Financial Services Compensation

2023 Recap and Unfolding 2024 Changes

March 2024

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Discussion Topics

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Trusted Experts. Independent. Forward-thinking.

Johnson Associates is a leading independent financial services compensation consulting firm focused on strategic advice, innovative design, and data-enhanced benchmarking. Much of our work is project-based for senior firm management covering a wide range of key issues. We also have extensive experience advising Compensation Committees across business cycles.

- **Range and Depth of Consulting Services / Expertise**
  - Annual / Long-term Incentive Design, Economics, and Metrics
  - Full Range of Competitive Market Benchmarking
  - Partnership and Equity Award Terms
  - Carry Designs, Allocations and Terms
  - Funding Rate / Fee Allocation Assessments
  - Leadership and Economic Transitions
  - Staffing Analyses Across Product Areas
  - Employment Terms and Agreements
  - Special Situations (Bankruptcy, Litigation)
- **Global Clients across Financial Services**
  - Asset Management
  - Hedge Funds / Alternative Products
  - Private Equity / Illiquid Strategies
  - Wealth Management and Family Offices
  - Investment and Commercial Banks
  - Insurance Companies
  - FinTech
  - Institutional and Retail Brokerages

2023 Incentives: Industry Incentive Changes (same store % ▲)

Major 2023 Takeaways:

- Incentives generally flat despite late surging equity markets
- Fundraising challenges persist in private capital
- "War for talent" fully replaced by headcount reductions and selective hiring

Segment	YoY % Change	Commentary
Asset Management	*Down 5% to Flat*	▪ Incentives down moderately to flat despite rising equity markets ▪ Outflows in active, higher-fee products compress margins ▪ Most firms reduced headcount as cost cutting continues
Illiquid Investments	*Flat* *Down 5% for Smaller Funds*	▪ Fundraising difficulties combined with overstaffing creates compensation issues ▪ Venture capital and real estate fundraising lags and valuations down ▪ Carry in focus ("firm" vs. "team" splits, fee-related earnings prioritized) ▪ Private credit in "bubble" as firms recruit for top talent
Hedge Funds	*Flat* *(With Variations)*	▪ Moderate industry inflows and fee levels stable ▪ Event-driven and activist funds outperform ▪ Outsized compensation for top-tier portfolio managers
Major Banks	*Up 5% (Management)* *Business Segments Vary*	▪ Advisory suffers another poor year and lower incentives ▪ Equity underwriting incentives moderately higher vs. weak 2022 ▪ Select hiring for boutique investment banks
Insurance	*-5% to +5%* *(Moderate Variations)*	▪ P&C challenges from rising claims partially offset by top-line growth ▪ L&A products benefit from higher interest rates partially offset by lower policy sales ▪ Corporate roles mostly flat with high-demand functions with moderate increases

2023 Major Surprises

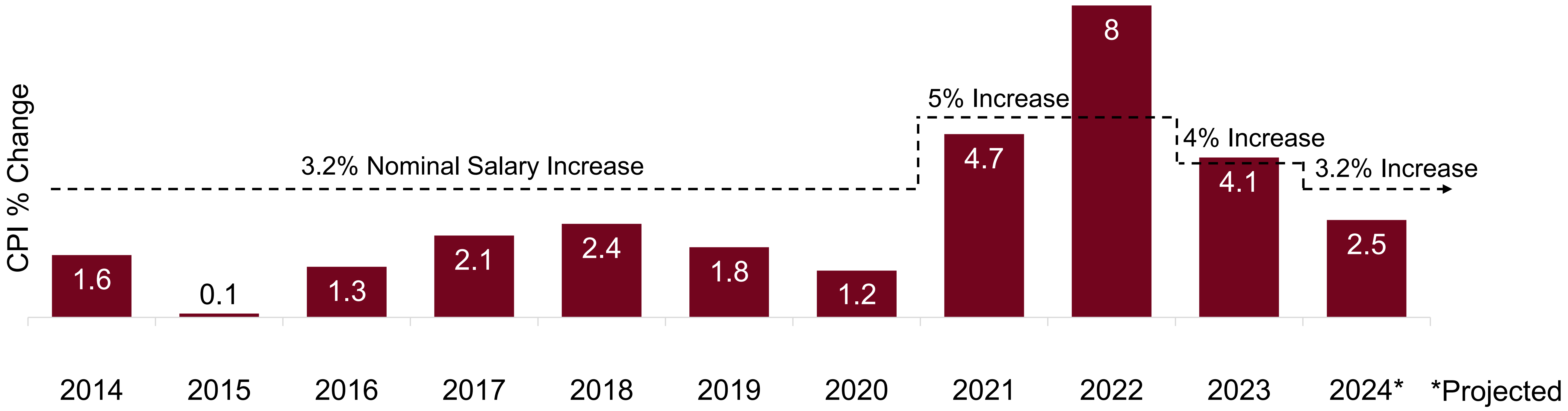
Mindset From "War for Talent" Continued into 2023	▪ Firms slow to adjust headcount <u>and</u> future staffing plans ▪ Continued fixation on average turnover in overstaffed / changing environment
2023 Compensation So-So Even With Up Markets	▪ De-link of misleading broad market averages from client fees ▪ Changing asset mixes and fee compression ▪ Continued malaise in M&A and equity capital markets
Continued and Building Fury Over Carried Interest	▪ Endless comparisons between Fund A and Fund B ▪ Basic team sharing allocations and participation ▪ Sizing and valuation across platforms
Greater Clarity On Systemic Market Changes	▪ Asset management mix changes (i.e., ETFs) ▪ Bank consolidation quietly continues ▪ Growth and value of wealth management
Continuing, If Slightly Waning, Love Affair With Alternatives	▪ Surprisingly little impact of fees and actual risk-adjusted returns
De-Link of Public Executive Pay From Broader Employees	▪ Impact of KPI scorecard vs. partner mindset ▪ Bank CEO examples: Citigroup (up 6%), Wells Fargo (up 18%), Morgan Stanley (up 17%)

