Financial Services Compensation

Moving Compensation Forward in Uncertain Times

March 14, 2023
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Johnson Associates is a leading independent financial services compensation consulting firm specializing in strategic advice, innovative design, and a full range of data-enhanced benchmarking. Much of our consulting practice is project-based assignments for senior firm management across a wide range of issues. We also have extensive experience advising Compensation Committees across business cycles.

- **Broad Range of Consulting Services / Expertise**
  - Annual and Long-term Incentive Design
  - Full Range of Competitive Market Benchmarking
  - Partnership and Equity Award Terms
  - Carry Allocations and Terms
  - Funding Rate / Fee Allocation Assessments
  - Leadership and Economic Transitions
  - Turnover and Headcount Analyses
  - Special Situations (Bankruptcy, Litigation)
  - Employment Agreements

- **Global Clients across Financial Services**
  - Asset Management
  - Hedge Funds / Alternative Products
  - Private Equity / Illiquid Investment Strategies
  - Wealth Management and Family Offices
  - FinTech
  - Investment and Commercial Banks
  - Institutional and Retail Brokerages
  - Insurance Companies
# 2022 Incentives: Industry Incentive Changes (same store % ▲)

## Major 2022 Takeaways:
- Incentives down broadly as “bubble” begins to burst
- Significant shift in staffing mindset
- Last gasp base salary pressures at year-end

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<tr>
<th>Segment</th>
<th>YoY % Change</th>
<th>Commentary</th>
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<tr>
<td><strong>Asset Management</strong></td>
<td>Down 20%</td>
<td>- Significant declines in equities and fixed income markets</td>
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<td>- Underperformance and outflows in higher-fee active strategies</td>
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<td>- Headcount reductions as firms recalibrate staffing needs</td>
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<td><strong>Illiquid Investments</strong></td>
<td>Flat to Down 10%</td>
<td>- Fundraising and dealmaking declines</td>
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<td>- Exits down significantly from 2021 levels</td>
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<td>- Mega funds dominate fundraising while small and mid-sized funds challenged</td>
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<td>- Private credit down moderately but direct lending strategies attract flows</td>
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<td><strong>Hedge Funds</strong></td>
<td>Down 10% (Wide Variations)</td>
<td>- Industry outflows despite moderately better performance</td>
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<td>- Multi-strategy and macro funds up while equities strategies down with markets</td>
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<td><strong>Major Banks</strong></td>
<td>Down 20% to 30%</td>
<td>- Massive decline in investment banking versus excellent 2021</td>
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<td>- Fixed income trading lone bright spot</td>
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<td>- CEO compensation down less than investment banking incentive pools</td>
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<td>- Layoffs as firms cut costs and recoil from 2021 hiring levels</td>
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<td><strong>Insurance</strong></td>
<td>Down 5% to 10%</td>
<td>- P&amp;C insurance hurt by rising claims</td>
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<td>- Interest rate impact on L&amp;R eases some margin pressures, but slowing demand</td>
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<td>- Moderate headcount reductions</td>
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2022 Major Surprises

**Slow Recognition of Lower Staffing Needs**
- Didn’t want to be understaffed after 2020-2021 experience
- Embraced “war for talent” mindset for too long
- Candidate expectations detached from evolving market reality

**Difficulty Managing Hybrid Work Evolution**
- Many firms unable to communicate clear reason for mandatory office
- “Wanting them back in the office” is not enough

**2022 Year-End Compensation Well Managed**
- Broadly sensible decisions and communication
- Turnover as expected in down/difficult year

**Carried Interest Opportunity and Program Obsession**
- Highlights alternatives growth
- More linear growth in opportunity with size

**“Corporate” Feel of Public Senior Executive Pay**
- Misaligned with firm-wide incentive pools as public senior executive pay less volatile
- Less being part of the team/sharing the pain than expected
- At odds with many statements on culture

