2013 Financial Services Compensation:

Pay Opportunities In The New Normal

PRESENTATION AND DISCUSSION

November 12, 2013

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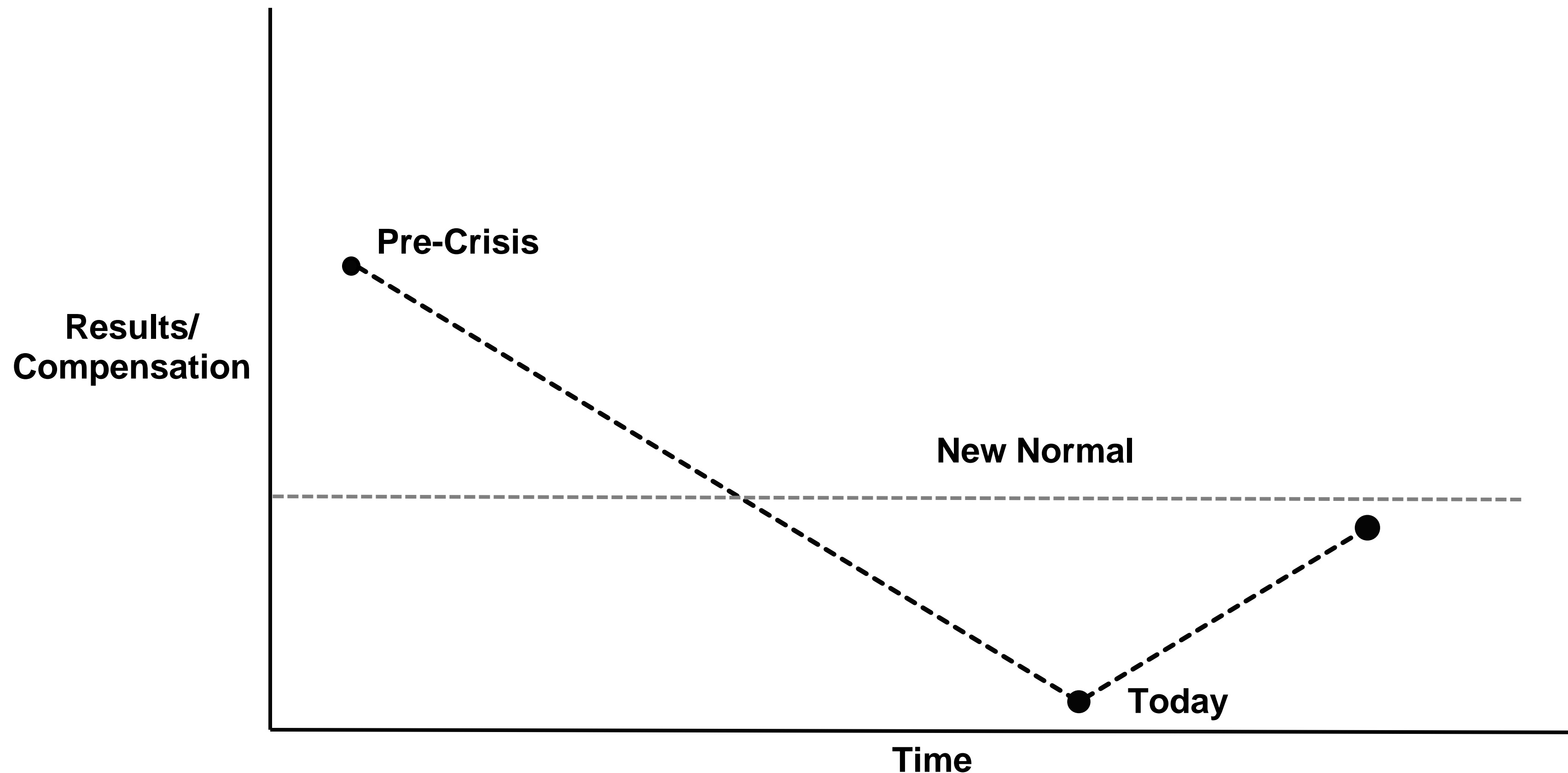
- Independent financial services compensation consulting firm. Tailored advice, annual and long-term incentives, market data and analysis, agreements, and goals/metrics. Equity, ownership, and partnerships. Deep knowledge across comparators, markets, and political/social considerations
  - Experienced, opinionated and informed
  - Both Board and Company consultant

- Diverse clients and issues
  - Universal and major banks
  - Asset Management and Wealth Management firms
  - Hedge Funds/Private Equity/Fund-of-Funds/Alternatives
  - Insurance companies
  - Brokerage firms
  - Trading organizations

