Changing Compensation Dynamics and 2014 Recap

Financial Markets Total Rewards Group

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19 West 44th Street, Suite 511, New York, New York 10036
(212) 221-7400 • Fax (212) 221-3191

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- Independent financial services compensation consulting firm giving informed advice and counsel, with customized solutions starting with best practices. Expertise navigating global headwinds to develop compliant yet motivationally aligned programs. Common services include annual and long-term incentive designs, market data, agreements, equity and partnership considerations, and Board Committee advice
  - Subject matter experts
  - Balance market/best practice with firm dynamics
  - Both Board consultant and company programs
  - Experienced, opinionated and informed

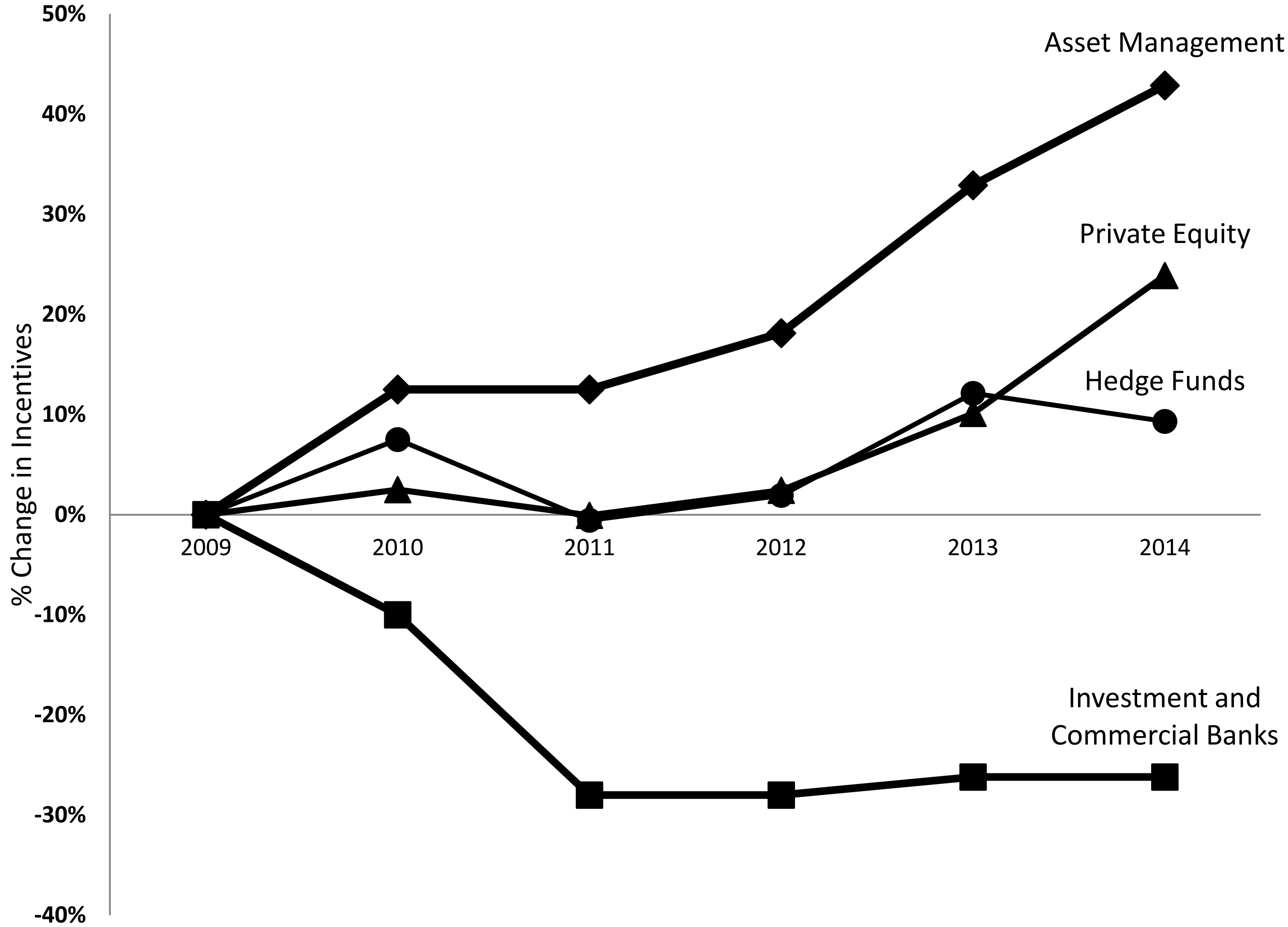
- Diverse clients and issues/experiences
  - Asset management and wealth management firms
  - Hedge funds/private equity/real estate/alternatives
  - Investment and commercial banks
  - Insurance companies
  - Brokerage firms
  - Trading organizations