- Competitive base salaries more important
  - Perceived / actual less certainty of incentives
  - Less visible career opportunities

- Salary levels and changes linked to market levels and performance (not inflation)
  - Johnson Associates rule: $ short on salary requires additional $1.5 to $2 makeup in incentive

- Adjusting for inflation is a no-win proposition
  - Often renege on promises you shouldn't have made
  - How to measure and allocate (i.e., U.S. coasts, broad U.S., global, select countries, etc.)

Inflation (CPI) vs. Base Salary Increase



Long-Term Incentives / Deferrals

- Program objectives often unclear / diffused
  - Many programs suffer from inertia in a changing business environment
- Mix of objectives: competitive economics, retention, motivation, alignment, feeling of belonging
- Ever growing matrix of audiences / vehicles / firms
  - Requires clarity on program objectives and priorities
- Market and needed client focus make it difficult to maintain single historical program
  - Requires serious gymnastics to work under a single unified total rewards toolbox

Firm Type	Public Firms	Illiquid Strategies	Hedge Funds	Decentralized Programs
Common Approach	▪ Restricted Stock ▪ Products	▪ Products ▪ Carry	▪ Products	▪ Unit Equity ▪ Profit Sharing ▪ Local Products
Strengths	▪ Broad corporate link ▪ Investor / NEO preference	▪ “Skin in the game” ▪ Incentive fee link	▪ Aligned to major fund(s)	▪ Line of sight ▪ Motivation and result ownership
Weaknesses	▪ Lack line of sight / impact ▪ Reinforces siloes	▪ Finance GP commitment ▪ No broader firm view / collaboration	▪ No link to new firm initiatives	▪ Design and administration ▪ Equitable treatment
Response	▪ More in products ▪ Tweak participation / levels / share across products	▪ Help fund investments ▪ Carry “pot” across funds	▪ Invest across products and share incentive fees	▪ Greater openness to specialized plans with clear business rationale

Compensation Designs with Business Diversification

- Companies expand past primary strategies as part of growth initiatives
  - Recognize existing cultural / compensation differences and need to balance internal dynamics
  - Success depends on ability to manage compensation structures and business implications

General Compensation Characteristics

Lowest Total Economics	*Highest Total Economics*
More Compensation / Job Stability	*Less Compensation / Job Stability*
Highest Work-Life Balance	*Lowest Work-Life Balance*
Higher Salary Proportion	*Higher Incentive Proportion*

Insurance	Asset Management	Banks	Private Equity	Hedge Funds
		Bonus Funding		
Scorecard	% PTPBI	% PTPBI	Management Fee	Management / Incentive Fee
		Common Long-Term Vehicles		
Stock	Investment Product / Stock	Stock	Carry / Fund Investment	Investment Product
		Program Flexibility		
Limited / Scorecard	Moderate Discretion	Moderate Discretion	Discretion (less used)	Limited / Formulaic

Example of Insurance Firm Launching Private Equity Fund

- Understand compensation dynamics and rationale of private equity
  - Differences in compensation levels, bonus funding, long-term vehicles, etc.
  - New entrants seldom receive benefit of doubt for unusual compensation structures / decisions