The New Normal

- In financial services different environment today than before crisis
  - Key to recognize pre-crisis was not normal either. Unsustainable economics not real reference point
  - Moved from well above “normal” to below “normal”. Differences of opinion on baseline opportunity in future, but likely better than results today



The New Normal-Implications

- Today parts of financial services, particularly major banks but also others, have returns below the cost of capital. In broad terms suggests one of two scenarios:
  - Parts of financial services in long-term decline driven by regulation and inadequate product demand. Capital exits industry and compensation below industrial companies

OR

  - Financial services will trend to normal returns driven by better global economy and demand for products. Regulation is a handicap but not debilitating. Meaningful but not excessive compensation premium to industrial firms

∴ ***Second scenario most likely and, over time, will be new normal. Clear positive indications in Asset/Wealth Management, Private Equity, Hedge Funds, and Insurance***

2013 Year-End: Industry Sectors Diverge

- U.S. major banks incentives flat to slightly positive (i.e. 0% to 5%) with European banks down moderately (i.e. down 5%-10%+)
  - Fixed income: -5% to -15%+
  - Equities : +5% to +15%
  - Investment banking: advisory -5% to -10%, underwriting +10% to +15%
  - Retail / Commercial banking: 0% to +5%
  - Asset / Wealth management: +10% to +15%

- Market–based businesses clearly up on improving fundamentals
  - Asset management : +10% to +15%+
  - Wealth management : +10% to +15%
  - Private equity: +5% to +10%
  - Hedge funds: +5% to +15%

- Better differentiation on performance

- New European pay caps reflect environment

- Moderate voluntary turnover continues

- Perhaps 2/3 of the way in cost cutting process

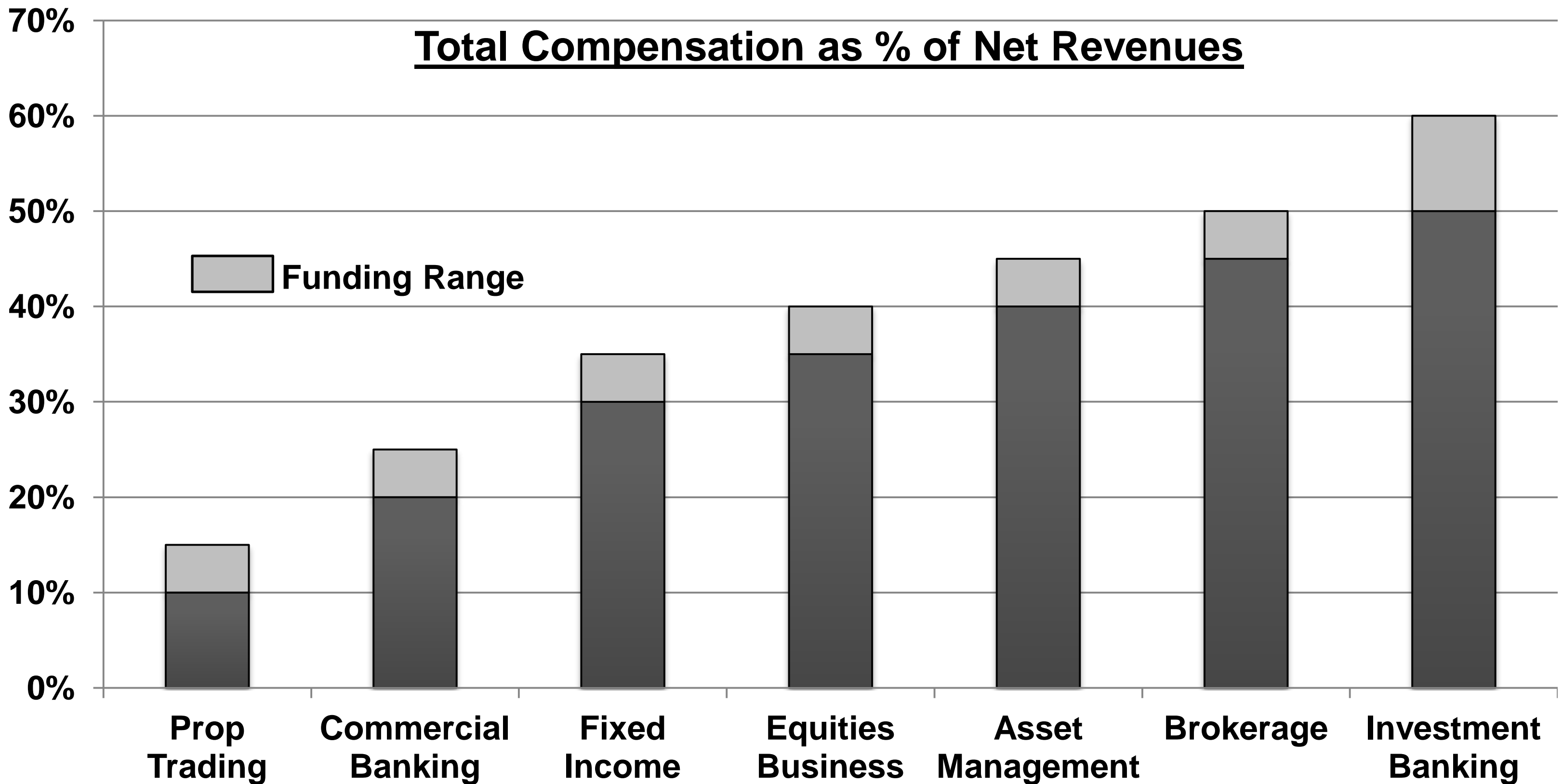
Compliance with Shareholder Advocates (And Institutional Shareholders)

