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Family Office Consolidated Reporting: The Value of Information vs. Data

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A Pre-Socratic Lesson in Consolidated Reporting for Family Offices

The philosopher Zeno of Elea produced a set of logical, but also impossible statements known today as "Zeno's Paradoxes." The most enduring of these is the arrow paradox, which states that an arrow in motion must always arrive at the halfway point before it reaches its goal. According to this logic, no arrow will ever reach its target, but instead will cross an infinite number of increasingly small bisections. From 430 BC to today, this paradox has pushed the limits of critical thinking and reasoning.

Zeno's arrow offers an important lesson for any family office developing or implementing a consolidated reporting platform. In the world of consolidated reporting, Zeno's arrow flies true: there is always an insurmountable gap between the desires for the platform and the reality of what any single platform can accomplish. Two reporting challenges, the mix of assets and the nature of unrealized gains, exemplify this gap.

This whitepaper argues that the most sustainable and adaptive solution for any family office reporting system is less a "consolidated reporting platform" and more a "comprehensive reporting system." Our shift in terms demarcates a move away from a single software solution and toward a reporting and communications team-based approach; one that uses software as well as traditional business practices in order to provide clear and effective communication to family office stakeholders.

What Counts as a Countable Asset?

The diversity of reportable assets is at least equal to the diversity of reporting packages and solutions offered by various vendors to the family office community. While some families have come to rely heavily on services and platforms provided by banks or investment managers; others utilize dedicated reporting solutions developed with the family office client in mind; finally others have developed home-grown proprietary solutions— which are often a mix of Excel, some well-structured macros, and lots of sweat and duct tape. These different approaches speak to the wide range of family office needs and to the non-standardized meaning of the term "consolidated reporting."

Most large, sophisticated family offices are a blend of operating business, private wealth management, asset management, concierge services, philanthropic foundations, and potentially a whole host of other activities. At its core, the family office represents the private and personal holdings of the family and the family trusts. Before one even begins the process of implementing a consolidated reporting system, the holdings of the family – what counts as a countable asset – must be documented and enshrined within the foundational family office governance documents. This understanding will be invaluable when developing other policy documents like an Investment Policy Statement and a Liquidity Policy Statement.

So, the first challenge for any reporting platform is the sheer scale and diversity of assets that exist within any large or sophisticated family office. Each asset class has its own quirks and industry conventions and many of these holdings do not support automatic data feeds. Managing a portfolio of houses, aircraft, and commercial real-estate is difficult but manageable; but the challenge becomes increasingly complex when one adds an art collection, equestrian holdings, entertainment investments, other illiquid or alternative investments, and traditional equity and debt holdings. The family office investment and operations team will need to work together closely with any consolidated reporting platform developer to make sure that all of these assets are properly accounted for in accordance with their respective conventions and industry standards. Often the final product will involve a certain amount work outside the platform itself, and a regular reconciliation process is absolutely essential.

Unrealized Gains and the Limits of Double-Entry Bookkeeping

In traditional investments, unrealized gains occur when the theoretical price of a security is higher than the purchase price. If one buys a stock for $100 and tomorrow it is trading at $110, then there is an unrealized gain of $10. To realize the gain, one must sell the stock for $110 and take the $10 profit. In the world of public securities there are many strategies on how to maximize one's unrealized gain, for example it may be advantageous to hold a security for over a year in order to have it eventually taxed under the long-term capital gains tax. Inversely, one may want to move the tax burden to another year, and so choose to sell the stock in January of the proceeding year. While not necessarily *easy*, performance reporting platforms are able to incorporate data feeds and macro-calculations to report on unrealized portfolio gains (and losses).

However, in other areas of the portfolio, unrealized gains are much harder to report. An important cornerstone within most sophisticated family office allocation strategies are illiquid and alternative investments, especially private debt and equity funds. Participation in these private funds often includes opportunities for follow-on investment or co-investment rights when certain benchmarks are met. Because private securities are not actively traded, there is no way to precisely establish a 'true' mark to market price. Analysts have a comprehensive set of tools in order to show a wide variety of investment metrics, but the relationship between these metrics and the realized value is speculation which often relies heavily on a range of underlying assumptions. Things become more complicated when these funds have a mixed allocation. Publicly owned securities can be used to hedge against some of the short-term risk of private companies held in the fund. This is an effective strategy and mirrors the strategy that many family offices adopt in their own allocation mix, however it only further complicates the task for any consolidated reporting service or platform.

The final nail in the coffin for a single consolidated reporting platform comes when one tries to reconcile a performance reporting solution with a traditional accounting package based on double-entry bookkeeping. Unfortunately, when Benedikt Kotruljević, who was born in Dubrovnik in 1416, invented double-entry booking he was not thinking about performance reporting[1]. Modern accounting, which is solely based on double-entry bookkeeping, enables merchants, entrepreneurs and their investors to keep track of every penny they received or spent, but it does not allow one to track and unrealized gains and losses.

Unrealized gains may vex 21st century software developers working within the tradition of 15th century double-entry bookkeeping, however the goal of consolidated financial reporting is not doomed. The actual performance of a family office's portfolio is best analyzed and presented through a combination of traditional qualitative and quantitative tools—and herein lies the solution to a family office's reporting needs. While it may not serve the growing industry of software companies developing 'turnkey' reporting solutions for their family office clients, the truth is that every investment a family makes should be based on a set of criteria with respect to its path to profitability, capitalization, debt service, macroeconomic considerations, and risk; and the value of that investment needs to be intimately understood by the family office's investment team. The difference between what a consolidated reporting platform can tell you and this kind of "high touch" analysis is the difference between *data* and *information*. Data will tell you what a security is trading at, assuming there is price discovery in the market, and what your tax burden is if you sell it; information will empower you to understand the true fundamentals, or lack of fundamentals, that is driving any business or investment opportunity.

A family office Chief Investment Officer and her team should cultivate data, but also stay focused on turning that data into usable information. A working knowledge or each investment coupled with a close relationship with outside managers will not only create new opportunities for the family but will also provide a deep understanding of the underlying assets and their prospective performance. The best, most useful, and sustainable form of consolidated reporting therefore incorporates qualitative and quantitative aspects. While software continues to improve, with better data-feeds and equations to best calculate various metrics, along with these technical improvements, the family office should also be developing written reports on a weekly, monthly, quarterly, and annual basis to best equip the family office with a more accurate understanding of the true value of these investments. This will most easily turn the data into information which will enrich the family's understanding of their holdings and the important work of the family office investment team.

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[1] The first recorded history of the description of double entry bookkeeping was done by Benedikt in 1458 in his work: *Book on the Art of Trade*. As a diplomat of Naples, he is also known by his Italian name Benedetto Cotrugli.

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