Lessons on Equity Transfers / Succession

Broad Continuum of Equity Transfer Design Choices

Each with different decision points and program intent

Important for founder-participant alignment on objectives and structures to maximize success

Lowest Opportunity → *Highest Opportunity*

Moderate Retention / Alignment Mechanism	Significant Economic Sharing	Succession Plan / Ownership Transition
Shorter transfer timeline	Moderate transfer timeline	Long-tailed transfer timeline
Standard vesting	Longer vesting	Significant vesting
Single vehicle / upside only (growth units)	Multiple vehicles (full shares and growth units)	Multiple vehicles (higher focus on full shares)
No governance change	Evolved governance (committee participation)	Eventual transfer of final decision-making

- Lessons from successful equity transitions
  - Potential firm growth key to resolution / success
  - Two vehicles often needed (i.e., “full 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
  - Modest valuation and periodic liquidity significantly impacts participant perceptions

Increasingly Broad Impact of Carry

- Economic impact felt beyond private markets
  - Broader firms with alternative strategies
  - Market comparisons of opportunity at Firm X (and Y, and Z)
  - Impact across both investment and support functions

- Carry scales directly with fund AUM
  - Large incentive fee ÷ few participants = outsized opportunity
  - Less ability to “manage” within a total rewards framework
  - Key balance between fund size and staffing

- Participation spread in investment teams and across support
  - Senior Associate in investment teams and Principal in support
  - Increase in platform grants vis-a-vis individual silos

- Several mega funds increasing carry vs. cash / stock
  - Stock vs. carry mix at senior levels
  - Increases highly valued fee-related earnings (FRE)
  - 50% becomes 60% to 65% to the investments team

- No uniform norm for funding GP commitment
  - Some fund from the firm while others from individuals
  - Required funding has increased significantly with fund sizes
  - Less accommodating environment for external financing (i.e., rates and limited providers)

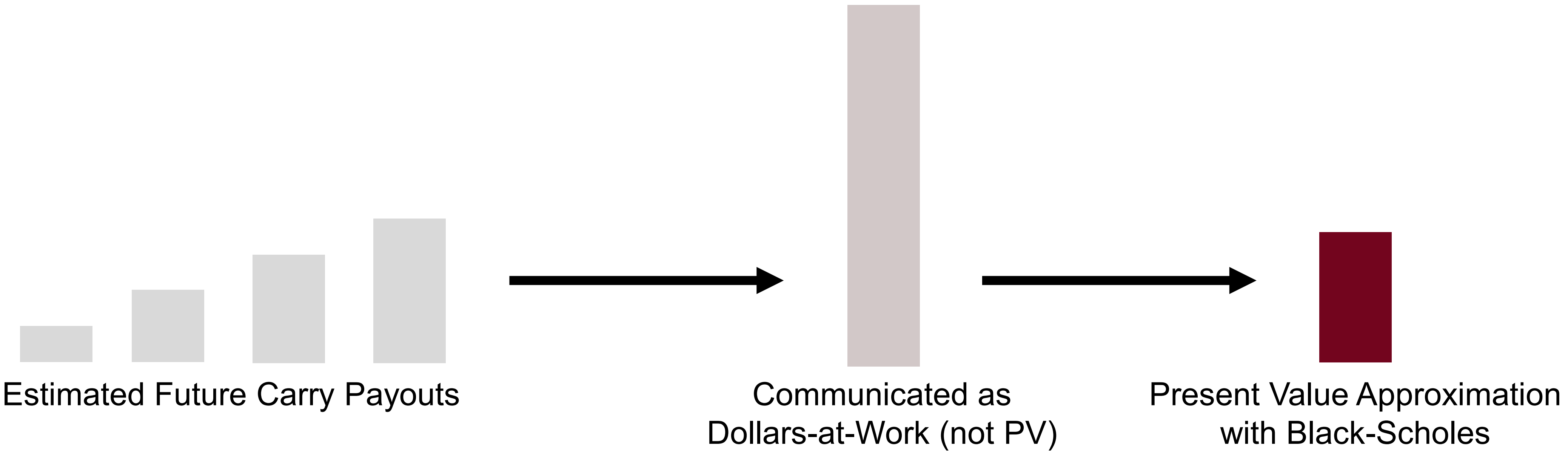
Valuing Carry

- Increasing need to realistically value / consider carry
  - Platform awards across asset classes / funds
  - Sizing buyout / transition for external hires
  - Broader inclusion of support professionals