- Recognize often predictable key issues driving recommendations and voting patterns

Common Issue	Potential Response
Dilution from equity plans	Narrow participation and consider other vehicles
Structure of performance plans	Limit to senior executive and adopt attainable goals
CEO compensation	Insure CEO pay consistent with results, consider significant executive chairman, and # 2 in place (i.e. reduce need for overly high pay)
“Abusive practices”	Avoid excessive contracts, perquisites, personal use of company plane, country clubs, etc.

Compensation Ratios Between Firms-Why The Differences?

- In reality, most of the variation (i.e. ≅ 70%) in the compensation ratios between firms can be explained by business mix. Businesses such as commercial banking and trading have lower compensation ratios, but use more capital. Client intensive units such as investment banking and brokerage have higher compensation ratios but often use little capital
  - This dynamic is often little understood. Overtime, emphasis on less-capital intensive units will result in a higher compensation ratio, but hopefully competitive and more predictable returns



Holistic Compensation Benchmarking-Pros and Cons

- Simply arraying compensation data, from imperfect (or flawed) competitors, position matches, performance, etc. to arrive at a reasonable market level is not optimal. This is particularly true as firms and positions evolve and simple easy matches disappear
  - One advantage of the traditional approach is defensibility. It often may be inaccurate, but there is a number to reference…

- A holistic approach considers position data, but also may include other similar firms, positions, market trends and projections, and job content
  - Mantra: "Better to be about right than exactly wrong"

<u>Pros</u>

- Compare non-benchmark positions
- Comparators of various size and complexity
- Consider multiple position scope factors
- Recognize internal relationships
- Data weighting reflects quality

<u>Cons</u>

- Requires degree of subjectivity
- Analysis often more time intensive
- Need greater knowledge of content
- Produce moderately different answers
- Have to recognize inherent imprecision

Deferral Vehicles and Choices

- Competing interests of significant deferrals and limited share availability. Need increasingly nuanced view of deferrals by level and potential vehicles besides stock
  - Consider effectiveness of deferrals lower in organization
  - Alignment and retention are not same objectives
  - Test value of symbolic allocations (i.e. stock for all)
  - Different vehicles by group and purpose

