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Family Investment Funds Go Hunting for Wall St. Expertise

By AZAM AHMED

GOING OUTSIDE Newer family funds can resemble venture capital funds, says John Rompon, managing partner of McNally Capital.

Family offices have quietly handled the financial affairs of the nation's wealthiest households for generations, privately playing the role of money manager and life planner to the likes of the Rockefellers and the Mellons.

Now, this obscure corner of the investment business is muscling onto Wall Street's turf.

Family offices are plucking top-notch investment talent from hedge funds and private equity firms to work in-house, promising big paydays without the sales and marketing responsibilities. They are also pooling their resources and making their own deals to buy companies or back start-ups.

The evolution reflects a postfinancial crisis mentality. Burned by poor returns and a lack of transparency, family offices are now seeking ways to circumvent the so-called alternative managers that have produced disappointing returns in recent years.

"They are saying 'I am not happy just handing my money over to Goldman Sachs or JPMorgan or anyone anymore,' " said Russ Alan Prince, president of Prince & Associates, a market research firm that specializes in global private wealth.

The earliest family offices in the United States date back more than a century, when ultrawealthy industrialists sought ways to manage and consolidate their financial and personal affairs. John D. Rockefeller, Thomas Mellon and others created these mini-firms for convenience and efficiency.

Now, the industry serves media, retail and technology titans like Oprah Winfrey and Michael Dell, the founder of the Dell computer company. The rise of hedge funds and private equity firms have also spawned new family offices.

Marc Rowan and Joshua Harris, two of the founders of the private equity giant Apollo Global Management, started groups to manage their personal affairs.

Wall Street's ultrawealthy typically manage their money in their own funds, unlike most family offices. A notable exception: Steven A. Cohen, the founder of SAC Capital, whose family office manages some funds separate from his firm.

It's an exclusive club. Most experts figure that a family needs a fortune of at least $500 million to justify the expense. Studies estimates that 3,000 to 4,500 family offices operate around the country.

"It's the single most opaque industry in the world," noted Raffi Amit, a professor at the Wharton School of Business who has focused his research on family offices.

In recent years, a cottage industry has sprouted up around them. For families looking into direct investing, firms like McNally Capital can help.

A consultant will charge as much as $700 an hour to help determine whether it makes sense for a family to hire a full-time flight crew for its private jets.

Natasha Pearl, the founder of Aston Pearl, who spent years as a consultant at Booz Allen & Mercer, has adopted the same analytical approach to tackle problems that only the wealthy face. She digs into historical price data to determine the most lucrative way to sell an art collection. She compiles thick black binders of workflow charts to determine the optimal number of staff members for a family to employ.

"Billionaires want to cut costs, too, especially when investment returns are flapping around," said Ms. Pearl.

While family offices look for ancillary services on the margin, investment returns remain critical. Increasingly, the industry is competing directly with Wall Street, striking its own investment deals.

"The newer family office is looking more and more like a venture capital fund than a family office," said John P. Rompon, managing partner of McNally Capital, which helps structure private equity transactions for family offices. "They are making a large number of small investments."

In 2010, a collection of family offices representing about $45 billion joined forces to create a clean technology initiative. The 13 families who make up the group have made about $1.2 billion in clean tech investments over the years, including companies like OneRoof Energy, which develops solar energy systems. As a group, they expect to deploy another $1.4 billion or so in the next five years, and have already made two investments, though the group declined to disclose what they were.

Black Coral Capital, the investment arm of an anonymous family office, says the effort was a way to leverage their vast fortunes to make their own opportunities in the clean technology space.

"We have the flexibility of a single source of capital," said Rob M. Day, a partner at Black Coral, who said the family backing the firm wanted to keep its name private. "Trying to take advantage of that flexibility means acting very much alone, or figuring out how to do it very differently from the institutional investors."

Family offices are not new to direct investing. First Solar, one of the nation's largest solar panel providers, was backed by the Walton family, whose fortune came from Wal-Mart Stores. But the rate of participation has increased substantially in the last few years, experts say, as these private firms begin to evolve into more professional shops.

The family office of Michael Dell, MSD Capital, manages more than $10 billion and has made direct investments in OneWest Bank, a regional bank in Southern California, among other private companies. Cascade Investment, the investment vehicle of Bill Gates, has parked money in Berkshire Hathaway and Ecolab, a food safety business.

But the more aggressive approach is not without challenges. Lacking the expertise and deep bench of talent needed to run a company or complex investment, families could wind up losing big on these investments. And concentrating resources on a small number of investments is a far riskier strategy than a diversified portfolio.

"You have to constantly assess what you're in-sourcing and ask if you are the better solution," says Laird Pendleton, co-founder of the Cairnwood Cooperative Corporation, the family office for the Pitcairn family. "To try to invest in the whole spectrum of opportunities is very challenging."

To execute the deals, family offices are looking to Wall Street — and sometimes one another — for talent. Bruce Kovner, the billionaire founder of Caxton Associates, staffed his new family office with a hedge fund executive.

Oprah Winfrey lured her chief investment officer from the family office of Eli Broad, the Los Angeles billionaire.

But often, the hires are less well known, in part because most family offices still cannot compete with hedge funds, which pay rich performance fees to employees.

Peter Muller, the pioneer of highly successful "black box" trading at Morgan Stanley, opened his family office to outsiders in 2004. With more money, he believed that the Chalkstream Capital Group would have a broader array of investment opportunities and a bigger recruiting pool.

"In order to be competitive with talent, we really thought that turning this into a business and taking in outside capital was critical," said Andrew K. Tsai, who runs the investment firm, which manages nearly $650 million.

But an increasing number of hedge funds are going in the opposite direction. A rash of prominent managers have turned their shops into family offices, hoping to evade onerous new regulations that will require hedge funds to disclose details about their strategies and operations.

Stanley Druckenmiller, the former lead portfolio manager for George Soros, who had one of the most enviable track records on Wall Street, shuttered his hedge fund in 2010 and created a family office.

Shortly after, his mentor followed suit. Mr. Soros returned what little capital belonged to outsiders in his hedge fund last year, opting instead to form a large, $24 billion family office. He noted that as a family office he could avoid the prying eyes of regulators.

This post has been revised to reflect the following correction:

Correction: April 4, 2012

An earlier version of this article misspelled the surname of the pioneer of highly successful "black box" trading at Morgan Stanley. He is Peter Muller, not Mueller.