **Expertise –** Does the firm employ the breadth of professionals (attorneys, CPAs, investment professionals, etc.) with the depth of experience required to serve families' complex needs?
- **Culture –** Do client family members know not only their relationship team, but also know (and are known to) the senior management of the firm? Does the entire firm have a culture of putting their clients' needs first?
- **Continuity of ownership –** Is the goal of the trustee's ownership to maintain the company

for generations (vs. a goal of building and selling the firm)? Is the ownership structure one that can maintain continuity for generations?

Benefits of an Effective Corporate Trustee

Trusts often are designed to last for more than 100 years and three or more generations of beneficiaries. Individual trustees are likely to serve only 10 to 20 years, so there will be many trustee changes over the life of the trust. Those trustee changes can become a focal point for family disagreement over the future direction and leadership of the family's wealth. An effective corporate trustee that is committed to long-term continuity can avoid the disruption associated with turnover of individual trustees. Occasional departures of the corporate trustee's employees have little impact on the family because senior management and the entire client service team know and are known by client family members.

Mega corporate institutions are susceptible to the vagaries of public shareholders' demands for quarterly profit performance, periodic cost cutting, successor CEOs' new business strategies, stresses of mergers and acquisitions, and the like. Conversely, the culture and service demands of the families that own a boutique trust company can provide a stability of philosophy, approach, and service that even a series of individual trustees cannot offer.

An individual trustee confronted with complex investment, business, and/or family demands can bring to bear only his or her experience. An effective corporate trustee has multiple professionals that have a variety of education, credentials, and experience. As a result, the administrative, investment, and distribution decisions can be made with a much broader set of insights. Qualified professionals with experience managing trusts with complex assets, complex terms, and potentially difficult family situations will make better decisions.

Effective corporate trustees have the safeguards in place to prevent nefarious actions along with the procedures to avoid unintentional errors. When combined with regulatory oversight, corporate trustees are able to obtain liability insurance, which provides further protection for clients. Because individual trustees are unable to maintain procedures (like checks and balances) and lack government oversight, they often are unable to obtain liability insurance, thereby leaving the family at risk for both malfeasance and unintentional mistakes.

Wealth shared by a family in trust creates the potential for conflict among family members. An effective corporate trustee can act as an impartial, respected, and neutral party that can lower the tension before it becomes actual conflict and mitigate any conflict that actually arises.

Mitigating Possible Concerns

Trust creators contemplating a corporate trustee may be concerned that the family will lose control over its assets. They worry about what happens if the corporate trustee does not perform as expected. To reduce these anxieties, we often suggest that the trust document provide for one or more positions that can be held by individual family members or trusted advisors:

- **A trust protector –** This person's primary role is to remove and appoint replacement trustees. The trust instrument should provide guidance on the characteristics of the replacement trustee. Even if never exercised, the family's power to change trustees likely will keep the corporate trustee on its toes.
- **An individual co-trustee –** This person, usually selected from among the family beneficiaries but not necessarily appointed at the trust's inception, would serve alongside the corporate trustee. Providing this position permits the family to have direct influence on trust decisions when desired. An individual co-trustee may have the added benefit of gaining some personal liability protection of the corporate trustee's insurance.

The rise of bureaucratic, mega corporate trustees created such problems that many families moved to naming only individual trustees. Unfortunately, these families are finding that individual trustees also present significant issues for long-term trusts. Boutique corporate trustees can offer what families ideally desire from both individual and institutional trustees while minimizing the potentially significant problems of both of them. ■

HEDGE FUNDS IN THE NEWS: *What You Need to Know*

Sophia Papadopoulos, CPA, CFA
Senior Vice President,
Director of Hedge Fund Investments

Hedge funds are often in the news but this year the headlines are particularly prominent. A veritable army of retail traders toppled some large funds and former hedge fund managers dabbling in highly leveraged bets lost personal wealth. Because these stories are often sensationalized and lack context, it seems like a good time to revisit the role of hedge funds in a diversified portfolio. A portfolio of well-selected hedge funds can add significant value, coupled with risk reduction, over time.

Any discussion of hedge funds should start with what they are and what they are not. Importantly, hedge funds are NOT an asset class, but rather a wrapper of sorts used to implement differentiated strategies. They can provide sources of return different from those achieved in traditional funds and lower the volatility of a portfolio by protecting capital in a sell-off while also participating in markets moving higher.

Opportunity set is another important factor in any hedge fund discussion. We are in a period of high macroeconomic uncertainty, catalyzed by the COVID pandemic and exacerbated by low fixed-income yields, elevated equity valuations, and large-scale global stimulus. These factors have created notable volatility and dispersion across markets but point to an attractive time to be a hedge fund investor.

Hedge funds provide access to alternative sources of returns not available through traditional investment managers. The reason largely is because the hedge fund structure allows more flexibility. Hedge funds can use derivatives, invest in distressed debt, short overvalued companies, opportunistically move gross and net exposures, participate in merger arbitrage trades, and even hold cash.

This flexibility, when coupled with uniquely talented and skilled managers, makes hedge funds more likely to produce outsized risk-adjusted returns relative to the market and their traditional asset management peers. However, not all hedge funds are created equal. There is a wide dispersion in historical returns and manager skill. When allocating to hedge funds, manager selection is often a key factor.

We find that the best strategy is to invest with a handful of exceptional managers where we have a large degree of confidence and expect to be long-term partners. Active managers should be expected to materially outperform a passive alternative investment on a risk-adjusted basis over a reasonable period.

Specific hedge funds should enhance overall risk and return metrics. Some important characteristics to consider:

- An identifiable edge that combines extensive original research with deep industry or local market knowledge,
- An effective risk management framework that allows the manager to play offense during market dislocations,
- Key elements driving historic performance remain intact and are relevant going forward, and
- The manager is capable of running a sustainable business by attracting, motivating, and retaining a talented, driven, and ethical team.

It requires time and diligence to identify and access top managers. Often the best managers do not seek out new investors because they recognize that there are limits on their ability to deploy new capital. They prioritize their long-term performance over their own short-term profits. Over time, building and maintaining a sourcing network can place the investor in a position to invest in attractive new-fund launches and closed funds that selectively re-open.

Despite the occasionally sensational headlines, hedge funds can play important roles in a diversified portfolio, especially during uncertain and volatile times.

Sentinel Trust Company is a family-owned, multi-family office focusing on the unique needs of affluent families and their closely held companies and foundations. Sentinel Trust provides advice on investment, tax, and estate strategies, serves as corporate trustee, and provides lifestyle services with a personal touch.

Together, families prosper SM

Founded in 1997 as the successor to two established, investment-focused single family offices, Sentinel Trust 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.

Sentinel Trust SM

2001 Kirby Drive, Suite 1200 | Houston, Texas 77019-6081
sentineltrust.com