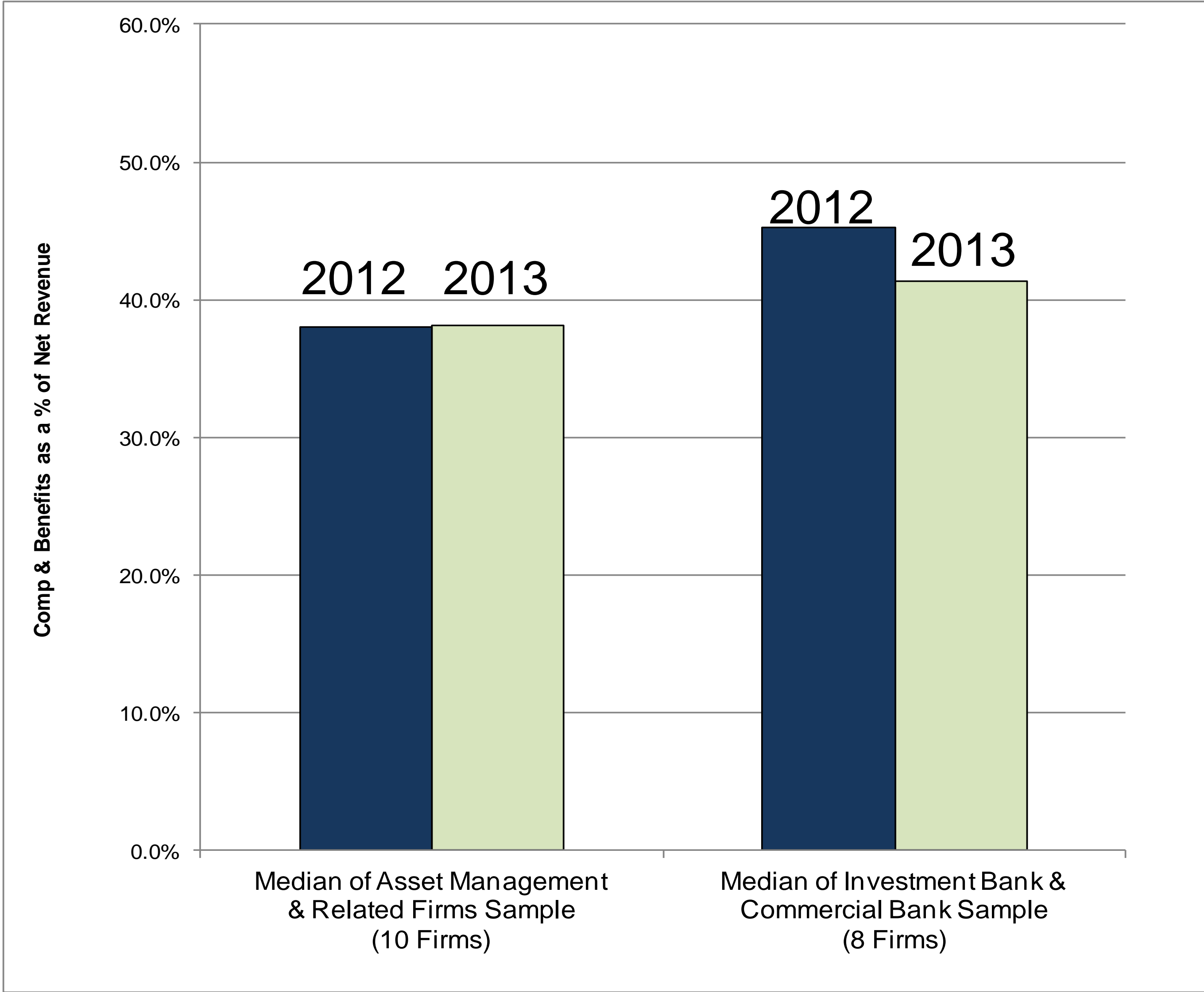
Illustrative Group	Major Objectives		Potential Vehicles
	Alignment	Retention	
Senior executives	80%	20%	Stock-Performance Plans
Business leaders	70%	30%	Stock-Performance Plans
Highly paid	50%	50%	Stock-Products-Cash
Moderately Paid	30%	70%	Moderate stock-Products-Cash
Retail brokers	20%	80%	Stock proxy-Account Balances-Cash

2014 Fearless Predictions: Recovery Continues

- Asset/wealth management and alternatives stronger in 2014 (i.e. +10%-15%)
  - Lag effect of AUM and equity products moves compensation
  - Cost cutting continues to positively impact results
- Investment/commercial banks higher (i.e., +15%)
  - Link to global economic improvements
  - Fixed income better than disappointing 2013. Equities improves with markets
  - Asset/Wealth management improve and become more significant
- Paradigm shift towards non-bank compensation and careers
  - Higher compensation opportunities in other parts of financial services. Less baggage from financial crisis and better business dynamics
- Continued movement towards Asian / Emerging Markets
- Movement to non-stock vehicles
  - Other vehicles can be more effective (i.e. performance plan, products, cash, etc.)
- Exit from New York/California/Europe continues
  - Cost and taxes
  - Governments
- Firms continue to become leaner in challenging revenue environment
  - Managing headcount / location and strategic exits