Changing Compensation Dynamics (Perspectives)

- Role of base salary
  - With greater market information, less viable to be meaningfully below market
- Turnover
  - Unusually low may not always be optimal
- Revenue and fee pressures are new reality
  - Require fresh thinking on organization and compensation
- Variety of pay models: Carry, incentive fees, and revenue sharing
  - Requires clarity on market norms and nuances
- Titles continue as distraction
  - Impact or recognition driven
- Raw compensation data often insufficient
  - Simple analyses can be misleading
- Top down funding can drive efficiencies
  - Suggests less headcount to accomplish objectives
- Wall Street no longer compensation leader
  - Asset management and alternatives
- Increased market rates and choices for young professionals

Compensation Divergence Across Industry Sectors

- Since financial crisis, industry sectors have not moved in lockstep
  - Tailwind for asset management and alternatives from economics of scale and untapped markets
  - Headwind for banks from business fundamentals and regulation

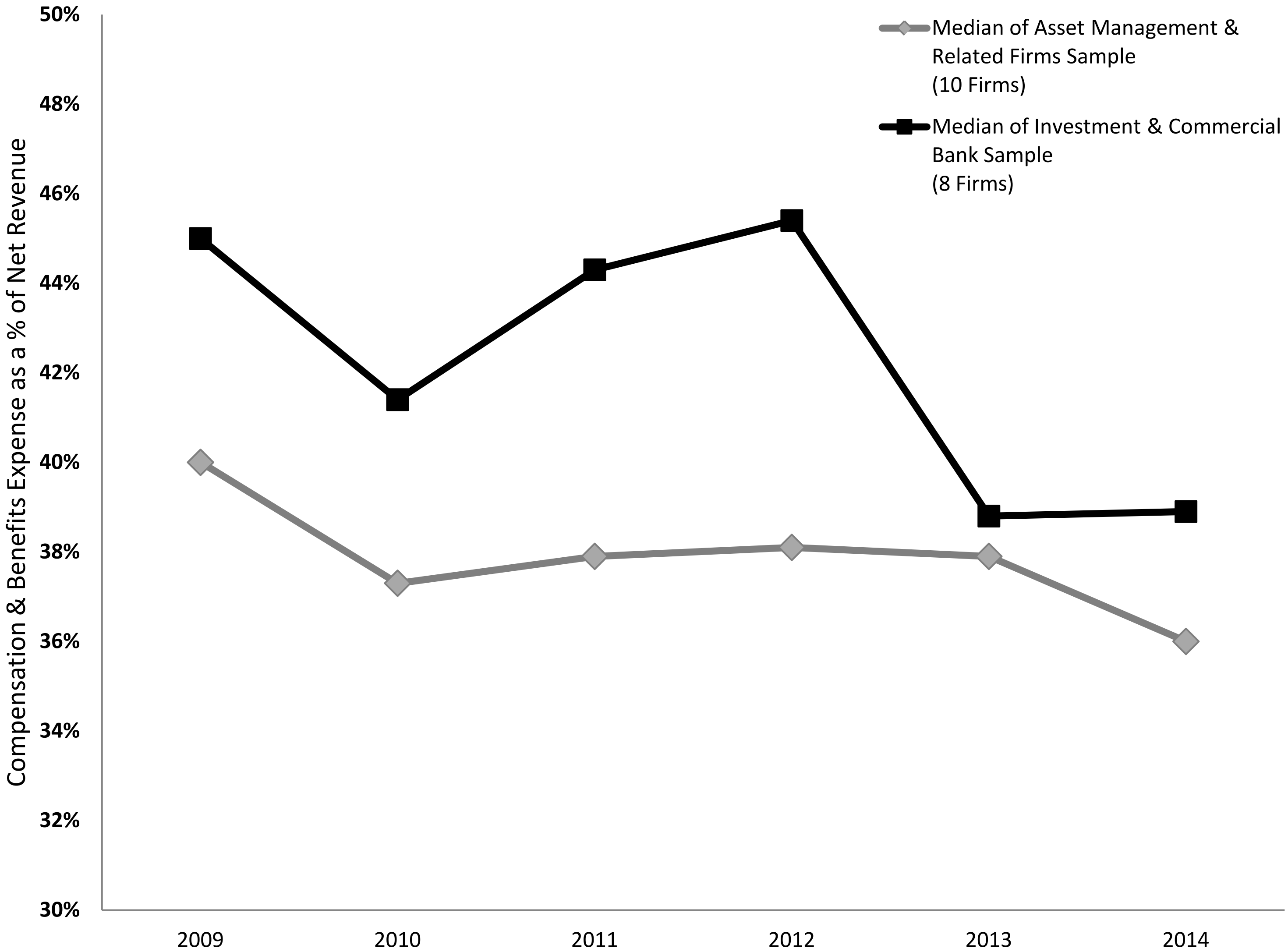


2014 Impact of Client Business

- Broad asset management benefits from better fundamentals and AUM increases
  - Asset Management: +5% to +10%
  - Wealth Management: +5% to +10%
  - Private Equity: +10% to +15%
  - Hedge Funds: -10%+ to +5%
- U.S. Major Banks' incentives generally flat (i.e. -5% to 5%) with European banks down moderately (i.e. down 5% to 10%)
  - Fixed Income : -10%+ to 0%
  - Equities: -10%+ to 0%
  - Investment Banking: Advisory +10% to +15%, Underwriting +5% to +15%
- Regional firms often outperforming major banks
  - Better local markets and fewer legacy issues
- European pay allowances continue to be under scrutiny
  - In time will require higher base salaries and some risks
- Viable equity increasingly important for improved alignment and motivation
  - Programs often overly broad and unfocused
- Major banks not leaders: Market driven by asset management and alternatives
  - Important perception change with long-term implications

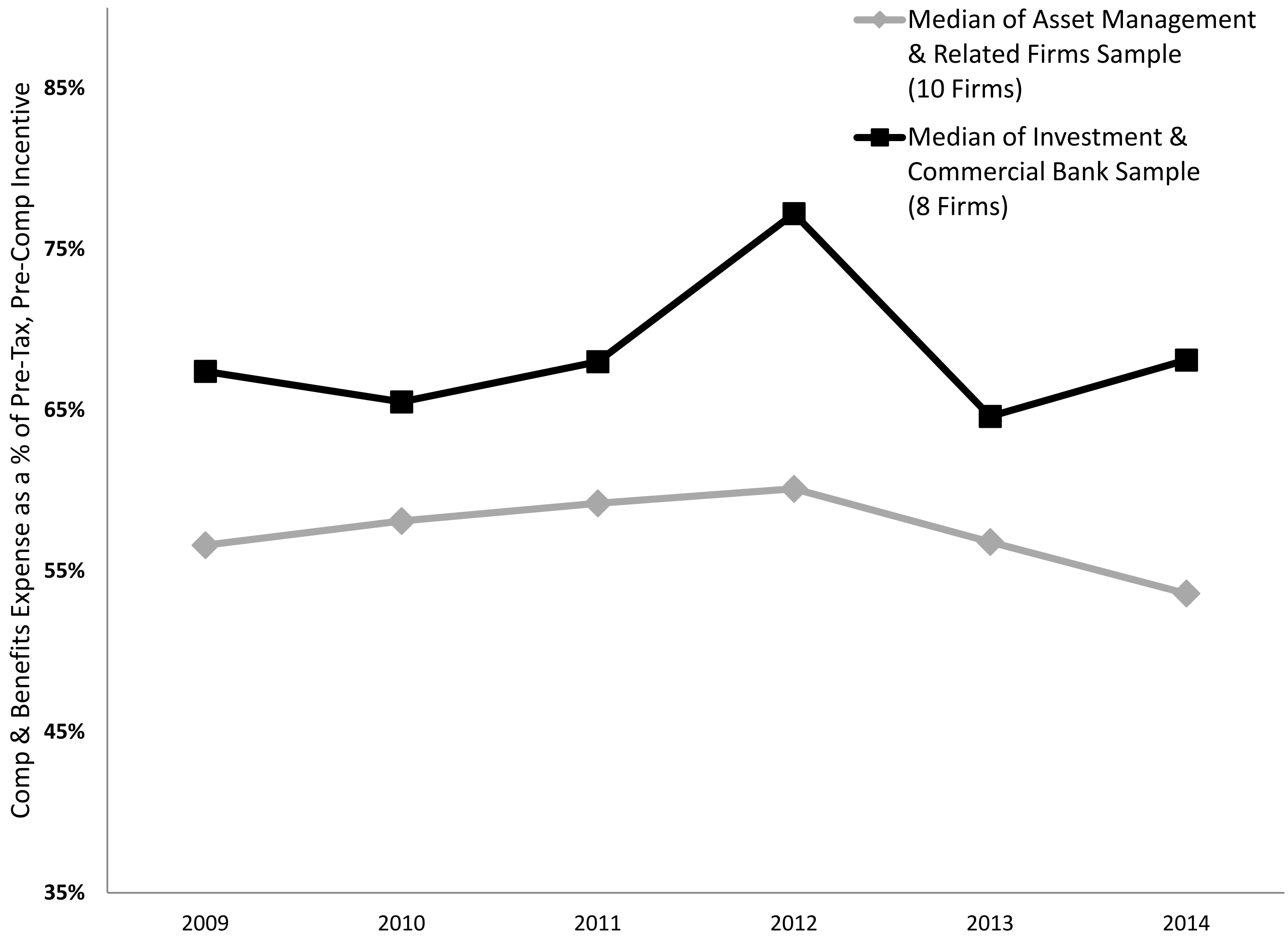
Trend of Compensation as % of Net Revenues

