EPISODE 454

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[INTRODUCTION]

[00:01:34.1]

FT: You're listening to So Money everyone. Welcome back, thanks for joining me. I'm your host, Farnoosh Torabi. Today we're talking about how to run your family like a business with the author of the new book, *Family Inc.: Using Business Principles to Maximize Your Family's Wealth* and Douglas McCormick, the author, he is here to talk about the road map to financial security for families given this premise that your family should be run like a business.

He has spent two decades managing money for institutional clients and high net worth families. He's helped them grow their businesses to create sustainable long term value. He's also currently a managing partner at HCI Equity, a company that he also co-founded. So with Douglas, I'm curious why does he think that every family needs a chief financial officer or CFO and who's the best person to play this role? With news of the UK's vote for Brexit, what does he think that will mean for our investment portfolios and the gift that he gives his children every Christmas to help them learn about the financial world.

Here is Douglas McCormick.

[INTERVIEW]

[00:02:41.4]

FT: Douglas McCormick, welcome to So Money. I'm curious to learn how to run my family as a business. Welcome to the show.

[00:02:48.5]

DM: Thank you very much. Happy to be here.

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FT: Congratulations on *Family Inc.* your latest book, your first book right?

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DM: It is, it's my first and probably my last.

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FT: Why? Why do you say that?

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DM: You know I think that I felt like I had something to say for this book and I feel like I have accomplished it and so I have to be I guess compelled by the next opportunity but for now, I feel like I'm pretty proud of the content of the book and I'm hopeful that I can make a big impact for folks.

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FT: You know it's refreshing to hear that because I think a lot of times especially authors, you write your first book, there's a lot of excitement around it people want to know, "What's next, what's next, what's next?" But it sounds like you're really enjoying the ride and you should be. The New York Times gave us a very glowing review. The premise is that you should engage in your financial management in your family as if you're running a business. Why did you come to that conclusion? Why do you think that works?

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DM: Well I think one of the big challenges in today's environment is that there are so many desperate decisions that people have to make and to achieve financial security. It's education decisions, it's career decisions, it's investment decisions, it's insurance decisions and what I found in my professional life is that many of the business concepts that I was working with as a professional investor seemed to apply to my family circumstances.

I think the thing that is so powerful about the Family Inc. model is it gives people a framework to connect all of these different decisions so that people can actually see your education choices and your professional choices have impacts on your risk profile and your needs for insurance, etcetera. So I was really intrigued by the way I could communicate how all of these decisions fit together.

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FT: One of your big tips is to elect a member of the family to be the CFO, the chief financial officer. How do you know whose best fit for that role?

[00:04:41.2]

DM: Yeah, I don't think there are any set rules in terms of should it be the father or the mother or the wife or husband. It's more about who has the time and who has the aptitude and I think that I would differentiate who is the CFO versus how decisions are made. So I think the CFO's job is to use this framework to help decide what the important decisions in life are that will dramatically impact your financial security and then as a family, you make those decisions. As you know, family decisions can be complicated and sometimes, it's not even about the best financial decision. There are other things that play into those decisions.

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FT: Emotions?

[00:05:23.2]

DM: Emotions, values, priorities, passions and those are all fair parts of the conversation.

[00:05:30.2]

FT: Many couples enter a marriage with financial disparity whether it's through income or even just their experiences. One's a spender, one's a saver, one has perhaps scarcity issues tied to money, another person looks at money as this thing of abundance. So how can couples find common ground when they arrive in a relationship with disparity around money?

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DM: Well, I think that's a tough one candidly. I find that honest communication, open discussion around these different value sets and then acknowledgement that a lot of these skills are not skills that are readily required but I think the journey to becoming a good family CFO is not something that happens quickly. I am almost 50 and I feel like I'm still working at it. So I think just patience and acknowledging that these are often tough subjects and everybody brings both capabilities but also these value sets which could be different.

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FT: Totally and I like how your book really outlines some of these best practices that get the job done and sometimes a lot of the argument and a lot of the arguing and a lot of the opposition brews from not knowing what steps to take, disagreement on steps but you lay some really nice frameworks for couples and families to at least be able to accomplish what they need to accomplish and then move on.