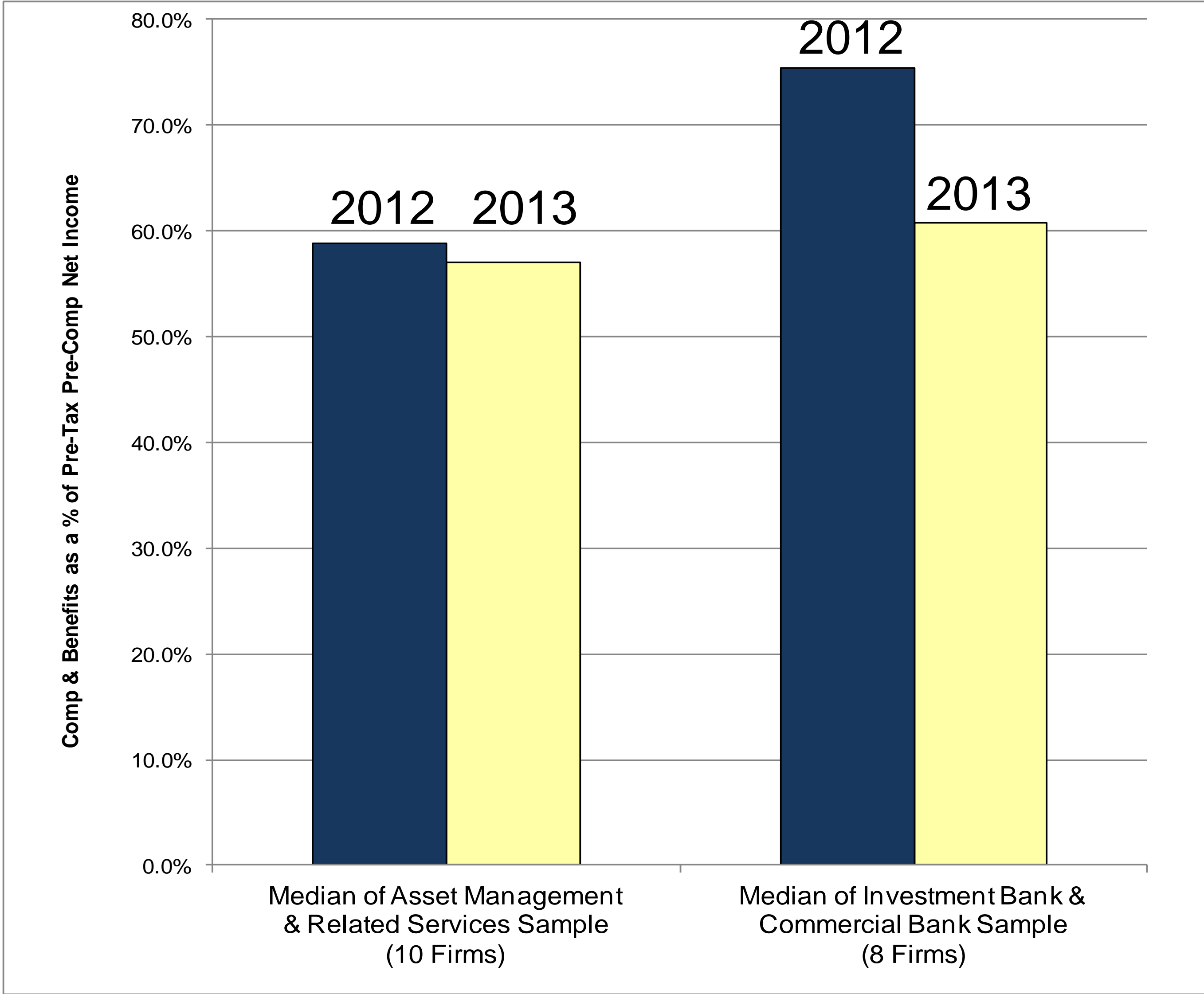
2013 vs. 2012 Compensation as % of Net Revenues