- Banks faced turbulence while Asset Management remained steady



Trend of Compensation as % of Pre-Tax, Pre-Comp Income

- Banks faced uneven profitability while Asset Management steady at higher income



Base Salary Role

- Base salary both economic and cultural signal
  - Competitiveness
  - Opportunity
  - Decision-making quality (i.e. presence or lack of odd practices)
- Available market information highlights any deficiencies
  - Employees believe/are better informed, especially younger professionals
- Tyranny of small increase pool (i.e. 3%)
  - Few adjustments for workforce demographics
  - Math does not work with young talented workforce
- Often silly legacy policies
  - No increase above X%
  - No review if hired after Y date
  - If salary above $X, review every 2 years
- Structure levels vs. individual amounts
  - All MD's have $400k salary
  - Large portfolio managers are $350k

Johnson Associates rule-of-thumb: Each dollar low on base salary requires $1.50-$2.00 of additional incentive. Low salaries can cost firm income

Turnover

- Voluntary turnover unusually low since financial crisis
  - Perceived increased risk in new positions
- Unweighted, by performance, low turnover not always positive sign
  - Compensation heavy to average/below average performers
  - Unwanted turnover of top performers masked by broad population
  - Less direct performance management system
- Turnover analysis helps drive greater skewing of compensation to performance
  - Average/below average performance often overpaid
- Few firms have targeted turnover
  - Turnover by performance and level
  - Perspective needed as labor market evolves, or by definition, increased turnover is a problem

Targeted Turnover Example

Level		Performance: Low	Performance: High
	High	6%	2%
	Low	12%	4%

JOHNSON ASSOCIATES, INC.

Implications of Revenue and Fee Pressures

- Revenue and fee pressures will continue/increase
  - Asset management impacted by index/ETF products
  - Hedge funds address fee and hurdle negotiations
  - Private equity adopts extended "waterfall" and fee changes
  - Banking linked to broader economy and less risk appetite
- Costs increase over intermediate term
  - Regulatory and compliance costs
  - Increased taxes
  - Technology expenses
  - Marketing in competitive environment
- Adding value more difficult at the margin (i.e., competition, client expectations)
  - Requires greater skill and expertise
- Forces aligning behind streamlined model *
  - Fewer/better people
  - Higher average compensation
  - More demanding environment
  - More incentive funding as results % than mostly "bottoms up"
  - Greater internal promotions

