Changing Pay Fundamentals
and
2018 Recap

Financial Markets Total Rewards Group

February 2019

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Johnson Associates

- Independent financial services compensation consulting firm providing informed advice, recognizing best practices and customized solutions. Proud of straightforward successful programs, often addressing difficult multi-faceted issues
  - Balance market/best practice with firm dynamics
  - Both Board consultant and company programs
  - Creative, opinionated and informed

- Common services include:
  - Annual and equity/long-term designs
  - Nuanced market pay data
  - Performance metrics and goals
  - Partnership issues
  - Board Committee advice

- Diverse set of clients with wide-ranging issues
  - Asset Management and Wealth Management firms
  - Hedge Funds/Private Equity/Fund-of-Funds/Alternatives
  - Major banks and units
  - Insurance companies
  - Trading organizations

Higher 2018 Compensation but Shifting Environment

- Moderately higher 2018 compensation, despite fourth quarter market performance
  - Firms followed normal funding and delivery practices

- Near term issues
  - Increased competition and consolidation
  - Reassessment of international/new products (i.e. time frames, scale)
  - Fee level erosion and lower cost products
  - Noticeable over-staffing in operations/sales/management

- Paradigm changing issues
  - Can you consistently add value to clients?
  - Compensation and staffing in an era of excellence

- Importance of culture and career opportunities

- Significant interest across private firms in reconsidering:
  - Objectivity/formulas vs. discretion
  - Alignment and motivational concerns
  - Program designs broadly

2018 Industry Incentive Changes

% change from 2017 “same store”

- Positive 2018 despite market volatility and fourth quarter
  - However, respite ending from longer-term dynamics

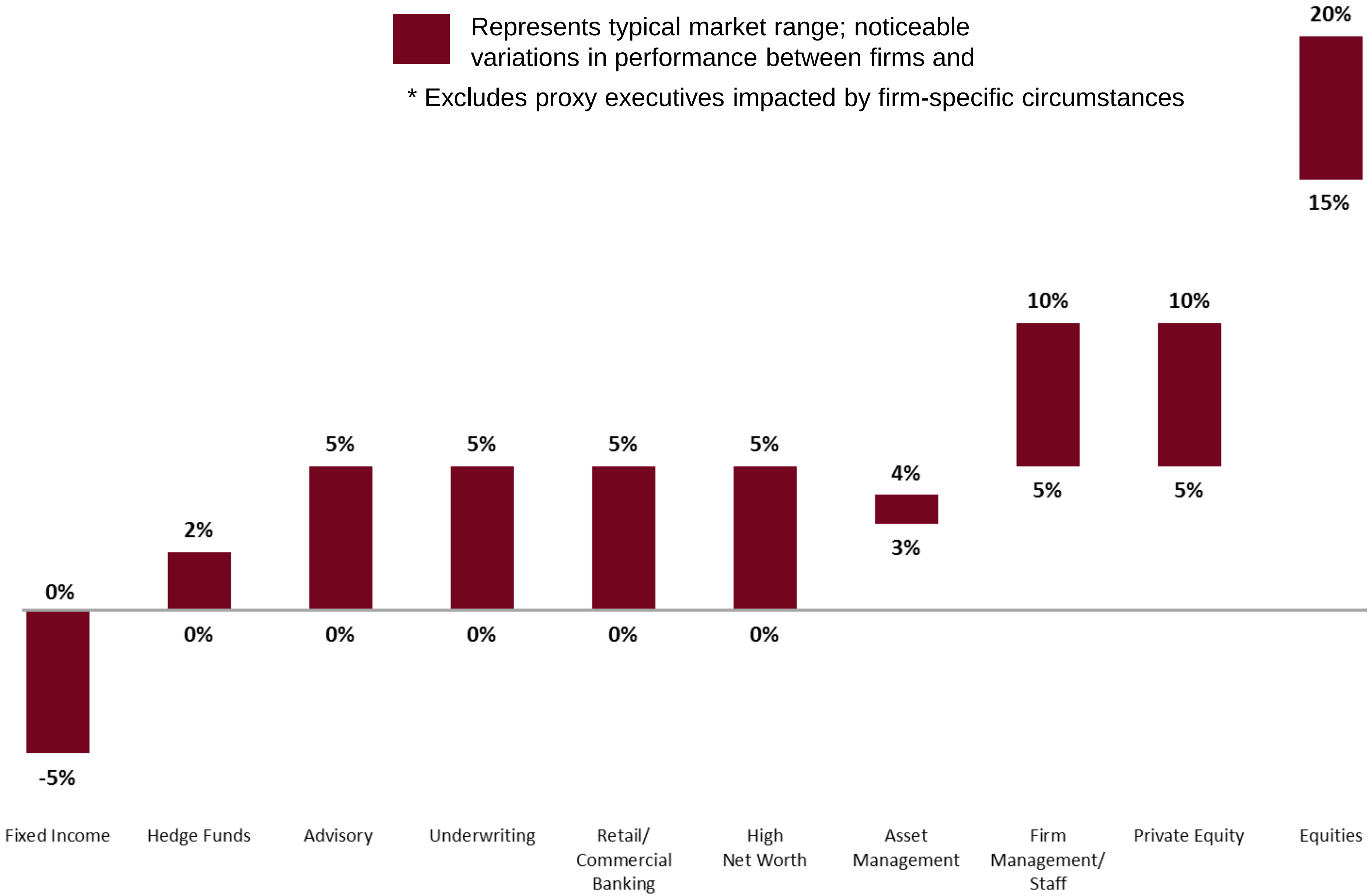
- Asset and wealth management: +3% to +4%
  - Slowing revenues
  - Difficult global markets and creating value