- Shorthand of “2x MOIC” carry worth $1X is less helpful across funds and comparing to regular compensation
  - Investment success over last decade has led to often overvaluing carry opportunity

- Black-Scholes type methodology can provide a realistic valuation but requires a moderate analysis
  - Akin to a stock option, value only upon appreciation including long timeframes, volatility, vesting, and carry hurdle rates
  - Baseline current value likely about 33% of “Dollars-at-Work” <u>before</u> including any tax advantages
    - $1,000,000 gain at a 2x return likely a present value of about $333,000

- Analysis also helps to understand the perception of participants
  - “Dollars-at-Work” often heavily discounted by new participants with small allocations



* *Please email <u>info@jaiconsulting.com</u> for our recent client memo on Black-Scholes type carry valuation*

Sales Compensation: 8 Questions

Question	Answer
▪ Is 20 / 10 / 5 revenue split still mainstream?	▪ Remains common but more upfront as well (i.e., 25 / 10, etc.)
▪ Move to discretionary program rather than mechanical?	▪ More hybrid (70%-80% objective, 20%-30% subjective / broader) ▪ Fewer fully discretionary programs
▪ Sales participation in carry?	▪ Increasing participation for senior sales driven by large funds
▪ How to handle difficult fundraising environment?	▪ Sound and realistic plan design, supplements if truly necessary
▪ Should we pay on gross or net?	▪ Heavily driven by controllability. Combination often found in retail plans
▪ Private firm equity for sales professionals?	▪ Typically Head of Sales and perhaps select senior professionals
▪ Market demand for proven sales talent?	▪ High demand for very good / great, especially those with alternative focus
▪ Does product profitability factor into payout percentages?	▪ Not directly but different percentages between broad categories (i.e., long-only vs. alternatives). Discount fee policy should reflect profitability

Benchmarking Challenges: CFO Example

- Benchmarking is fundamentally the analysis and interpretation of comparator information
  - Real analysis needed due to inherently imperfect data (i.e., peers, role differences, scale, timing, number of data points, performance, etc.)
  - Judgment is important and required. Without it benchmarking can be flawed / biased and misrepresent actual positioning

- CFO example: "publicly disclosed… shouldn't be hard"

Firm	CFO Additional Responsibilities	Firm Size	All-In Compensation
A	Strategy, Relationship Management	$1,000B	$8,000,000
B	Risk	$900B	$7,000,000
C	CAO	$750B	$6,500,000
D	None	$650B	$6,000,000
E	COO	$350B	$5,500,000
F	Business Head	$400B	$5,000,000
G	None	$550B	$4,500,000
H	Investor Relations	$500B	$4,000,000
I	Tech / Compliance	$300B	$3,500,000
J	None	$200B	$2,750,000
	Raw Median		**$5,250,000**

Question: What is the real median pay for a CFO with no additional responsibilities in a $350B firm?

- *$5.25M mathematical median does not consider lack of additional responsibilities or smaller firm size*
- *Role and scale can result in premium / discount*