**More Line of Sight and Less Sameness**
- Asset/wealth management vs. bank/insurance company
- Differing investment strategies across many firms
- Market/client driven changes
Changing Signals on Base Salary

- Pay transparency laws and discussion increase focus and attention
  - In financial services generally doesn’t impact levels
  - Administrative/implementation challenges

- Competitive base salaries significantly more important
  - Both economic and signaling of overall competitiveness
  - Artificial salary caps often not helpful/competitive
  - More information available to employees/candidates

- Continued work on adjusting pay mixes
  - Rightsizing balance between base and bonus

  **But**

- 2023 return to ≈3.5% base salary increase levels
  - Reflects softer labor market and less recruiting
  - At odds with continued inflation levels
  - Employee expectations higher after 2021-2022

### Year-over-year Base Salary Increases

<table>
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<tr>
<th>Year</th>
<th>Base Salary Increases</th>
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<tbody>
<tr>
<td>2021</td>
<td>≈5% - 6%</td>
</tr>
<tr>
<td>2022</td>
<td>≈4% - 5%</td>
</tr>
<tr>
<td>2023</td>
<td>≈3.5%</td>
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Market Data Needs Increase

- Rapid compensation market changes make stale data obsolete
  - 2020-2023 has stressed the status quo
  - Reliance on broad averages in traditional surveys/datasets

- Rise of unique/multi-hatted jobs
  - Simple title comparisons often misleading

- Corporate/business leader demand for more data and analysis
  - Recognize detailed analysis on mediocre/stale data provides false certainty and comfort
  - Quality analysis increasingly requires judgment

- Broad labor markets vs. narrower
  - Sources of talent often different from business competitors

- Recognition of different sized roles within the same title/job description
  - CFO example: Controller, standard CFO, strategic leader, key advisor to CEO
  - Blended compensation data incorporates all these roles. “Market” probably not the median of all the roles combined

- Potential principles
  - Market data must be fresh even if it requires some estimates/additional work
  - Recognize unique/multi-hatted jobs
  - For senior leaders explicitly consider real roles
  - Geographic location increasingly matters
  - Apples-to-apples comparisons requires understanding of incumbent role and fresh market data
Movement Away From Centralized Programs

- Increasingly simple phrases don’t capture what firms actually do
  - Variety of businesses and products with different compensation norms/audiences

- Natural inclination to “cherry pick” best program features
  - Higher pay levels, stability, work-life balance, great benefits, etc.

- Market and client forces make it difficult to maintain single historical program
  - Requires serious gymnastics to work under a single total rewards approach

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<th>Core Business</th>
<th>Compensation Intersection</th>
<th>Major Challenges</th>
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<td>Multi-Year Commitments and Vesting</td>
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<td>Private Equity Style</td>
<td>Product Variety in Fees/Timeframes</td>
<td>Varying Compensation Amounts/Norms</td>
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<td>Asset Management / Alternatives</td>
<td>Inclusion of Multi-Year Investment Performance and Carry</td>
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<td>Asset Management / Alternatives</td>
<td>Different Compensation Levels, Incentive Funding, and Ultimately Carry</td>
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### Long-Term Incentives/Deferrals

- Program objectives often remain unclear
  - Many programs suboptimizing/devalued