Like you say, "Have a cash reserve. It's the most important role of your financial assets is to have a cash reserve to buffer the family from unexpected setbacks like unemployment," which could happen to any member of the family. How much cash reserve do you recommend?

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DM: I'll answer that in the context of the family framework. I think it has to be evaluated in the context of how risky your jobs are and what the rest of your financial profile looks like but in general, I think at an absolute minimum is three months if you have a job that has a fair amount of risk to it and would be hard to replace that income. For some folks, that could be up to a year.

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FT: You arrived with this frameworks with years and years and years of experience but also, as somebody who is a military vet. How did that play into your perspectives and your advice around money and money management?

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DM: Well I think one of the real motivations for the book is, first of all, I think this is a huge national problem. I think it's only going to get worst in the context of what we see in the economy, the labor markets and the investment markets, and so this is becoming a critical life skill in a way that was not for maybe your parents or your grandparents and so I found it ironic.

I graduated from West Point with a Bachelor of Science degree in economics. I graduated from Harvard with a business degree with a focus on finance and never had a personal finance class with all that education and so as a late 29-30 year old professional, I kind of pursued my own journey of trying to figure this stuff out and really felt like there was not something in the market place that was rigorous, written for people that were not professionals in the business.

And also, holistic enough that I could actually apply it to my own personal situation and so, again as I endeavoured on my professional career, I saw a lot of overlap between the investments I was making and how we were managing companies and how I could apply that to my own personal situation.

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FT: One of the calculations that you make in the book to determine a family's net worth is the value of their labor. What do you mean by that, "value of your labor"?
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DM: I would say I think the biggest flaw amongst most financial planning programs, among the advice that many financial advisers give today is that they give it in regards to the financial assets that a family has and I argue that for most families, the largest single asset that we have is our labor and that is an asset the same as stocks and bonds and other real estate are.

And if you think about it in that framework, I think it really focuses people on where the key decisions can be made. So for most of us, the surest way to financial independence is by investing in ourselves through education and good choices around career and I also think it has meaningful implications to help people think about risk.

I would argue a young person can endure a lot more risk not only because they have a much longer time horizon but they also have this significant labor asset, which in my view of the world, looks a lot like an annuity or bond and so I think including labor assets, including social security assets, really changes the game in terms how people think about their financial choices.

And just to give you a little definition around what the labor asset is, it's simply of you around you have so many years remaining in your professional life and you're making assumptions around how your income will change overtime, what kind of tax burn you'll endure and that gives you some kind of estimate around the value of that labor.

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FT: And also perhaps how employable you are?

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DM: Yeah, absolutely and that gets back to education is certainly one of the best investments for most of us, not only does it result in higher income levels generally. It results in more employability and I think one of the things that people really underestimate, education generally results in a longer ability to work and as people live longer in today's environment, I think that's increasingly important. You're going to see a lot less people retiring in their early 60's and I think given the opportunity, will choose to work into the 70's.

[0:11:12.3]

FT: Oh yeah, I completely agree. You touched a little bit on your background, I would love to go even further back to childhood. We talk about childhood a lot on this show, I'm sure you'd agree that our upbringings have so much to do with why we make the decisions that we do as adults especially pertaining to money. I read in your bio that your journey to achieving financial independence started at the age of seven?

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DM: Yeah.

[0:11:39.8]

FT: What happened at seven?

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DM: Well, my dad was an educator and so he loved teaching, he also was a stock investor as a hobby, and so I was exposed to him reading the Wall Street Journal and watching stock programs and at a very early age, he took a sabbatical from teaching and we took a trip across country and he told my brother and I that through this trip, we would have the opportunity to buy one stock from something we learned about on this trip.

So my brother invested in a company that owned Barne and Bailey Brother Circus and I bought Home Stay Gold Mining company. This was a real eye opener for me because at that point, stocks became not a piece of paper but I got to tour the Home Stay Gold Mining company and I realized that I was becoming an owner in a very small way of a real business that had employees and product and assets like this gold mine.

So that was a real exciting point for me, it began to appreciate what I was doing as a stock owner. I got lucky too, so this was in the 70's, inflation was on a rampage and stock, gold stocks performed very well. So as a young person I also convinced myself that I was good at this. So I've kind of had a love affair with the markets ever since that time and it was a great learning lesson for me and my father.