**exception is well executed retail banking, usually in home market*

Varying Compensation Models

- Private Equity
  - Structured annual compensation by level. Moderate individual variations
  - Bulk of pay from carry earned over 4-7+ years. Vesting over ≅ 5 years, and paid even if compete
  - Carry to VPs/Associates with more individual variations for senior professionals
  - Deferrals from annual pay but carry has greater impact
- Hedge Funds
  - Annual compensation generated by % of returns. Heavy pay skew towards return generators and teams
  - Compensation delivered in cash bonus with graduated deferrals. Invested in broad fund or individual products with forfeit on competition
  - Blend of formulas and discretion across firms
  - Variety of ownership structures and impact on economics
- Asset Management
  - Structured pay common for portfolio managers and sales
  - Cash annual bonus with deferral, at least 50% in own product
  - Ownership often more valuable in private firms
  - Discretion dominates for broad population

Compensation Data and Analysis

- Few important business processes rely as heavily on market information as compensation planning and delivery

AND

Often willing to accept, without adjustment, a median or other percentile from an imperfect group, incomplete data, matching issues, small sample size, unequal firm weighting (i.e. incumbents), no performance dimensions, incomplete scale dimensions (i.e. portfolio size), stale data etc…

- The only wonder is that the audience for compensation data and analysis has not been even more skeptical

- In many cases judgment and revisions should be applied to raw compensation data to produce an answer much more likely to be accurate
  - Requires more effort and knowledge to establish credibility
  - “Better to be about right than exactly wrong”

Deferral Choices and Alternatives

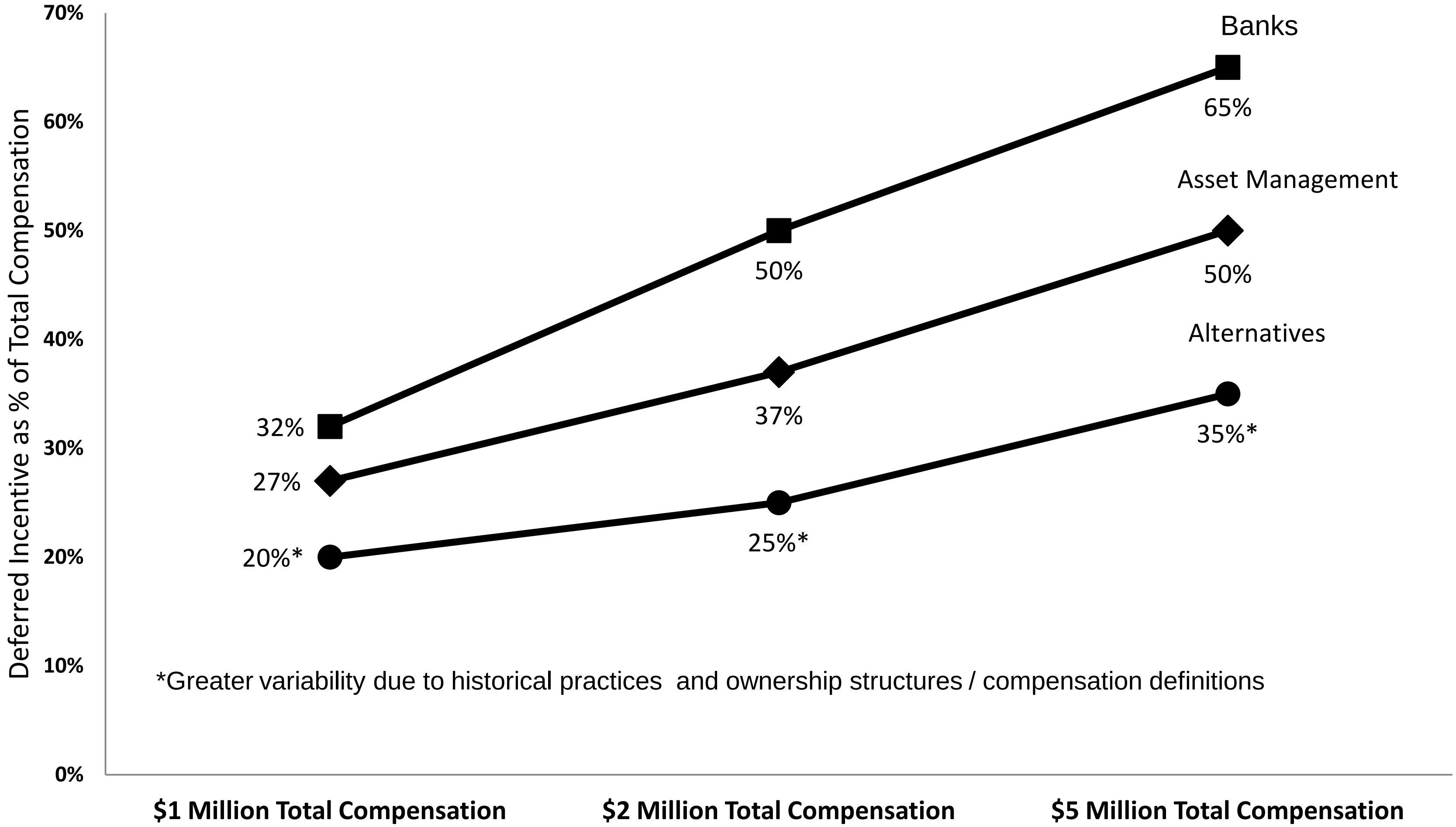
- Variety of deferral choices utilized depending on business