- Mix of objectives: Motivation, Alignment, Retention, Feeling of Belonging

- Matrix of audiences/vehicles/firms
  - Requires clarity on program objectives

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<th>Firm Type</th>
<th>Common Approach</th>
<th>Strengths</th>
<th>Weaknesses</th>
<th>Response</th>
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<td>Public firms</td>
<td>▪ Restricted Stock</td>
<td>▪ Broad corporate link</td>
<td>▪ Lack line of sight/impact</td>
<td>▪ More in products</td>
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<td></td>
<td>▪ Products</td>
<td>▪ Investor preference</td>
<td>▪ Reinforces siloes</td>
<td>▪ Tweak participation / levels / share across products</td>
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<tr>
<td>Illiquid Strategies</td>
<td>▪ Products</td>
<td>▪ “Skin in the game”</td>
<td>▪ Finance GP commitment</td>
<td>▪ Help fund investments</td>
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<td>▪ Carry</td>
<td>▪ Incentive fee link</td>
<td>▪ No broader firm view/collaboration</td>
<td>▪ Carry “pot” across funds</td>
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<tr>
<td>Hedge Funds</td>
<td>▪ Products</td>
<td>▪ Aligned to major fund(s)</td>
<td>▪ No link to new firm initiatives</td>
<td>▪ Invest across products and share incentive fees</td>
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Broad Impact of Carry

- Carry scales directly with fund AUM
  - Large incentive fee + few participants = outsized opportunity
  - Little ability to manage within a total rewards framework
  - For many source of continuing frustration

- Participation has spread in investments teams and across support functions
  - Senior Associate in investment teams and Principal in support
  - Heightens equity and compliance issues across broader firms

- No uniform market norm for funding GP commitment
  - Some fund from the firm while others fund from individuals
  - Fee waivers can create phantom income issues
  - Required funding has increased significantly with fund sizes

- Fees/profits from alternatives may overtake traditional asset management

- Heightened importance of product diversification/fundraising
  - Need available valuable carry somewhere when a fund or product goes cold
  - Carry too important today to just wait for the next fund
Illustrative Carry Impact Across a Career

- Carry impact by title for investment banking and private equity style
  - Cash compensation is a fraction of carry opportunity at large firms

- Hedge funds also scale compensation
  - Bigger P&L leads to higher pay
  - Less transparency and comparability

- Chart highlights investment banking vs private equity compensation and the outsized role of carry
Lessons on Equity Transfers/Succession

- Current focus in private firms on transferring ownership/succession
  - High market value of many investment firms
  - Increased expectations of both founders and next generation

- Major success factor is understanding founder(s) actual priorities
  - Maximize value and over what timeframe
  - Stabilize firm with next generation opportunity
  - Firm continue beyond founder(s)

- Lessons from equity transfers/succession
  - Significant transfers take a long time (i.e., 5-10+ years)
  - Most of the equity will be granted/purchased at modest cost
  - Potential firm growth key to resolution/success
  - Two vehicles often needed (i.e., “whole shares” and “growth units”)
  - Clarity on governance transition surprisingly important
  - Importance of eventually ending discussions and starting program
  - Realization program/participation will evolve over time
  - Understandable straightforward balanced design
Structured Program Designs Continue Under Stress

- Structured compensation designs have had a difficult period
  - 2020-2023 volatile business and compensation markets
  - Difficulty in reliable forecasting and goal setting

- Important to recognize financial services differences from broader economy
  - Inherent compensation and business volatility with markets
  - Many comparable positions within industry (i.e., “my friend at firm x…”)
  - High levels of absolute compensation

- Realistic expectations around program “scoring”
  - Should be considered a guide rather than often the final result
  - Balance with market data and other objectives

- Usually difficult/impossible to fairly and fully quantify non-financial objectives
  - Key to identify objectives and create substantial early dialogue
  - Informed judgment is both necessary and appropriate

- Highlights advantages of clear compensation philosophy
  - Ultimate objective to reward and shape performance
  - Thoughtfully recognize and challenge market pay norms
Fearless Predictions

2023 Another Down Compensation Year
- Bubble continues to burst (i.e., housing/business and consumer credit)
- Difficulty of “soft landing” and economic impact
- Fragile markets amid still high valuations
- Base salary increases return to \( \approx 3.5\% \)

Headcount and Layoffs
- Broad layoffs on table by third quarter
- Muted hiring/recruiting through year-end

Sales Compensation
- Fundraising challenging as investors grow more conservative
- Discretionary overlay key component of commission/hybrid plans