Note: Reflects available year-to-date data

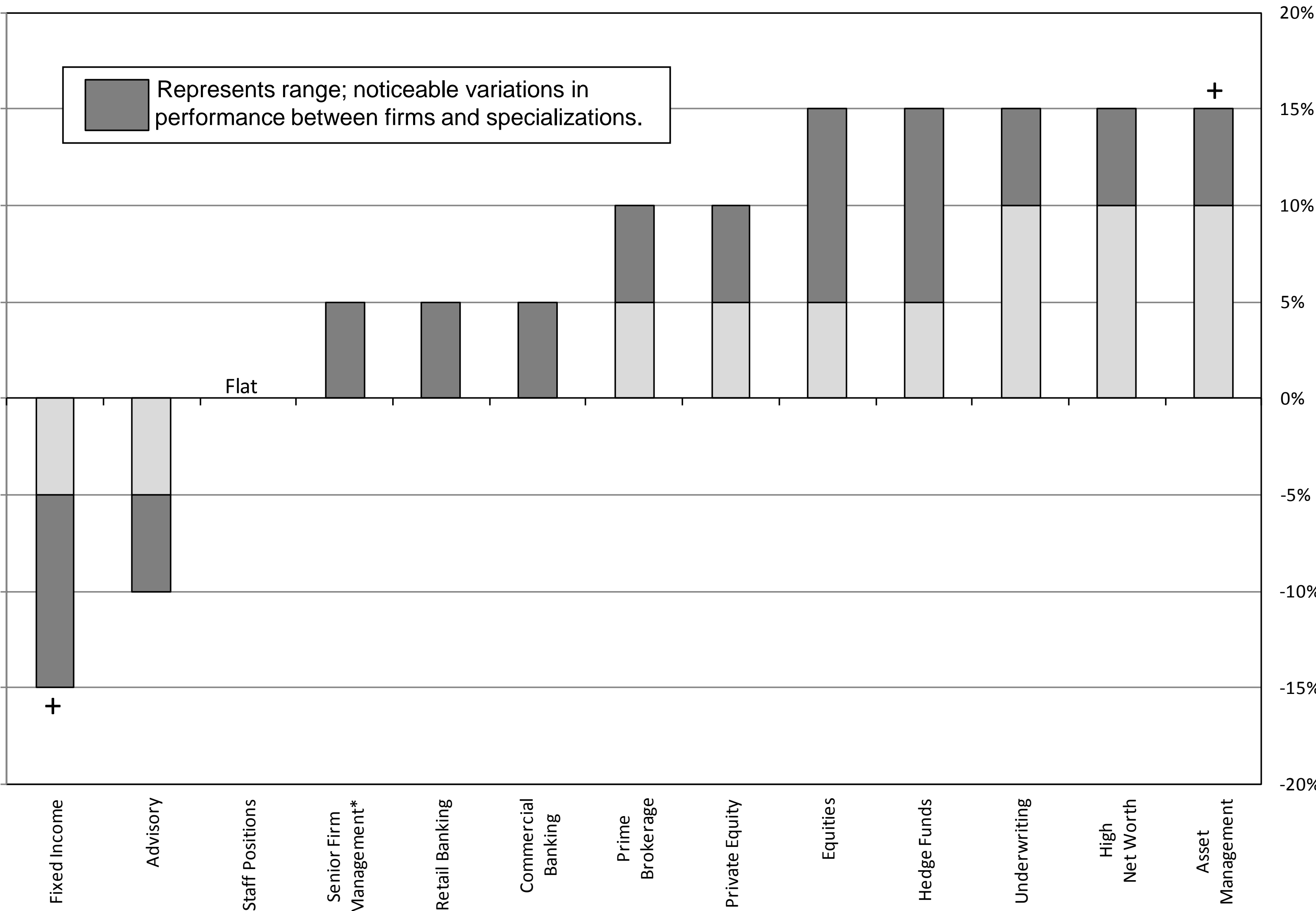


2013 vs. 2012 Compensation as % of Pre-Tax, Pre-Comp Income

Note: Reflects available year-to-date data



2013 Typical Incentive Changes (Value of Cash & Long-Term / Equity)



*Excludes proxy executives impacted by firm specific circumstances

2013 Bank Executive Compensation

- Bank executive incentives broadly flat (i.e. 0%-5%)
  - Firm by firm variations
  - Senior management moves with other professionals and firm's results

- Overall compensation is roughly consistent with performance
  - "So-so" results with "so-so" pay. Better link than in 2010-2012
  - Current pay bands for bank executives below high-end asset management (also weaker performance)

- Common view executives should increase/decrease with earnings
  - Requires considering multi-year scenarios since starting point is important

- Long-term incentive grants/earnouts on annual awards complicate comparisons
  - Structure and goal difficulty varies by firm

Relative Performance In Incentive Plans

- Increasing interest in adding relative performance, either financial or stock price, as incentive plan measure. Avoids some of the difficulties in forecasting and may reflect alternative choices for investors
  - Many firms are not very correlated with comparator firms due to business mix, geography, scale, and regulation. Moreover, often not highly linked to broader index (i.e. S & P financials)
  - Reality is often a few (i.e. 4-6) comparators highly correlated. Requires careful incentive design and provision for adjustments / discretion

Example: Major U.S. bank correlation with other financials

Group	R^2 of 3 year stock price
Named comparators (i.e. 4 – 6)	50%+ - Strong
Other named (i.e. 5 – 8)	40% - Moderate
Other banks (i.e. 10)	30% - Weak
Other Financials	20% - Weak
Total	Problematic for plan design