- Hedge funds: slightly above flat
  - Continued consolidation and pessimism
  - 5th disappointing year in a row

- Private equity and real estate: +5% to +10%
  - Strong fund raising and realizations
  - Economics of scale increasingly dominate

- Major bank incentives driven by equities and underwriting
  - Fixed income slightly negative
  - U.S. Banks generally well positioned
  - International Banks struggling to keep pace

2018 Common Incentive Changes (Cash & Long-term/Equity)



🟥 Represents typical market range; noticeable variations in performance between firms and

* Excludes proxy executives impacted by firm-specific circumstances

Gender Inequality Major Issue Today

- Ongoing need to monitor compensation across levels and positions
  - Relatively blunt tool provides an indication of potential problems
  - Analysis of performance, role, tenure and other factors (i.e. location, title and content differences) can identify if real problems exist

- Oftentimes, more significant issue is opportunity inequality. Are promotions fair, has the organization done enough to recognize circumstances, where do we recruit, etc.?
  - Unfortunately, limited real analysis of available candidates for roles and levels
  - Lack of clarity or planning to recognize available talent pools

- Gender inequality is a long-term business issue
  - Expectation that financial services should make significant progress, even if remedies don’t come easily or quickly
  - Continued public and political scrutiny
  - Should be thoughtful and exhaustive process

2019 Fearless Predictions

- Layoffs/downsizings are occurring
  - Reflects both business dynamics and productivity increases/automation
  - Recognition of half-hearted product and geographical expansions

- 2019 compensation down moderately (i.e. 5%)
  - Markets, fee levels, and product shifting

- Continued angst about competition for high-end technology talent
  - Requires improved employee economics and identifying areas of need

