Financial Services Inflection Point and Annual Recap

Financial Services Compensation
Financial Markets Total Rewards Group

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- Independent financial services compensation consulting firm providing informed advice and counsel, with customized solutions grounded in best practices. Expertise navigating global headwinds and inertia to develop aligned and successful programs. Common services include annual and long-term incentive designs, market data, agreements, equity and partnership considerations, and Board Committee advice
  - Real 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

Why Today Is A Rewards Inflection Point

- Fundamental business conditions are improving slowly
  - Product demand generally tepid
  - Excessive capacity particularly in trading businesses
  - Wealth and Asset Management facing fee pressures
  - Hedge Funds not generating adequate returns
  - Private Equity impacted by recent markets

- Business platforms complex, expensive, and with overcapacity

- Compensation for some functions ≅ at/below other industries
  - Is current pay enough considering demands?
  - Uncertain attractiveness of future opportunities

- ***Industry must provide overall rewards to attract and motivate high-end talent***
- ***Home-field advantage is gone, and no one cares about your problems***
- ***Firms have to be far leaner, differentiate greatly on contribution and be creative/flexible in compensation design and delivery***

Needed Changes in Compensation Dynamics

- Competitive base salary
  - Signal of strength. Salary freezes message overstaffing/future problems

- Nuanced view of turnover
  - Historical: Broad %'s across population
  - Best practice: %'s by level and performance rating/contribution
  - Turnover often too low for average performers

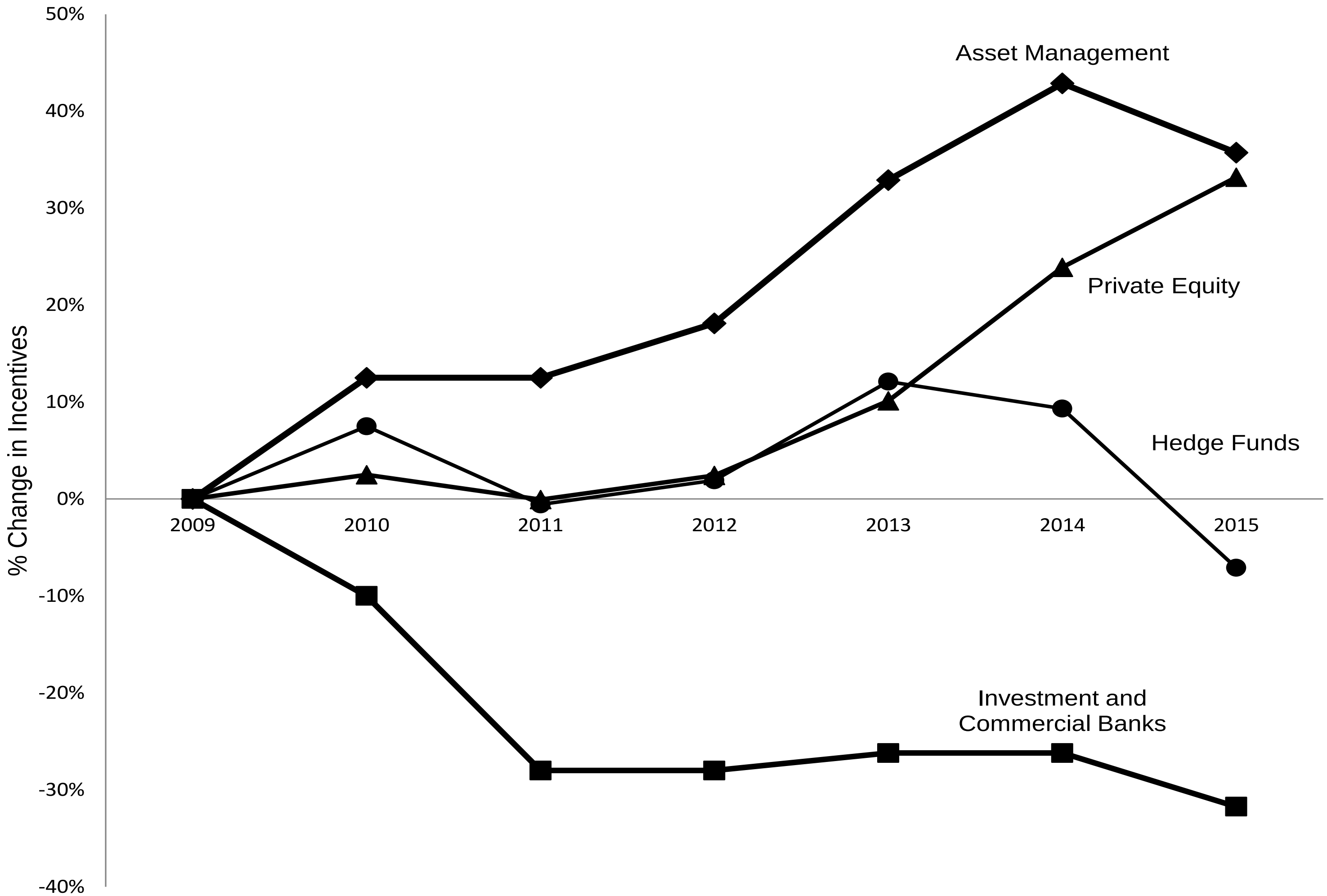
- Choice and design of long-term vehicles matters
  - Shares, options, products, carry and structured debt
  - Creativity in structure and design (i.e. vesting/economics/participation)