Sales Compensation In Flux

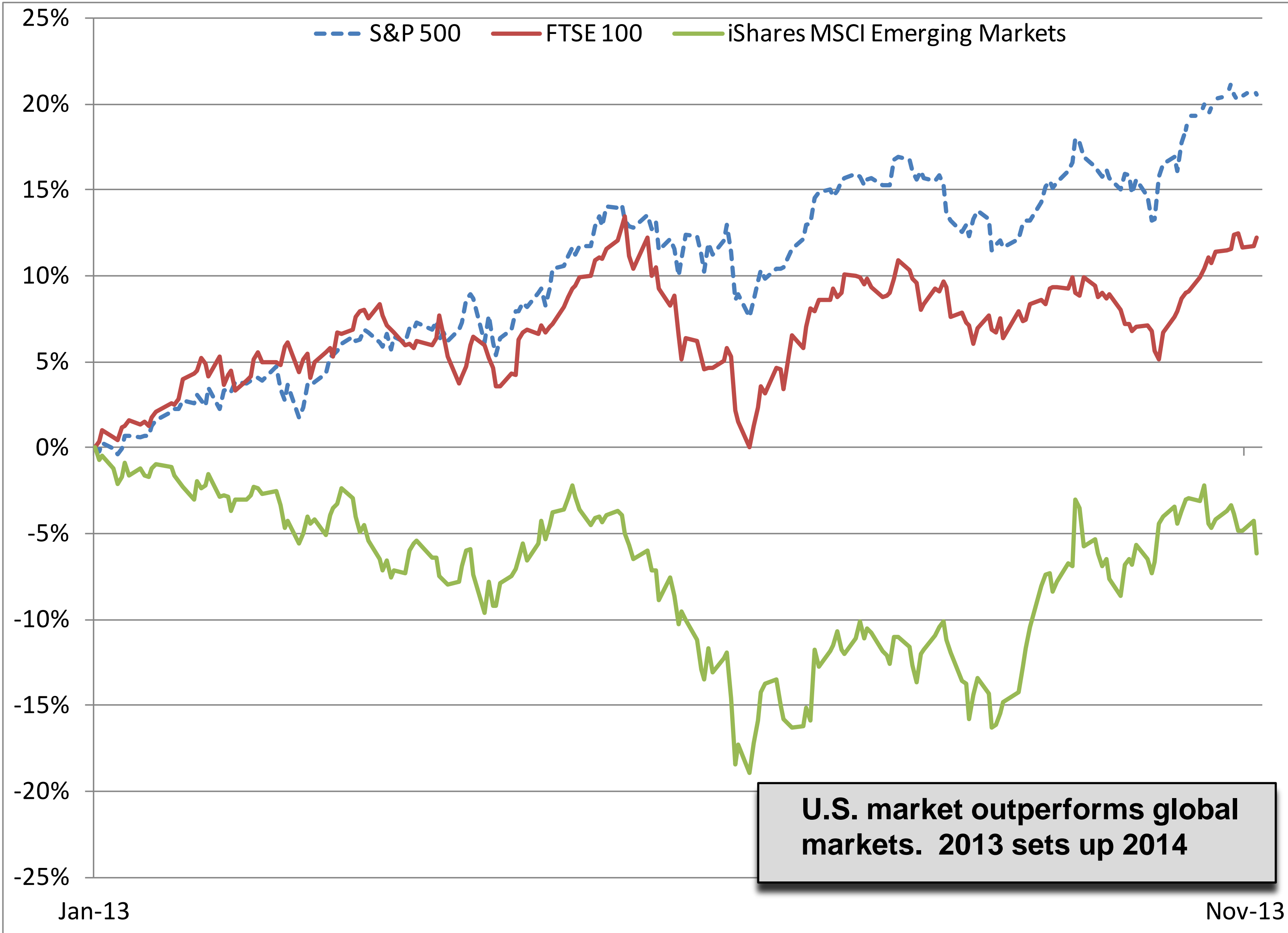
- With renewed interest in sales, focus on appropriate compensation model. Visceral reactions and personal past experiences often cloud the issue
  - Three broad choices: commission, pool, and discretion; and also combinations (i.e. commission with x% discretion)
  - Firms should decide which choice(s) make the most sense. Balance weighting of competitive practices and overriding objectives