- Effective base salary increase often in 4% to 5%+ range

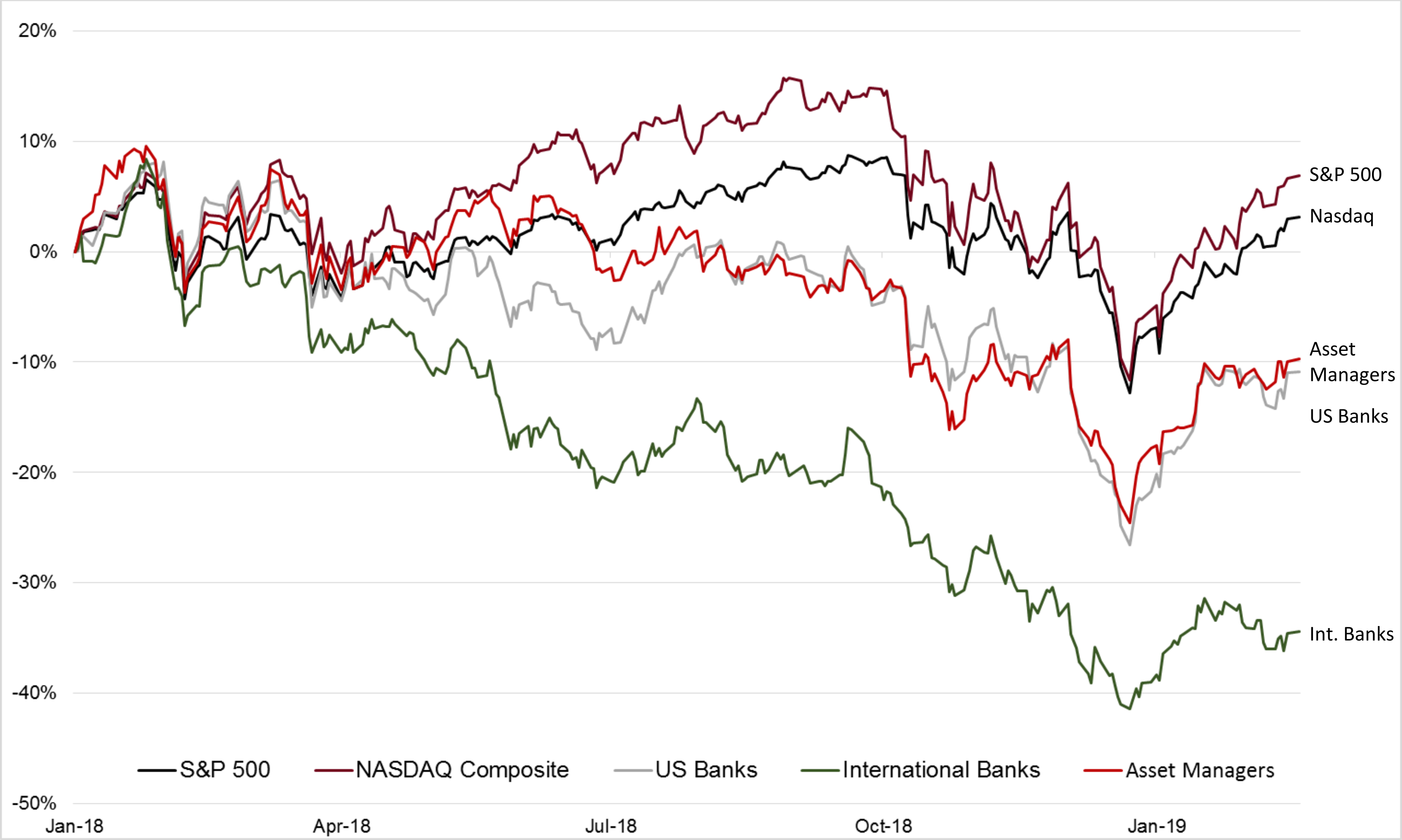
- Hedge fund/alternatives utilize more “direct drive” compensation designs
  - Greater individual accountability vs. group success/harmony
  - Asset class in need of a spark

- Greater focus among private firms on both annual and long-term incentive designs
  - Emphasis on performance and metrics
  - More thoughtfulness around alignment and behaviors
  - Less tolerance for historical inertia and complacency
  - Implications of succession/ownership concerns

- European banks will continue to struggle
  - Impact of regulation, restructuring, economic woes, and Brexit