Shaded box "often utilized" vehicle

Business	Range of Potential Vehicles			
Bank	Stock	Options	Products	Risk Bonds
Captive Unit	Stock	Ownership	Products	
Asset Management	Stock	Options	Products	
Private Equity	Stock (less)	Carry	Products	
Hedge Fund	Stock (less)	Incentive Fees	Products	
Insurance	Stock	Options		

Differences in Deferrals Across Industry

- Due to regulatory constraints and market dynamics, noticeable differences in deferrals



Sales Compensation Approaches

Market Approach	Highly Formulaic	Objective / Blend	Fully Discretionary
Compensation Structure	• Salary • Structured commission schedule	• Salary • Incentive with targets on assets raised or quasi-commission schedule with discretionary adjustments	• Salary • Discretionary incentive
Primary Vehicles Used	• Cash • Deferral	• Cash • Equity	• Cash • Equity
Commentary	• Straightforward • Easily communicated • Does not account for unexpected business or market changes	• Relatively straightforward • Ability to incent additional responsibilities/broader focus (i.e., cross-selling, teamwork) • Allows for adjustments based on unexpected events	• Less transparency • More difficult to communicate • Allows adjustments for unexpected events • Lack of transparency/ expectations creates more pressure for carried interest
Approximate Market Prevalence	**≈35%**	**≈50%**	**≈15%**

Titles

- In 2015, surprising titles continue to be often a distraction
  - Lack of clarity on meaning, significance/job scope or recognition
  - Meaning clarity is crucial
- De-link compensation from titles
  - Removes much of the tension
- It is difficult to define titles on significance/ job scope in evolving environment
  - Especially if overlay client facing needs
- Titles with real substance fit better in “up-or-out” organization
  - Law firm
  - High-end consulting
  - Officers in military
- Best practice usually to have titles primarily as recognition
  - At margin, clearly “over title” (i.e. cheap reward)
  - No direct link to compensation
  - Relatively few titles
  - External need is priority
  - Not overly emphasized

Five Hard Earned Lessons

1. Easy to undervalue excellent performance
   - Rule of thumb: excellent performers produce 2x or more than average
   - Significant pay differentiation critical
2. Overly fearful of even moderate voluntary turnover
   - Average voluntary turnover quite low/too low
3. Not enough emphasis on culture/training/promotion from within
   - Positive culture matters; reduces needed compensation spend
   - Recognizing trend toward reasonable work life balance
4. Importance of alignment with firm long-term value creation
   - Retention and alignment are different
   - Senior professionals should have significant long-term equity
   - Ownership culture is vital
5. Talented young professionals are valuable
   - Tenure driven reward systems less helpful
   - Has the industry earned their patience?