I do something similar with my kids today. Every year at Christmas, my kids and I select a stock for their portfolio and it's based on their interest not on the quality of the investment. So we have things in the portfolio that they purchased like Facebook and Chipotle and Google and it's a lot of fun as a way to find common ground with my kids about money matters.

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FT: Although when it comes to your investing advice for families, it's not about stock picking necessarily right? It's more about perhaps index funds or ETF's.

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DM: Totally, I think the example I gave is a great way to educate but in the context of how I recommend managing the family capital, I'm a huge fan of passive investing with a big focus on long term after inflation returns, I think that's best accomplished with a heavy equity exposure.

[0:14:02.6]

FT: All right, so you've had a pretty polished journey up till now as far as your money goes and people come to you for advice. But come on, there must have been a time when you made a financial booboo, can you tell us about it and what you learned?

[0:14:15.1]

DM: Yeah. So first of all, not only had there been a time, there had been way too many times and I'm still making them. I think good investors and good financial managers bring with them the humility of realizing there's always mistakes to be made here. I think my most humbling experience occurred shortly after graduating from Harvard, I went directly from the army to business school at Harvard and at that point had already had a family. So I was married with my first child and over the course of the next two years while I was getting a great experience and really benefiting from my investments in education.

We wrapped up so much debt through school loans and consuming while we're up in Boston which was much more expensive than I had anticipated that by the time I graduated, I had to go find a family friend to loan me enough money to move my family to New York to start working more in Stanley and by my first two suits.

That was very hard for me to go ask a family friend for support like that and I think it also highlighted to me the importance of humility and also that these financial challenges can happen to anyone no matter how hard you work, no matter how educated you are and it kind of goes back to one of the things we talked about earlier.

The first step to financial security is ensuring you have an emergency fund or near term liquidity. I think we all focus so much on wanting a secure retirement but the number one way to get to a secure retirement is ensure you don't have a financial hardship or distress in the near term. That's a valuable lesson that stuck with me from 20 years ago now.

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FT: Sort of unrelated question, I'm just curious, how did you get a book published? Many people listening consider themselves experts in their fields and their dream would be to write a book one day. How did you go about it? What was that first step?

[0:16:15.9]

DM: So I will tell you but I also tell you I think I did it absolutely wrong almost at every turn. First of all, I'm not a financial adviser by trade, I'm a professional investor and I'm working exclusively with institutions to manage their money but I found this need where I really believed I could have a positive impact on people through this Family Inc. approach. So the first thing I did was I wrote the entire book by myself without getting input from a publisher, from anybody in the industry and I did that because I felt like I'd be my toughest critic and I wanted to make sure that I would be proud of a content.

Then I went out and tried to sell it. Most people would tell you it's much better to get input and market receptivity before you go write the book. I did get a lot of input once I started sharing it with folks and I think the general feedback was they liked the ideas and it was a novel approach, my writing style at that point was to text bookie. spent a lot of time getting it to publication by trying to make it more conversational, trying to make it more accessible in a way that it would have a bigger impact on more people.

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FT: The book deal was probably a very So Money moment for you. What's another one?

[0:17:36.2]

DM: So first of all, the book deal was not a So Money moment.

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FT: No?

[0:17:38.9]

DM: Anybody that writes a book who make money…

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FT: Not financially but just the accomplishment is so Money.

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DM: Yeah, okay, I give you that. First of all, I've been doing this for a long time investing, there's lots of So Money moments and I think the thing I would share with you is you also have to remember there's lots of "So No Money moments". Lots of failures mixed in with those successes. I see a trend that I think is worth highlighting and that is that my best investments have been in myself, in my education and in entrepreneurship in general.

What I mean by that is, one of my big pitches of the book is that the labor markets are very efficient, right? If you're just out in the market, trying to find a good job, one in three people makes more than 65,000 in America today, one in 20 people makes more than 150,000. So it's very competitive. At the same time, the public equity markets are very competitive and if you look over the long term, you're lucky to make 5% after inflation in the equity market over the long term.

What I found is, by combining my labor and my capital, that's entrepreneurship, I can create much better returns on both of those assets. So let's talk about my school for a second. I estimate that in terms of what I spend to go to school and the foregone income, probably cost me about $200,000 and I believe I've earned that many times over, given the opportunities I've had because of that schooling. 10 years ago, I decided to start my own money management business.