- Need greater focus on bonus plan designs and utilization
  - Tailored programs can increase alignment and motivation

- Greater planned differentiation on performance
  - Aggressively reflect contributions across market (i.e. 10^{th} - 90^{th} percentile)

Compensation Divergence Across Industry Sectors

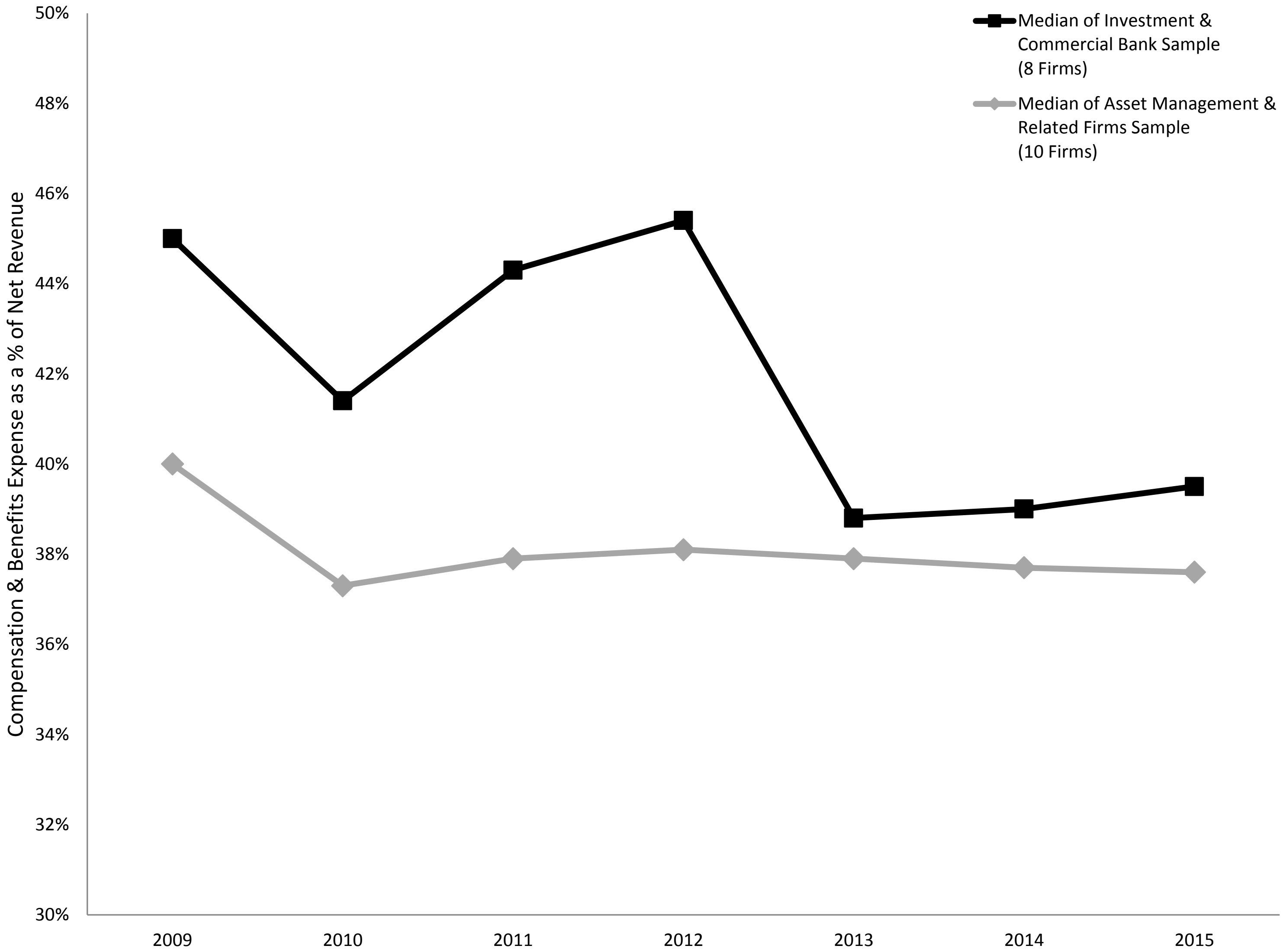
- Since financial crisis, industry sectors have not moved in lockstep
  - Expectation 2016 far more difficult due to markets and continuing fee pressures