Equity Programs
- More private firms addressing ownership
- Succession, retention, wealth creation
- Public firms continue to broaden into products

Environmental Investing
- Polarization continues as politicians debate ESG future
- U.S. investor interest has waned from recent frenzy

Alternatives / Carry
- Aggressive push into alternative products for traditional asset managers
- Small and mid-sized funds use more creativity on carry payouts and designs

Customized Compensation Programs
- Movement away from centralized programs in favor of customization
- Business unit/strategy P&L with own incentive program and funding
Hedge Funds

- 2022 outcomes unusually dispersed
  - Multi-strategy, macro, and value outperformed
  - Equity and credit funds lagged

- Very high levels/offers for select portfolio managers
  - Outbreak of $5M and $10M+ levels
  - High demand for successful portfolio managers with track record

- Deferred compensation clearly increasing in prevalence
  - Typically invested into products
  - Focus on retention and additional alignment

- Serious ambitions beyond existing strategy(s)
  - Continued blend of liquid and illiquid investments/funds
  - Opportunity for successful firms to fundraise

- Premium on having high caliber support staff
  - High value placed on strategy, finance, legal, and human resources

- Continued presence of both formulaic and discretionary compensation approaches
  - Many formulaic “winners” in 2022. Formula designs and calculations in focus
  - Gradual movement to formulaic as firms build out teams and broaden strategies

- Tougher non-competes and clawbacks on heightened competition for best portfolio managers
Illiquid Strategies

- Boom muted and portfolio exits elongated
  - Fundraising clearly slows but still at high level
  - Fewer buyouts as interest rates impact deal funding

- Likely further write-downs in portfolio values
  - Valuation process results in slower adjustments
  - Weaker performance/outlook for many portfolio companies
  - Not significantly impacting annual compensation levels (for now)

- Large firms skew compensation comparisons
  - Professional pay levels impacted by firm size
  - Annual compensation scales moderately with size
  - Carry opportunity increases significantly with scale

- Small and mid-sized funds need more creativity with carry to compete
  - Significant dollars at work disadvantage due to fund size
  - Advancing partial carry payouts, providing phantom carry to broader population, earlier participation, etc.

- Major push into infrastructure and private credit
  - Infrastructure with longer realizations
  - Private credit with shorter investment cycle
  - Direct lending demand up significantly

- Increasing variety of strategies requires nuanced compensation approaches
  - Differences in both compensation amounts, provisions, and timeframes
  - Details really matter across terms
Fee compression continues amid volatile markets
- Sharp investment return swings highlight importance of multiple strategies
- AUM growth/stability but swing to lower fee products

Increasing incentive variance from product/strategy mix

Firms considering entering/expanding alternatives offerings
- Host of compensation challenges (i.e., pay levels, carry, juggle total rewards, equity/product participation, etc.)

Many firms are moderately overstaffed
- Moving cautiously to right size headcount for current strategy

Continued variety of portfolio management programs
- Structured: Explicitly linked to AUM/returns on a schedule
- Discretionary: Linked to market, returns, AUM, and firm results
- Revenue sharing: Team % of management fee with performance overlay

Sharp increase in the use of firm products in deferral programs
- Often replaces firm stock
- Better alignment/acceptance and meets investor requirements
Major Banks and Insurance Companies

- Significant incentive declines for investment bankers
  - Underwriting down substantially
  - Advisory and equities trading down

- Investment banking incentive declines broadly
  - Year-over-year comparisons muddled by step progressions
  - 2021 market “cocktail” of talent war, base salary pressures, increased hiring, strong sector performance

- Broad layoffs for major banks (i.e., 2% to 8% of workforce)
  - Underperformance and overstuffed after major hiring
  - Mortgage banker layoffs substantial

- Executive compensation increasingly delinked from absolute results / business unit incentive pools
  - CEO compensation more aligned with strategy execution and relative results (TSR, financial performance vs competitors)
  - Interesting cultural implication