Market Sending Clear Signals

- Market believes Banks (particularly international) and Asset Managers will have challenging time going forward



Base Salary Increases Accelerate – Direct and Indirect

- Single meaningful merit budget has lost much of its meaning. Most firms do not formally recognize the various sources of increase (i.e. 3% is really 5%)
  - Title changes
  - Equity adjustments
  - Promotional increases
  - New hires and replacement hires

- Focus on base salary increases/levels remains an oddity in an industry preaching total compensation
  - It has an innate appeal as a simple metric. Low base salaries today often indicate dated thinking
  - Continues to make technology hiring more difficult (i.e. can't explain logic)

- Firms have made meaningful progress adjusting base salaries of outstanding young professionals. Inexpensive but impactful dollars spent

- Reality that base salary levels matter to almost every professional
  - In a world focused on incentives, it remains underappreciated

Technology Competitors – “It Is Not Rocket Science”

- Recognize various technology skill sets have different reference points
    - Technology utilization and maintenance (i.e. broad financial services/general industry)
    - High-end development (i.e. core technology firms and select financial services)

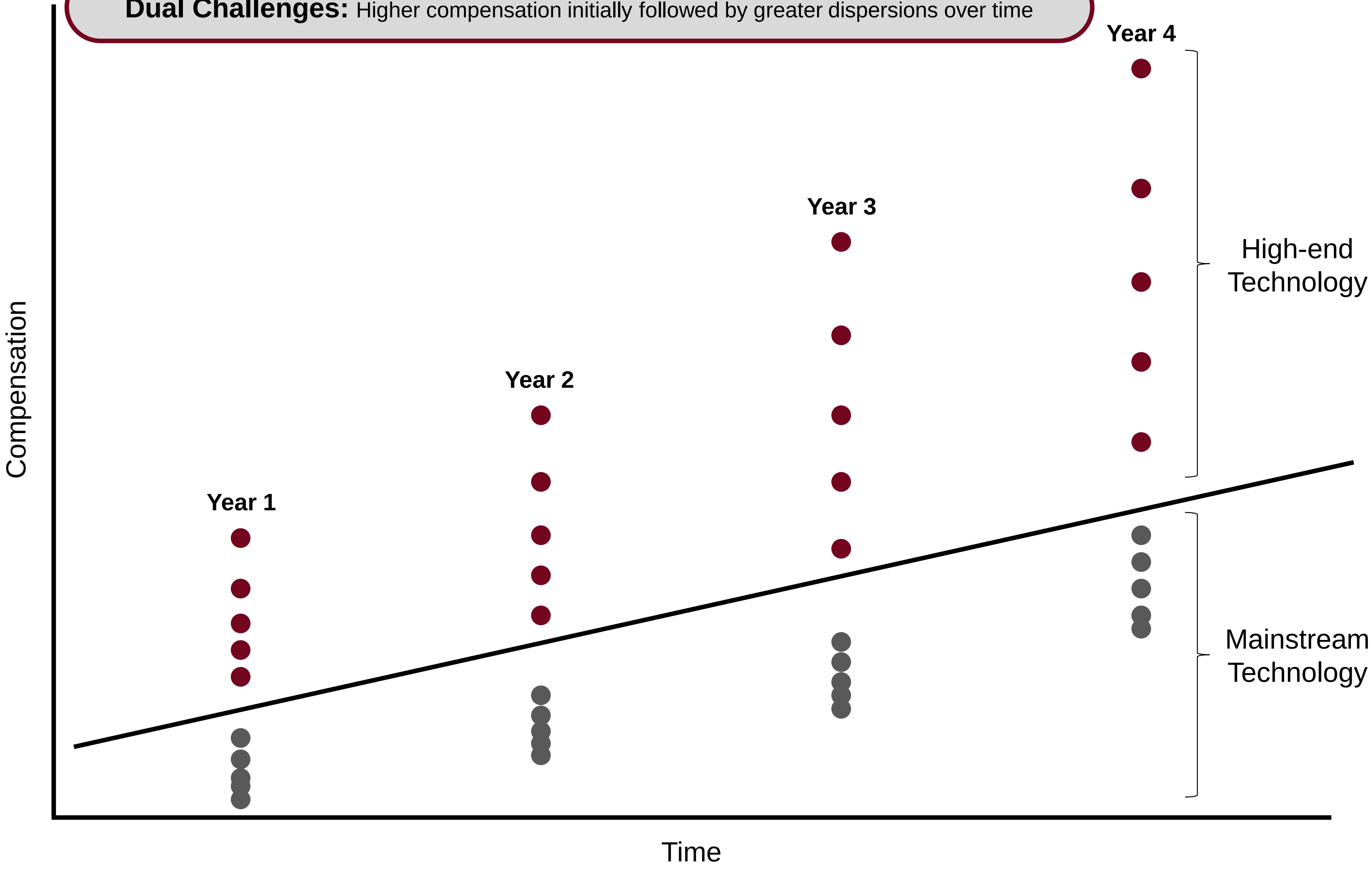
- Much of the compensation confusion revolves around actual skills/duties necessary for a role. Many firms need a mix of talent – requires several perspectives