<u>More Accurate Market Median ≈ $4,000,000</u>

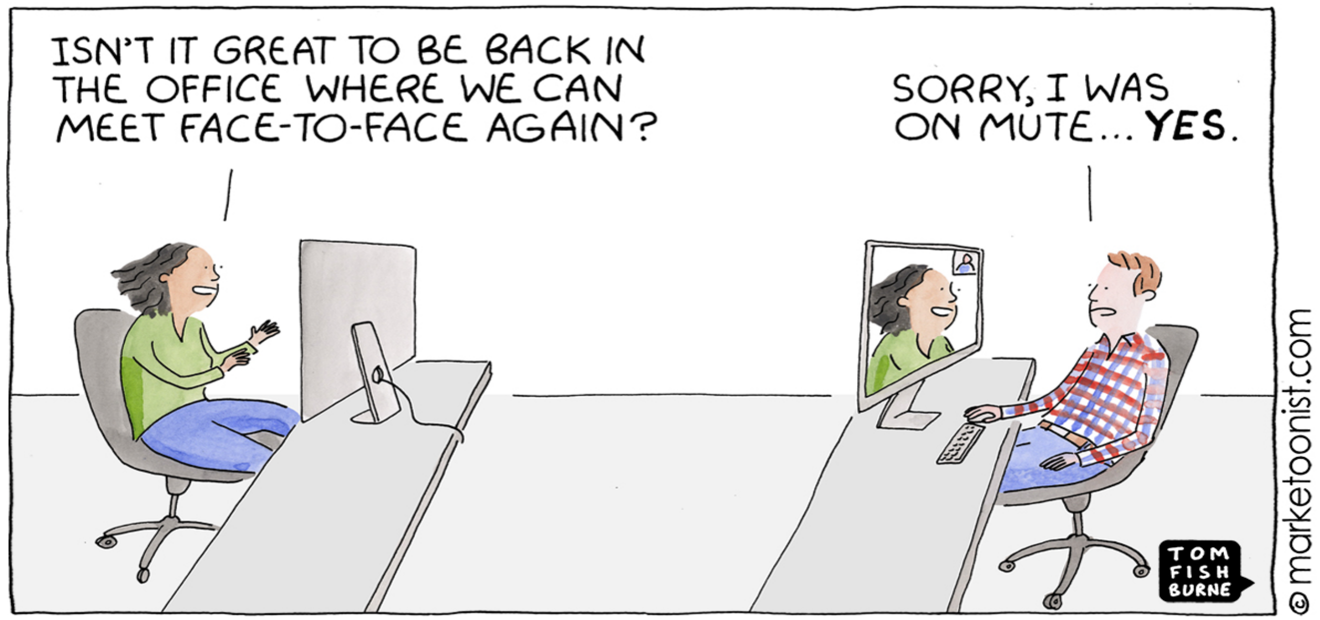
Hybrid Work

- Technological and cultural change is often adopted unevenly and with resistance
  - Hybrid work reflects a rational response to the flexibility provided by Zoom / Teams

- Many professional positions do not require five days in the office (and probably never have)
  - Culture / training / idea generation is important but is not a compelling argument for five days
  - Many firms expect work after hours, over weekends, holidays, and vacations. Firms fully comfortable with <u>additional</u> out-of-office work

- Balanced approach we have seen adopted:
  - Agree on fundamental approach (i.e., 3 or 4 days a week)
  - Recognize additional periods (i.e., no in-office required for two weeks each in August and late December)
  - Perhaps handful of additional days (i.e., 5 to 8) at employee election

- Hybrid work has unfortunately been divisive / problematic
  - Firms have been inconsistent and often half-hearted (i.e., badge swipes <u>maybe</u> a factor in your bonus / evaluation)
  - Mean-spirited solution: Each day you don't come in reduces your bonus. Ex. 0.4% reduction on a $500,000 bonus ($2,000 a day)



Source: Marketoonist

Talent Bifurcation

- Talent bifurcation results in different compensation markets for average / standard talent vs. high performers
  - Also growing split between market leading payers and “standard firms”

- Headcount reduction and voluntary turnover will impact firms / talent segments differently
  - Impact of AI
  - Cost cutting initiatives
  - Future down markets
  - Industry consolidation

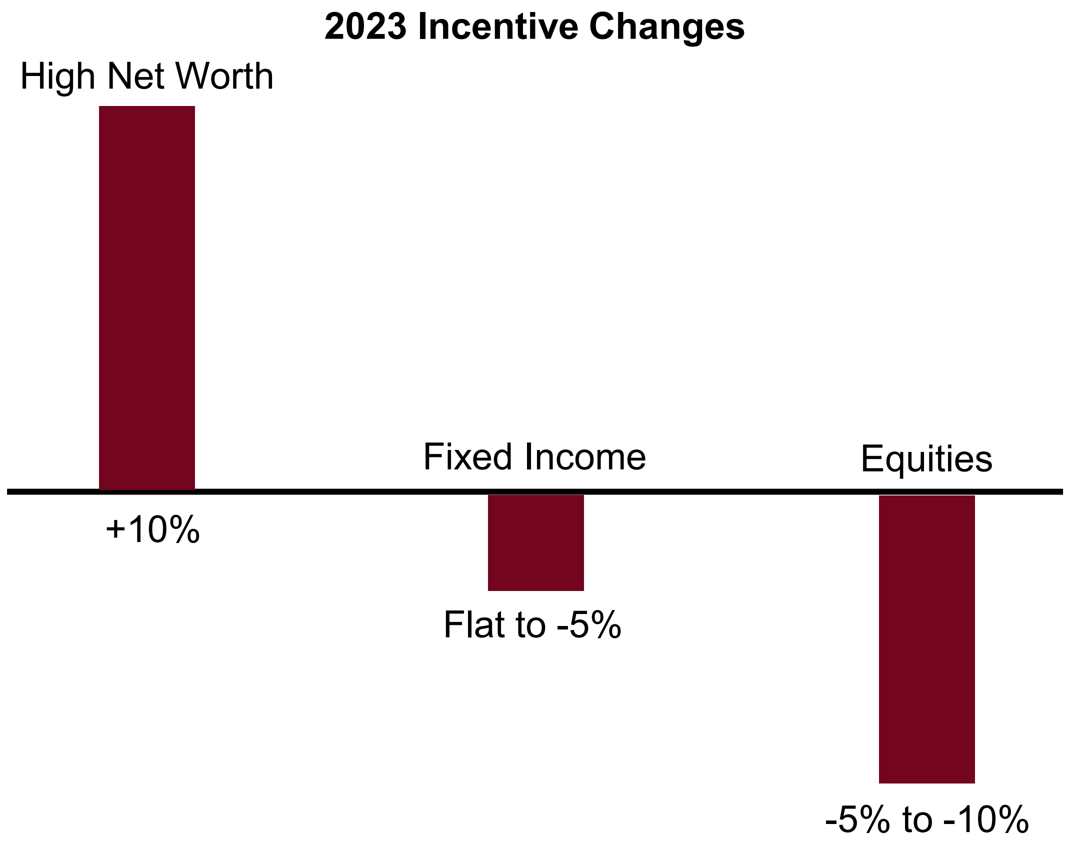
- Have philosophy on how to treat two different population segments
  - Strategies to counterbalance high compensation for everyone
  - Potential trade-offs at high paying firms with additional deferrals, vesting, and restrictive covenants