Asset & Wealth Management: Key Pay Issues

- Significant firm equity for alignment (i.e. Asset management <u>not</u> the parent)
  - Surprising importance both for independents and captives
  - Expectations of clients and investment consultants
  - Variety of potential vehicles and terms (i.e. options, stock, profit interests)
- Incentive funding on results vs. survey “bottom up” approach
  - Many/most successful firms fund on results. Impacts aggressiveness, headcount, and expense control
  - Understanding and agreement on funding implications across scenarios
- Significant focus on sales compensation design
  - Commission vs. hybrid vs. subjective
  - Reflects involved sales process and multitude of products/channels
- Meaningful year-over-year compensation changes for high performers
  - Focus on portfolio management. Great performance requires outlier compensation
- Succession issues and equity valuation receive attention

Hedge Funds: Positioning on the continuum

- Successful hedge funds aggressively reward contributions to returns. With growth and diversification, need for select key professionals to have broader perspective
  - Raises difficult economic and cultural issues
  - Partner behavior, if important, has to be incentivized
  - Change slowed by confusion over flexibility, economics, and governance

Silo	Partner	Owner(s)/Founders
• 5% to leader	• 3% of silo to leader +	• 6%+ economics totally linked to firm
• Discrete strategy	• 2.5% silo equivalent in firm	• Silo leader and contribute to other strategies
• No cooperation	• Expected cooperation	• % <u>sticky</u> overtime
	• % <u>flexible</u> overtime	

Private Equity: Carry Allocation Questions

- Most major firms allocate carry across portfolio
  - Individual receives x% of gains regardless of transaction involvement
  - Drive team work and minimize staffing issues
  - On smaller scale, all have meaningful input on each investment

- Bulk of carry (i.e. 80%) at fund beginning, and reserve (i.e. 20%) over-time on performance
  - Reserve helps address promotions and unexpected contributions
  - Approach reflects maintaining capital gains opportunity

- Reality today large firms more dependant on individual professional to generate excess returns
  - Initial carry allocation too much on title/level; differentiation so-so

- Differentiate more in initial allocations, and consider some carry investment-by-investment
  - Higher value on deal origination and returns
  - Less emphasis on credentials and experience

2015 Fearless Predictions: Equilibrium

- Asset/Wealth Management pay momentum (i.e. +10%)
  - Recognize different compensation models
  - Focused expense management
  - Fee pressures but mostly medium term issue

- Hedge Funds (i.e. +10%) on increased volatility
  - Energy, distressed, global dislocations

- Investment/Commercial Banks move with economic conditions (i.e. +5%)
  - Both fixed income and equities improve moderately on less capital
  - Asset/Wealth Management improve but limited internal traction
  - Expensive infrastructure and legacy costs. Need for aggressive cost-cutting
  - Promote from within, or understand why not

- Paradigm shift continues towards non-bank compensation and careers
  - Perceived as better cultures and alignment
  - Tailored compensation and equity plans

- Continued advantages in being away from New York/London/EU
  - Costs and entrenched mindsets (i.e. working from home considered radical idea)

Simple Governance Not Enough

- Compensation Committee with simple governance focus
  - Senior executive levels and ISS/Glass Lewis mandates
  - Less proactive in terms of business impact
  - Episodic consideration of broader compensation and programs

- Adequate governance inclusive rather than narrow concept
  - Compensation philosophy
  - Nuanced business knowledge
  - Equity strategy and ownership
  - Key performance metrics (i.e. <u>not</u> just income)
  - Incentive funding and affordability
  - Working knowledge of key incentive programs
  - Understanding of turnover and diversity

- Typical Compensation Committee reconsider mission and work harder*/smarter
  - Move beyond minimal compliance, and focus on greater impact
  - Have Human Resource backgrounds on Committee

*Recognize harder is a loaded word but, alas, it is the truth

Summary and Final Thoughts

- Asset management and alternatives compensation leaders
  - Economic and cultural advantages
  - Continue to refine distinct compensation models
- Bank compensation has reached short-term equilibrium
  - Move with economy but low to other choices inside and outside industry
  - Must adjust cost structure to provide competitive compensation
- Human Resources initiatives needed
  - Refocus on excellent performance
  - Culture matters
  - Train and promote from within
  - Lean staffing and adequate turnover
- Sales compensation evolving
  - Hybrid approach reflects complexity of sales process, products, and channels
- Firms must continue to reduce costs and complexity. More aggressive management of human resources
  - Compensation will trend upwards with the economy