- Differences in compensation designs can be overcome
    - Higher base salary/more equity drives higher compensation
    - Key is to be competitive on total compensation for the skills actually required

- Address non-compensation issues
    - Culture
    - Attractiveness of the work
    - Career opportunities

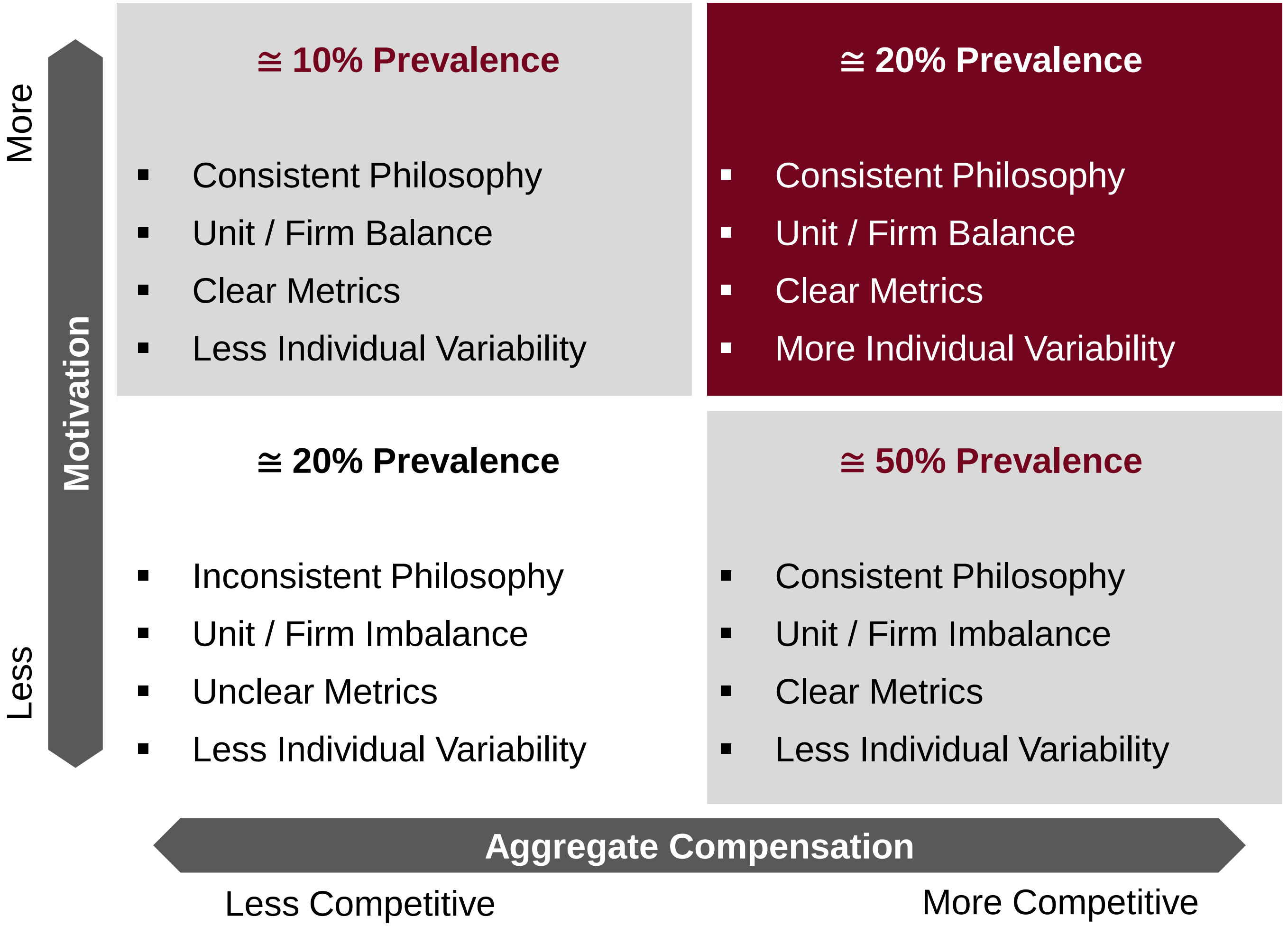
Illustration of Technology Marketplaces

Dual Challenges: Higher compensation initially followed by greater dispersions over time



Annual Incentive Effectiveness *

Greater recognition that existing designs require reassessment



More

Motivation

Less

≅ 10% Prevalence

- Consistent Philosophy
- Unit / Firm Balance
- Clear Metrics
- Less Individual Variability

≅ 20% Prevalence

- Consistent Philosophy
- Unit / Firm Balance
- Clear Metrics
- More Individual Variability

≅ 20% Prevalence

- Inconsistent Philosophy
- Unit / Firm Imbalance
- Unclear Metrics
- Less Individual Variability

≅ 50% Prevalence

- Consistent Philosophy
- Unit / Firm Imbalance
- Clear Metrics
- Less Individual Variability