	Standard Talent	High Performers
Compensation	Flat / Consistent for Most	High and Increasing
Protection from Headcount Reduction	Limited / Likely Candidate for Reduction	High / Potential for Special Awards
Career Progression	Standard / More Limited	Higher Ceiling / Faster Progression
External Opportunities	Lower / Moderate	Significant / Focus on Retention
Firm Protections	Less Necessary	Increasing Area of Focus

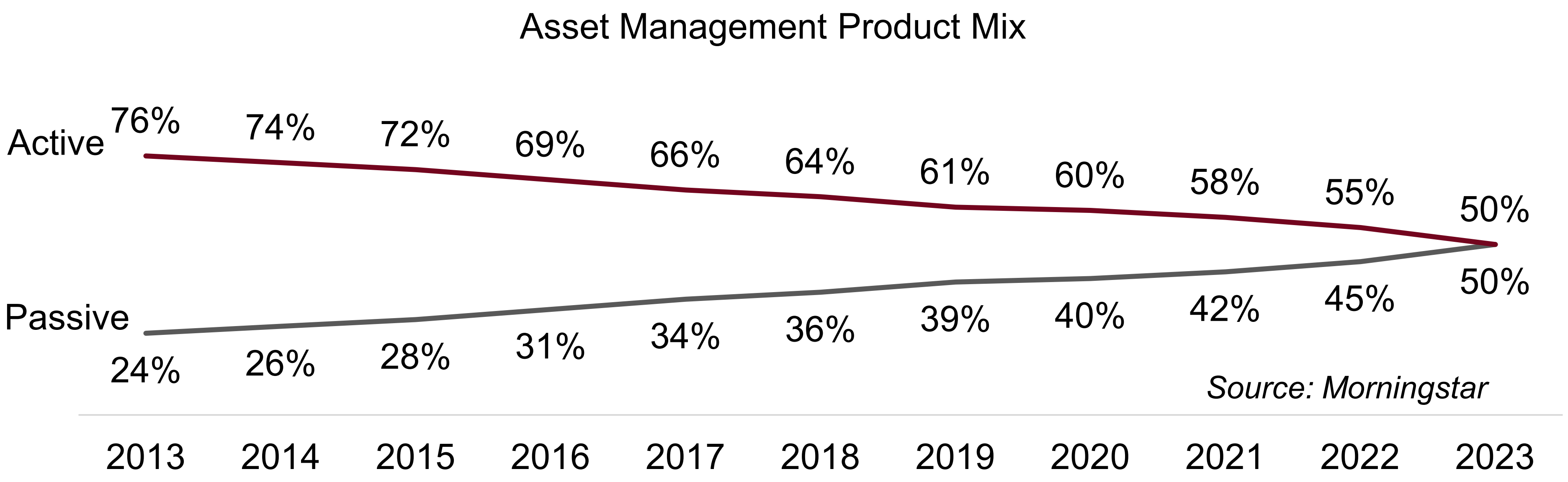
Fearless Predictions for 2024 and Beyond