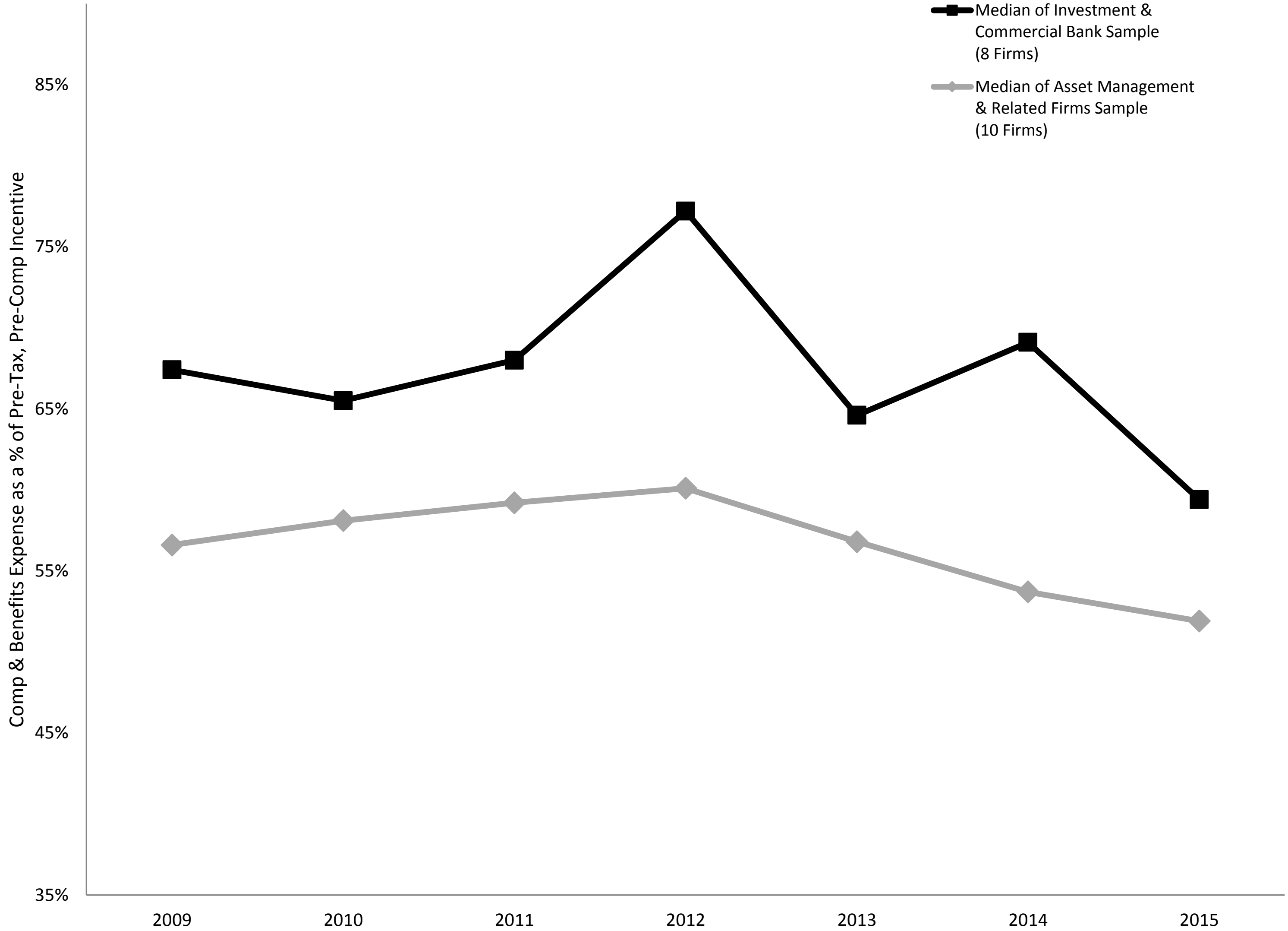
2015 Compensation Changes Across Sectors