Aggregate Compensation

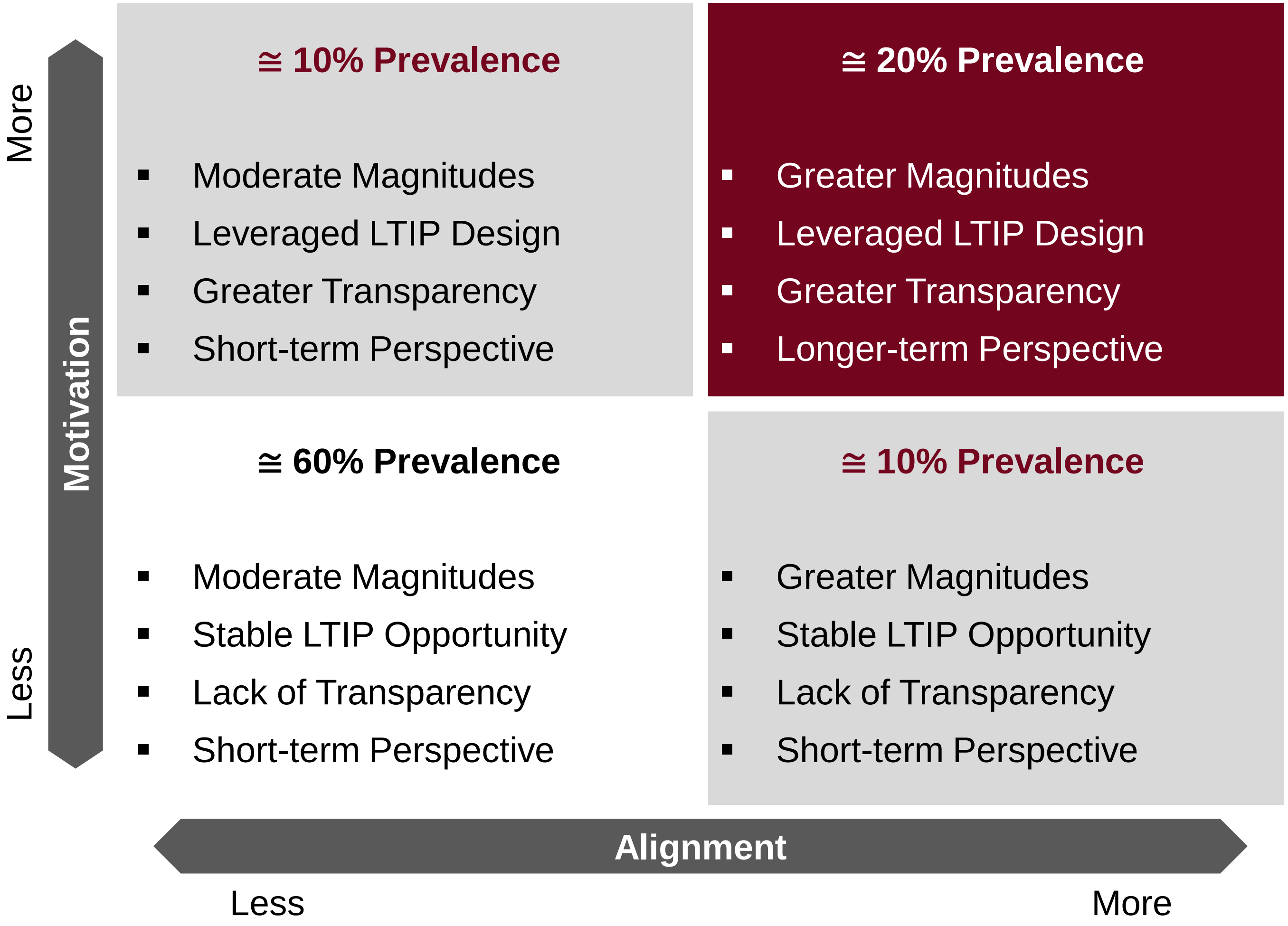
Less Competitive

More Competitive

* *Focus on private firms. Public firms often have similar issues but limited by shareholder advisory groups, regulators, and institutional shareholders*

Long-term Incentive/Equity Effectiveness *

Greater recognition that existing designs require reassessment



≅ 10% Prevalence

- Moderate Magnitudes
- Leveraged LTIP Design
- Greater Transparency
- Short-term Perspective

≅ 20% Prevalence

- Greater Magnitudes
- Leveraged LTIP Design
- Greater Transparency
- Longer-term Perspective

≅ 60% Prevalence

- Moderate Magnitudes
- Stable LTIP Opportunity
- Lack of Transparency
- Short-term Perspective

≅ 10% Prevalence

- Greater Magnitudes
- Stable LTIP Opportunity
- Lack of Transparency
- Short-term Perspective

* *Focus on private firms. Public firms often have similar issues but limited by shareholder advisory groups, regulators, and institutional shareholders*

Asset Management – Future is Here

- 2018 compensation moderately positive, but clearly slowing
  - Systemic fee issues continue
  - Client perceptions of value and cost become more acute

- 2019 staff reductions – announced and yet to come
  - Firms over-hired from 2016 – 2018
  - Impact of technology and productivity/automation
  - Review products and geography

- Need for more focused annual and long-term incentive plans
  - Clear understanding of objectives and metrics
  - More accountability
  - Consider separate programs for autonomous major units

- Observing more “Haves” and “Have Nots” in firm results and prospects
  - Real variations in future prospects
  - Increasingly, compensation impacted by firm results and situation. Affordability, headcount, and individual performance more important