AI and Broader Technology Significantly Reduces Headcount	▪ 20% to 50% declines common in some functions ▪ Impacts career progressions, earnings, and opportunities ▪ How do you organize if the bottom of the "pyramid" is smaller?
Bank Consolidation Will Quietly Continue	▪ U.S. doesn't need 4,000 banks. On journey to 2,000 or lower ▪ Cost of technology / cybersecurity weigh heavily
Long-Only Asset Management Fragments Further	▪ Opportunities continue in smaller / specialized categories ▪ Focus on areas of strength and costs ▪ Further movement into alternatives
ESG Will Remain a Troublesome Issue	▪ Legal and political issues on environmental investing and diversity ▪ Continued differences between major markets (i.e., US / EU / China / UK)
2024 Same Store Incentives Increase 10%	▪ Moderately better markets and revenues ▪ Staffing reductions aid in same store comparisons ▪ Rebound in M&A and equity capital markets
2021 Will Be Compensation High Point Akin to 2007	▪ 2021 not helpful reference to form expectations around ▪ Changing markets temper upside potential

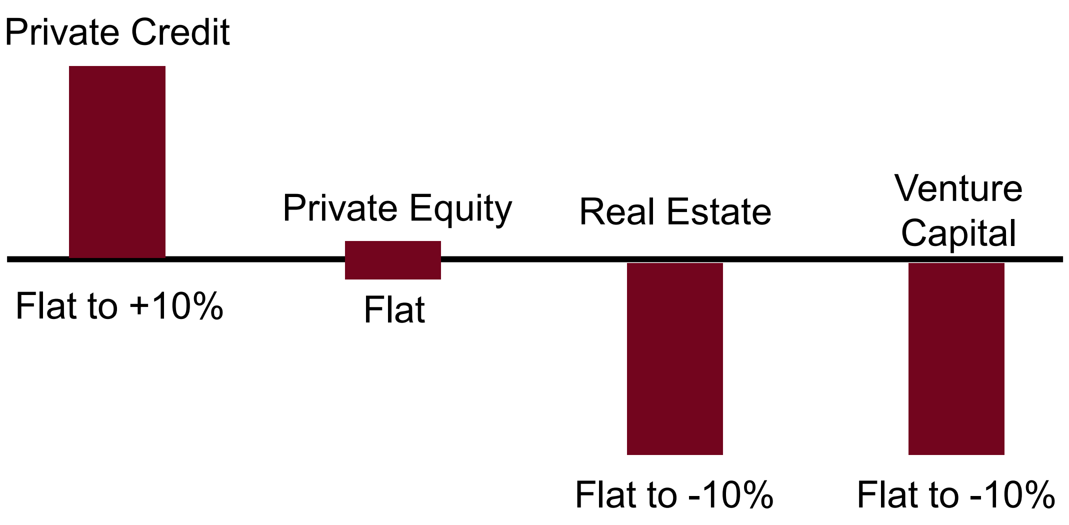
Asset and Wealth Management Systemic Changes



- Systemic change is a key strategic issue
  - Net outflows for active products with passive shift
  - Trend reinforces fee pressure on asset managers
- Headcount trends much lower in medium to long-term
  - Fee pressures compress margins
  - Operations and back office most impacted
- Industry consolidation resulting in boutiques and giants
  - Largest firms focus on asset gathering scale and product variety
  - Boutique firms rely on niche expertise and lean headcount
- Alternatives buildouts amplified as firms seek higher fees
  - Acquisitions / lift-outs / organic business unit scaling
  - Highlights inequities (i.e., higher pay and carry for private markets staff)



2023 Incentive Changes



- Fundraising down and increasingly difficult for small / mid-sized firms
  - Institutional investors reducing exposure to private equity
  - Firms with mediocre returns likely won't meet fundraising targets
- Major alternatives firms delve into retail investor pool
  - Permanent capital and evergreen vehicles with lower investment thresholds
- Private credit and infrastructure remain hot sectors
  - Private credit fills void left by major bank regulations
- Benchmarking challenges and the competitive market
  - Firm / fund size dramatically impact compensation levels
- Carry issues evolving
  - More current funds won't generate meaningful carry
  - Team and individual allocations, percentages and dollars at work, team size
  - How to consider carry for partners vs. non-partners
- Headcount levels vs. carry expectations
  - Many firms overstaffed from optimistic fundraising expectations
  - Employee belief in carry growth will diverge from reality

First real headwinds in a decade. Upsets assumptions on returns, timing, and growth