- Not a strong year with headlines of weaker markets
  - Clear weakness in late 2015 continued into 2016
  - Highlights cost and capacity problems
- Major bank incentive compensation generally down
  - Fixed Income: -10% to -20%
  - Equities: Flat to +10%
  - Investment banking: Advisory +20%, while underwriting -5% to -15%
- Client businesses impacted by markets and returns
  - Asset management: -5%
  - Wealth management: -5%
  - Private equity: +5% to +10%
  - Hedge funds: -15%+
- European banks continue to face significant economic and political headwinds. Unclear path forward with reluctance to relocate headquarters/take bold steps
- Equity and ownership importance continues. Natural advantage for smaller/more focused organizations
  - Stake in the future along with alignment and motivation

Compensation as % of Net Revenues



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



JOHNSON ASSOCIATES, INC.

Staff Compensation: Take Off the Bubble Wrap

- Staff compensation should vary with firm performance and contribution
  - In many firms unclear linkage to pay. Too much entitlement

- Variations should flow from impact and compensation levels
  - More impact for senior professionals

- Approach should be clear with less surprises
  - Mindset needs to be more aggressive. Identify roles with less value added or opportunity to grow

- ***Working Assumption: Generally difficult compensation environment makes providing "undue" protection increasingly unworkable. Better to address directly before issue exacerbated***

2016 Fearless Predictions: Systemic Change

- Significant headcount reductions most visibly for banks
  - Reducing footprint and complexity
  - Overcapacity and tepid demand
  - Trading does not rebound meaningfully
- Asset/wealth management down significantly (i.e. 10% - 20%)
  - Poor 2016 start with AUM well below 2015 average
  - Fee impact of passives/ETFs continues and builds
  - Renewed cost focus on higher expense base
- Hedge funds have third disappointing year
  - Forces review of return drivers. Many need process improvements now
- Private equity hit by valuation changes
  - Fee pressures and vanishing carry
- Far greater intensity around high-performers
  - Balance available funds and opportunities
- Need to sharpen incentive practices and designs
  - Funding approach and guidelines
  - Design and delivery

Reward Lessons From Technology Sector

- Importance of a few great people
  - Often worry about having too many people
  - Fear of bureaucracy
  - Talent and contribution more important than hierarchy
- Broad turnover accepted and generally healthy
- Competitive base salaries. No excuses
- Substantial levels of differentiation on contribution
- Time in-grade far less important
- Both restricted stock and stock options
  - In start ups, often performance-based vesting
- Flexible hours and dress code
- Often see player/coach roles
- Greater internal promotions

Base Salary – Remains Important

- Base salary both economic and cultural signal
  - Competitiveness
  - Opportunity
  - Decision–making quality (i.e. presence or lack of odd practices)
  - “Old Wall Street” vs. Global economy
- Available market information highlights deficiencies
  - Employees are better informed, especially younger professionals
- Tyranny of small increase pool (i.e. 3%)
  - Few adjustments for workforce demographics/static view
  - Math does not work with young talented workforce (i.e. treat separately)
- Salary freezes reappearing
  - Often reflects misguided view on compassion and fairness
  - Signals too many professionals
- 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 reduce firm income***

Banks: Compensation in a Challenging Environment

- Sharpen compensation accrual methodologies for bank and units
  - Market percentages of profits
  - Monthly/quarterly accrual process to reinforce directions
  - Involvement and buy-in of Compensation Committee
  - Greater utilization of both broader/narrower incentive programs
- Ensure clear, aggressive methodology for differentiating between professionals
  - Expectation for compensation changes by performance/rating
  - Link indirectly to desired turnover/headcount
- Heavier use of real analytics
  - Need deeper insights into relationship between business economics, market compensation and funding across professional levels
  - <u>Far more</u> than year-over-year changes with existing headcount
- Embed "no scholarship" concept
  - Senior professionals have to live and die with results
- Appropriate variety in philosophy and design
  - Flexibility and creativity is needed
  - Stop putting all of deferrals into bank stock