- Paradox: Need to invest in period of declining margins
  - Requires significant nuance around expectations/tradeoffs
  - Difficulty in changing mindsets

Private Equity – Balancing Carry with Performance

- Compensation clearly up on fundraising and realizations
  - Outpacing other sectors

- Need to make decisions on professionals, throughout investment period
  - Imperfect information, but need to make the call

- Carry is economically crucial – but often a human resources crutch
  - Allows annual compensation and performance management to be neglected. Need to make human resources decisions recognizing incomplete information and timeframes

- Compensation allocations and messaging need to be more calibrated
  - In reality, few middle and senior level professionals will voluntarily quit. Treating them as irreplaceable counterproductive
  - Should not strive for “equalness” of bonus and carry rewards

- Need to adjust compensation over time
  - Carry “Holdbacks”
  - Reallocations of forfeitures
  - Individual bonus variability
  - Timing of promotions and assignments

Hedge Funds – Momentum for Change

- More “direct drive” incentives focusing on individuals/teams
  - Reaction to broad malaise, promote greater accountability

- Need considerable redesign of long-term incentives
  - Focus around objectives, designs, vehicles, and economics
  - Copying competitors and public firms largely ineffective

- Often lack clear compensation philosophy and practices
  - More important in periods of volatility and pessimism

- Technology firms provide instructive template(s)
  - Focus on excellence
  - Wide variations in compensation and career with performance
  - Less emphasis on tenure and non-relevant experience

- Increasingly targeting ultra high-end talent
  - Desire the best computer scientists
  - PhDs and data scientists (i.e. “Big Data”)
  - Have explainable compensation philosophy and trajectory

Broad Environmental Considerations

- Energy is building for higher income taxes on the affluent/wealthy
  - Places like NY/CT/NJ/CA/MA at further disadvantage
  - Increases importance of capital gains opportunities

- Increasingly will need to customize pay levels to reflect markets
  - Can't afford "New York" wages for everyone and shouldn't try
  - Local market rates will continue to diverge

Annual Compensation for Equal Standard of Living

City	Annual Compensation
San Francisco	$265,000
New York	$250,000
Boston	$204,000
Chicago	$170,000
Atlanta	$136,000
Austin	$134,000
Salt Lake City	$133,000
Tampa	$130,000

Source: CNN Money

- Era of excellence
  - Greater compensation/performance divergence creates increased cultural stresses and uncomfortable choices. Legacy thinking less sustainable

Final Thoughts

- 2019 compensation moderately lower
  - Impact of markets and fees

- Selective staff reductions continue
  - Technology and productivity/automation

- More energy focused on incentive approaches
  - Need for clarity, urgency, and accountability

- Employee excellence paradigm has broad implications
  - Talent increasing in importance relative to experience
  - Both compensation and career trajectories

- Many equity/long-term incentive plans in need of a reboot
  - Objectives and metrics refined

- More hedge fund “direct drive” incentive plans
  - Requires accurate measurements and sound design

- Increasingly complicated compensation environment requires greater analysis and willingness to break from past practices and mindsets. Inertia is usually not your friend

Appendix of Additional Issues

- Potential influence of Democrats on compensation (more regulation?, change in tone?)
- Europe vs US – pay differentials growing (how should a global firm think about local market pay within same business lines?)
- CEO pay – crisis levels well behind us
- Evolving practices for long-term plans – not just company stock (greater deferral into product, goal based
- New “hit list" items for shareholder advisory groups
- Sales compensation during market downturn or less than stellar investment returns
- Hedge fund capital levels continue to hit record highs: will it ever dissipate?
- Ripe environment for M&A within financial services
- Carry programs: Is it in the right hands? Are we too top heavy? Do we grant too deep in the organization? Do we have star performers who don’t get enough? Do we have legacy partners taking too much?
- Reward sales professionals: worth paying up for best-in-class business development