Financial Services Compensation

Moving Compensation Forward in Uncertain Times

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Discussion Topics

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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

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

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

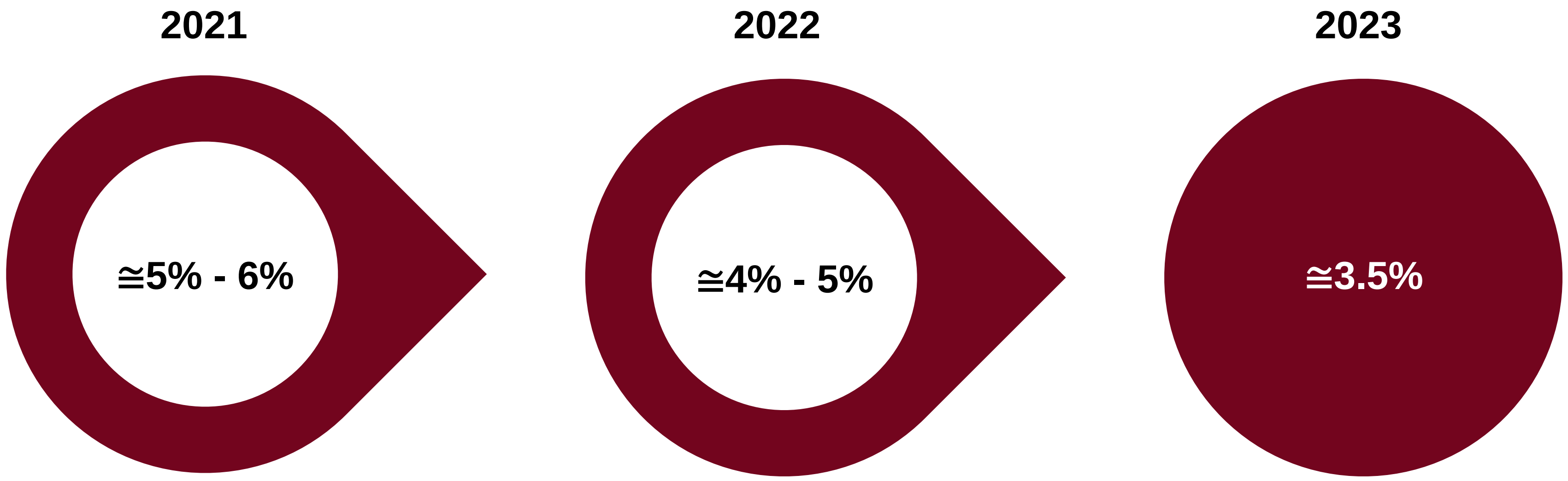
- Competitive base salaries significantly more important
  - Both economic and signaling of overall competitiveness
  - Artificial salary caps often not helpful/competitive
  - More information available to employees/candidates

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

<u>But</u>

- 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



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 <u>not</u> 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

Illustrative Program Challenges		
Core Business	**Compensation Intersection**	**Major Challenges**
Asset Management	Alternatives	Carry and Overall Compensation
Hedge Funds	Illiquid Investments	Multi-Year Commitments and Vesting
Private Equity Style	Product Variety in Fees/Timeframes	Varying Compensation Amounts/Norms
Banks	Asset Management / Alternatives	Inclusion of Multi-Year Investment Performance and Carry
Insurance	Asset Management / Alternatives	Different Compensation Levels, Incentive Funding, and Ultimately Carry

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

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

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

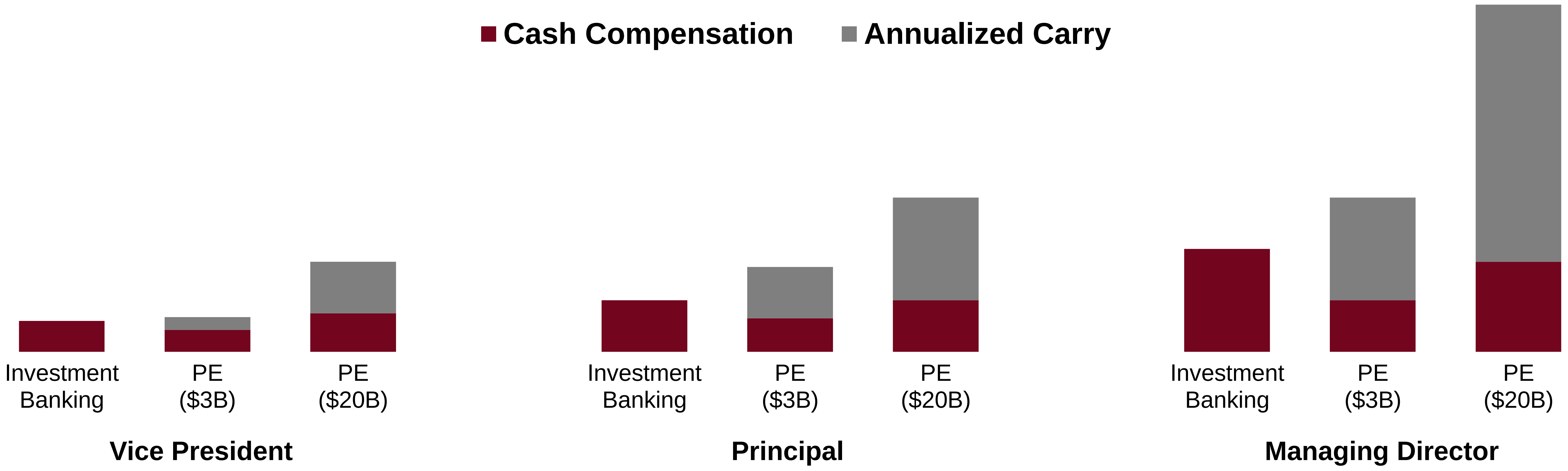
- No uniform market norm for funding GP commitment
  - Some fund from the firm while others fund from individuals
  - Fee waivers can create phantom income issues
  - Required funding has increased significantly with fund sizes

- 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 <u>key</u> 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 ≅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

Asset Management

- 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 overstaffed 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

Sales compensation in spotlight as fundraising environment evolves

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

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 <u>and</u> 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