- Asset management business units impact bank and insurance results
  - Key growth area as firms raise third-party assets
  - Steadier/more predictable fee income

- Insurance company incentives down 5% to 10% on weaker business fundamentals and expense pressures
  - Inflation impact on property and casualty
  - Life and retirement business boosted by interest rates balanced with slowing demand
  - Structured programs make cultural transition more difficult
Sales Compensation

<table>
<thead>
<tr>
<th>Traditional Asset Management</th>
<th>Alternatives</th>
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<tbody>
<tr>
<td>▪ Many model compensation outcomes across scenarios</td>
<td>▪ Fundraisers have had “wind at their back” for a decade</td>
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<tr>
<td>- Less target / budget-based plan designs</td>
<td>- Strong performance and investor demand</td>
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<td>- Increased focus on sales outcomes rather than compensation expense (i.e., if sales professional has great year, okay with high pay)</td>
<td>- 2023 headwinds (record dry powder, longer sales cycle, smaller funds, etc.)</td>
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<tr>
<td>▪ Mix between discretionary bonus and “commission” common</td>
<td>▪ Sales compensation often discretionary but some have explicit management fee share</td>
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<td>- Programs still primarily objective on results</td>
<td>- Often paid over 3 years and can differ by strategy</td>
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<tr>
<td>- Variety of commission, hybrid, and discretionary plans</td>
<td>▪ Mixed practices on carry for senior sales staff</td>
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<tr>
<td>- Hybrid could be 70% commission and 30% discretionary</td>
<td>- Carry for Head of Sales and/or Regional Head(s) common</td>
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<tr>
<td>- Account penetration key objective</td>
<td>- Mega funds have moved market with high allocations</td>
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<tr>
<td>▪ Managing sales compensation in down market</td>
<td>- Carry deeper within sales creates challenges with other support and not fully valued by participants</td>
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<td>- Many programs have “tail” to smooth payouts</td>
<td>- Sales/support allocations should come from “team” carry split</td>
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<td>- Some provide subsidies/floor bonus</td>
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Benefits

- Benefits “don’t matter” is wrong mindset
  - Many are tax efficient and address real needs
  - Pure cost minimization often a failed strategy
  - Boutiques behind on maximizing programs

- Many firms reassessing benefits programs beyond cost savings
  - Generous programs can be competitive advantage
  - Employees care when benefits are sub-par
  - Communicate pre-tax equivalent of select benefits

- Significant opportunity to reward employees through retirement programs
  - “Cheap” retirement plans are poor signaling from firm
  - Magnitudes and designs no longer encourage retention
  - Maximum defined contribution $66,000 and maximum annual pension benefit $265,000

| Caregiver Leave | Policies have evolved
|                 | 3-5 months for primary caregiver common
|                 | Mixed practice non-primary caregiver
|                 | More firms extending fertility benefits

| Paid Time Off   | More ambiguous/difficult to track with remote work
|                 | 15-20 days “middle of the road” with some carry over
|                 | Typically increases with tenure
|                 | Some firms less “strict” with policies |
Final Thoughts

**Successful firms will break out of inertia and more aggressively address opportunities and challenges**

- 2022 year-end incentives were down but still for many above/comparable to 2020
- Return to ±3.5% base salary increase norms
- 2023 will be another down incentive year (i.e., ≅10%)
- Current/focused market data important given compensation volatility
- Bespoke compensation structures by business unit/strategy within overall firm context
- Firms reassess sales compensation structure (magnitudes, variation, objectivity vs. subjectivity, performance)
- Layoffs/hiring slowdown continues with moderate overstaffing (for now)
- Carried interest in focus (allocations, reserves, payout timing, competition)
- ESG in political crossfire and ultimate impact unknown
- Succession and equity transition driven by investors and founder(s) priorities
- Firms reassess benefits and look for competitive advantages