Asset and Wealth Management: New Challenges

- Mildly down in 2015 – but felt worse. 2016 likely down significantly (i.e. -10% to -20%)
  - Added costs and global build out/investment
  - Client expectations becoming more sophisticated

- Increasing need for high-end support (just not too many)
  - More/better resources needed in challenging environment
  - Creating/maintain partnership feel to reinforce criticality
  - Equity structure and design key variables

- Wide reassessment of value proposition
  - Ability to produce superior returns
  - Active vs. passive

- Often lack of product development/differentiation
  - Credit, real estate, select countries, secondaries, etc.

- Significant focus on sales compensation design
  - Commission vs. hybrid vs. subjective

Hedge Funds – Drive to Improve Performance

- 2014 – 2015, and early indications 2016, low return years
  - Great pressure to improve returns

- Re-testing of fundamental compensation models
  - Both formula and discretion have large/subtle requirements and motivations
  - Understand market economics and differences (i.e. capital, costs, clawbacks, etc.)
  - Silo vs. cooperative model

- Key question: Lack of implementable ideas and/or ideas not executed well enough
  - Often requires better process and enhanced tracking system and commitment

- Tangible measurement factors receiving more attention
  - Risk (traditional measures, credit, reputational, etc.)
  - Cooperation (incremental/intangible value creation attributable to sharing)
  - Internal rate of return (not all gains are equal) -or- cost of capital
  - Minimizing style drift (and looking for help if not within one's expertise)

Private Equity – "Real" Reward Opportunity

- Volatile markets and multitude of funds requires clarity on way(s) to consider carry
  - Often three models used to different degrees
  - Increasingly no one answer, blend of opportunity and expectations

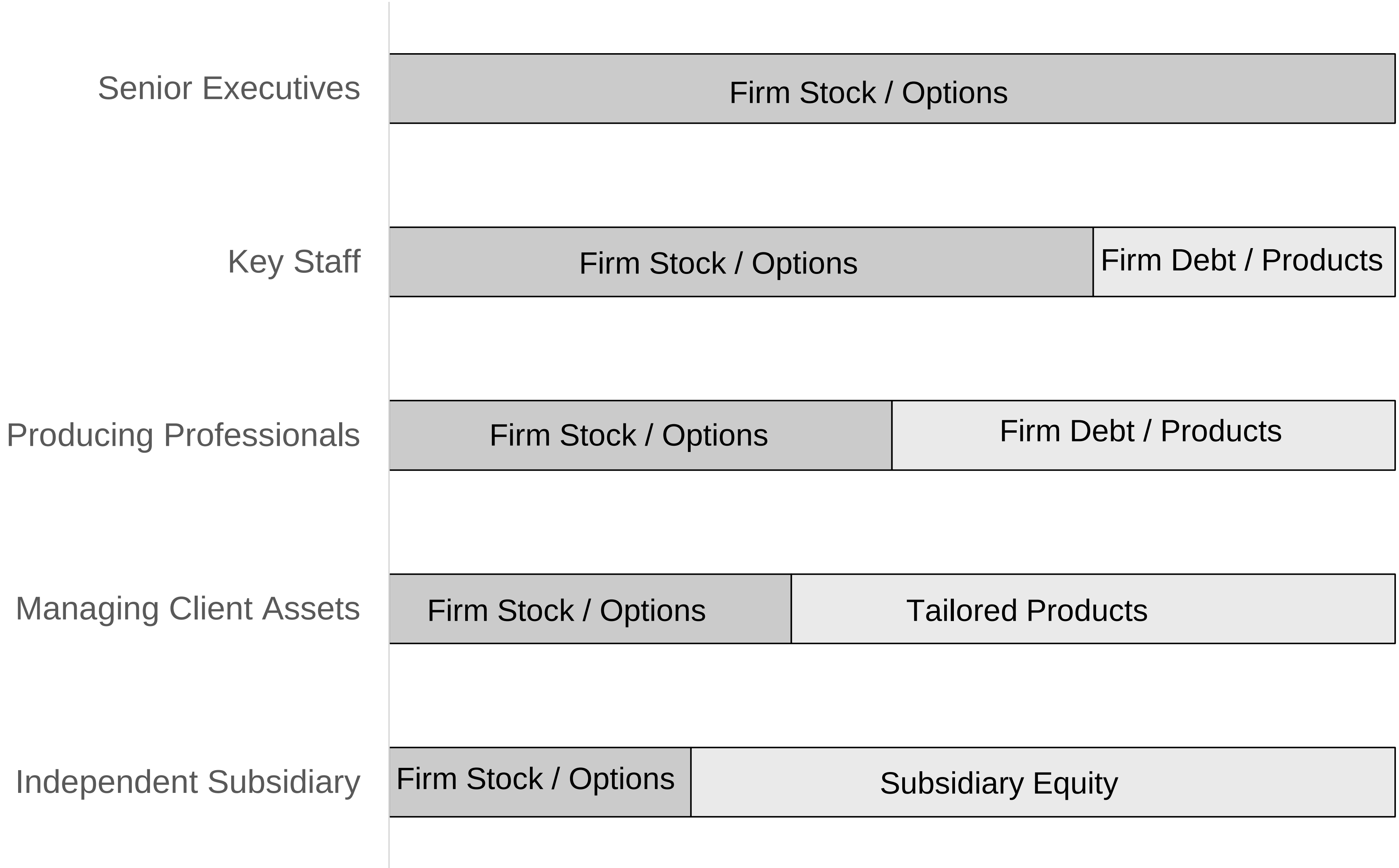
■ "Old" private equity:	Annual pay + other (carry %, to the side)
■ Evolving private equity:	Annual pay + carry-at-work (invested dollars working on behalf of individual)
■ Aspirational private equity:	Annual pay + realizable carry (using assumptions/projections)