With my partner, put in my own capital and my own labor and that's been very good returns for my labor and my capital and my very best investments have been once where I backed a professional or an entrepreneur to buy somebody else's business or to start their own business and I've found that that combination of using your capital and your unique skills with your labor, I can drive returns there. Much better than I can when I separate t hose two activities.

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FT: You got to be able to roll with the risks.

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DM: You do, you do. But I think a lot of people over estimate the risks and find, they think startup and they think Facebook and Google, they think massive amount of startup capital and what I see in America today is most entrepreneurs are much less ambitious but they also have taken much less risk and in many cases, they learned with OPM, other people's money, other people's dime in terms of you acquire to some really good skills at your previous employer and then accumulated enough money that you could go pursue that a similar business on your own. So I generally think that entrepreneurship is not as risky as people presume.

[0:20:32.0]

FT: Now it's being taught in our generation whereas two, three generations before ours, it was something that you just learned through failure and not that there isn't failure today but I think that you're right, the risk is being negated by other people's money and then also the education that's out there around how to properly start a business, at least you're not going to make a lot of the simple mistakes that perhaps people made over and over again 10, 20 years ago.

[0:20:59.8]

DM: Yeah, I think there's a lot of things in our economy to be worried about, evaluations, growth rates, deficits. But one of the things that I'm most excited about is this ecosystem that we've created in the United States which encourages risk taking and entrepreneurship and teaching those skills and really defining failure as success in many cases, which I think is a really powerful way to think about how people allocate their labor.

I often say, in my investments when I'm investing my capital, I'm a value investor because I can both lose and make money with my investment. When I think about investing my labor, I like to say that I'm a growth investor because I think when you pursue growth oriented opportunities with your labor, you can create significant wealth and if it doesn't work out so well, you take your experiences, you take your labor and you go put them somewhere else where you can try again.

[0:21:58.2]

FT: Right, it's not really a loss, it's more like a win/win. Well as I'm talking to you, we just learned about Britain's decision to Brexit. How do you think that's going to impact the global economy and particularly our portfolios in the short term, should we be worried?

[0:22:16.6]

DM: Yeah, so I think there's the academic answer and then the practical answer. The academic answer is yes, you should be worried and you should expect increasing volatility. Then I say, "How does that affect family Inc. and I don't think it does because I think when you subscribe to the family and principles, you subscribe to a very long term time horizon. This is a bump in the road and it's probably immaterial in the context of those long term financial independence retirement goals.

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FT: Right, so no knee jerk reactions, I actually think it's a good time to buy. Are you scooping up some beaten down shares?

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DM: I'm always trying to buy. I feel like I'm a better buyer of specific businesses than I am timing the market so I'm not a big market timing guy but I think generally, the desire to continue to stay invested, given how long my time horizon is until I'm likely to use that money, I think in the long run that's a great bet.

[0:23:14.6]

FT: All right, cool, last question here Douglass for you is, your number one financial habit? What is something that you practice in your financial life that equates to greater wealth and security for your family?

[0:23:30.4]

DM: Once a quarter, I look at a balance sheet and that's the family balance sheet. For me, there's lots of different ways to monitor your budget and see if you're on track. But if I just simply look at my balance sheet this quarter versus last quarter, that tells me some very valuable things. It tells me, is my net worth growing or shrinking?

It forces me to lay out my assets and kind of convince myself that I'm appropriately allocated and it also forces me to lay out my liabilities and make sure that I've adequately kind of planned for those and thought about the appropriate tradeoff between interest rate and maturity dates and things like that. So once a quarter, look at the family balance sheet and I think that gives me a good deal if I'm heading in the right direction in terms of my own retirement goals.

[0:24:18.9]

FT: This balance sheet that you speak off along with calculators and other tools available at Familyinc.com if anyone listening wants to follow in Douglass's footsteps and start running their family like a business, that's a great place to start.

Thank you so much and congrats again on your book even though you don't call it a so money moment. I think I will.

[0:24:39.4]

DM: Okay, well listen, I appreciate the vote of confidence and thanks for the time, it' was a lot of fun.

[END]