Selection Consideration	First – Order Direction
Geographically separated	Commission
Co-operation key	Pool, discretion
Heavy management / Investment involvement	Pool, discretion
“Rolodex” of contacts key	Commission
New geography / Product set	Discretion
Great investment track record	Pool, discretion
Poor investment track record	Discretion
Recruiting salespeople with track record	Initially commission

Asset & Wealth Management

- 2013 good year, setting up for even better 2014
  - Bifurcated results. Markets lifted all boats, but especially those with broad based returns and products
- Diversified financial firms continue to generally lag best independents
  - Lack of consistent compensation management (i.e. % of operating profit)
  - No subsidiary stock (with exceptions)
  - Multi-year perspective required
- Independent firms have smaller deferrals and less regulatory intrusion
  - Competitive advantage vis-à-vis major banks
- Increasingly compensation / equity issues surrounding partner succession
- As firms become more global, question on how to sync right local pay and reward approach with core successful paradigm
  - Helpful lessons from other global firms… Retain flexibility and values,but recognize impact of local market practices

Asset Management



Private Equity: Stability and Progress

- Clients remain committed
  - Sustained AUMs and positive fundraising
- Recent vintages positive (2009-2013)
- Wide variances in returns by fund
  - Less clarity on annual pay vs. carry
  - Unusual number of haves and have not's
- Public firms often emphasize carry to save on management fees
  - Projected to drive higher valuation on predicable fees
- Issues created by varying business models / history
  - Fair rewards for founder(s)
  - Carry split between professionals and firm
  - Competitive annual compensation; Size? Geography? Ownership?
  - Ownership counting towards compensation

- **Perception adequate global opportunities exists for experienced investors. Less agreement on continued investments from market dislocations**

Hedge Funds: Partner Transition and Co-operation

- In Hedge Funds, significant issues around partner transition
  - Firm valuation less clear, particularly without founder and if thin investment bench
  - Economic and control transition. Tail on economics
  - Profit participation for new partners
  - Struggling with seeing beyond "overpaying/sharing" in short-term, to continue momentum to have value and sustainability over medium / long-term

- Addressing co-operation of partners/senior professionals
  - Want laser focus on portfolio parts, but also enough co-operation not to miss opportunities or avoid problems
  - Founder DNA opposed to any type of perceived socialism
  - Integrated firms benefiting from co-operation need to split annual compensation between desk and firm, and often use firm equity. Mix of elements depends on level and potential future impact

Firm Protections

- In recent years financial service firms have made significant progress in adding protections. Firms generally attempt to insure either appropriate compensation is delivered, or to provide limits on the ability to compete or solicit customers and employees

Provision	Intended Purpose	Comments
" Clawback"	Return and forfeit awards for bad behavior	Often untested broad language
Gardening leave	Short period to stop immediate solicitation of clients	Expensive but common feature
Non-compete ($)	Forfeit existing awards for competitor	Nearly universal practice
Non-compete (stop employment)	Legal action for competition	Use increase but still selective. 6-12 months common
Non-solicit of clients	Protect clients	3-12 months common practice
Non-solicit of employees	Protect employees	1-2 years quite common

Director Role and Pay Implications

- Increased time commitments, complex issues and new legislation/regulation evident
  - Pressure for increased accountability
  - Unprecedented scrutiny of pay designs and magnitudes
- "Say on Pay" increases pressure
  - Highlights impact of weak/nervous Directors
- Transparency and proactive communication between Boards and management
  - Crucial importance of open communication
  - Boards retain discretion on payouts
- While requirements increased, compensation growth slowed
  - Consistent with declines for management and employees
- Sense of fatigue pervasive
  - After 4-5 years frustrated with both financial and compensation process
- Meaningful compensation changes needed

> - **Director compensation increased in 2012-2013 after sluggish period. Need to insure both appropriate magnitudes and structure. Opportunity to consider greater compensation for committee heads**

Summary and Final Thoughts

- The new normal provides significant compensation opportunities
  - Business improvements
  - Good compensation for good results
- Asset management, in all of its flavors, moving ahead
  - Favorable business trends
  - Lack regulatory and capital baggage
- Evaluating market data often requires a nuanced approach
  - More difficult to reliably use raw data
  - Requires both more analysis and judgment
- Greater variety of deferral vehicles need to be used
  - Stock/Performance plans/Products/Cash
  - More thought given to participation
- Sales compensation – increasing variety of models
  - Commission/Pool/Discretion (and combinations)
- Need to balance reasonable professional concerns and firm protections
- 2014 will continue positive momentum in the new normal environment. Challenge to manage expectations both inside and outside of firms. Performance and compensation will move towards trend line