- "Waterfall" where firm and professionals receive incentive fees after capital and cost returned. Results in elongated periods (i.e., often 5 - 6+ years until payouts)
  - Annual compensation becomes more important
- Initial allocations and reserves crucial
  - For professional unhappy with current carry share, 8-10 years for payouts from next fund. Does it make sense to wait?
- Vesting needs to be rethought
  - Often see 20% + vesting on realizations; will become more significant

Compensation and Motivational Drivers

- Deep equity participation usually not motivational or creator of alignment
  - Broad participation often inefficient
- Clear bonus plans often underutilized
  - Line of sight and communicated metrics
- Unit equity/long-term can be effective
  - Create alignment and often resonates externally (i.e. investors, candidates)
- Long-term vehicle(s) and terms matter
  - Restricted stock
  - Stock options
  - Growth units
  - Products
  - Vesting
  - Non-compete/non-solicit

Illustration of Long Term Vehicle Utilization



Ownership and Partnership

- Significant current interest in ownership/partnership
  - Opportunity to be more than an employee
  - Wealth building if successful
  - Alignment and transparency
  - Degree of certainty and stability
- Partner title has many diverse potential meanings
  - Equal share
  - Unchanging share
  - Governance and decision making
  - Risk and capital requirements
  - Permanent position
- Lessons
  - Partners are diluted overtime
  - Formal governance clear (i.e. usually founders)
  - Details really matter (i.e. termination treatments)
  - Legal documents often unclear/overly complicated/no summary of intent
  - Valuation approach can drive decisions (i.e. book, market, full market)

Employment Agreement Checklist

- Limit evergreen contracts
- Market based salary, with a sensible review frequency
- Utilize bonus dollar targets (not a % of salary)
- Longer vesting and restrictions around long-term incentives
- Sensible treatment on separation (for cause, not for cause, good reason)
- Definition of cause, good reason, and/or similar “trigger” language
- Market based severance (closer to 1x; avoid 3x old world approach)
- Extended non-competes and non-solicits; sufficient (3-6 months) notice
- Are the terms aligning the executive with all other employees?
  - “Generals should not eat before the troops”

Summary and Final Thoughts

- 2015 – 2016 is an inflection point
  - Weak business tides won't "lift the boats"
  - Cost and complexity have to decrease significantly
- Compensation analysis has to improve
  - Quality benchmarking requires judgement and context
- Hedge funds challenged
  - Greater cooperation required
  - Test fundamental compensation model(s)
- Asset management facing headwinds
  - Suffers from overcapacity
  - Increase support emphasis and rewards
  - Selective headcount
- More aggressive management of human resources
  - Less wasted management time
  - Performance management/differentiation up a notch
  - Turnover expectations refined
- Need best practices and thinking across variety of issues
  - Little vitality left in historical/conventional views