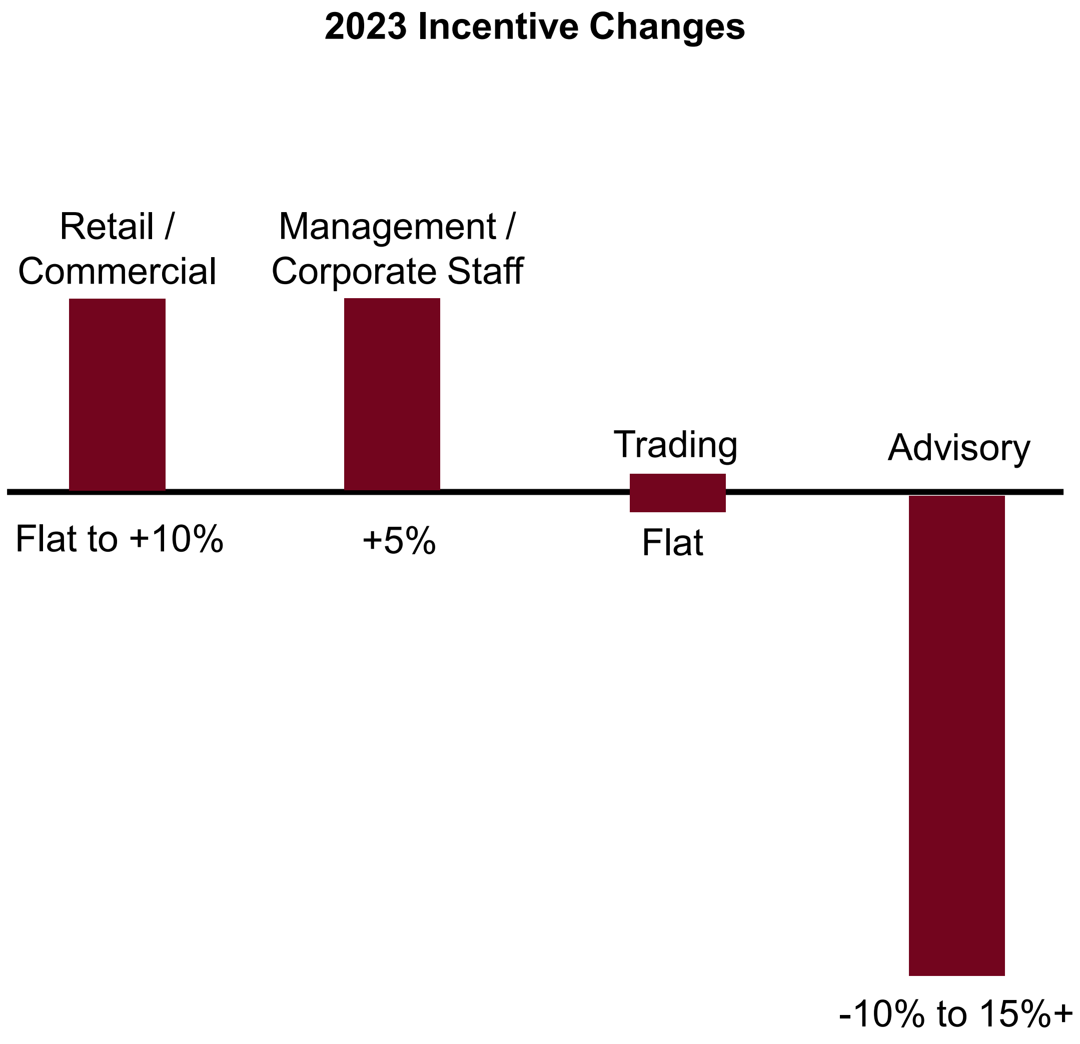
Outperforming Strategies
Commodities
Activist Equity
Event-Driven

Market Performing Strategies
Relative Value
Multi-Strategy

Underperforming Strategies
Macro
Volatility

- Incentives generally flat
  - Industry mixed at about +/- 5%
- Variation by strategy
  - Equity funds outperform but trail broad equity indices
  - Major multi-manager funds generate double digit returns and continue growing
  - Commodities strategies outperform while macro funds underperform
- Pass-through fees drive compensation expenses higher
  - Star portfolio managers with multi-year guarantees and outsized signing bonuses
  - Lateral recruiting of teams declining but team lead compensation often higher
- Formulaic vs. discretionary programs driven by firm scale / founder impact
  - Formulaic most common at large funds and multi-manager funds with many teams
  - Formulaic / hybrid align pay and more straightforward hiring / firing teams
  - Smaller and founder-led funds often have discretionary bonus programs
- Equity programs focus on narrow group of senior professionals
  - Emphasize key leaders; not stand-alone traders
  - Deferrals most common retention tool

Major Banks



- Compensation increases for management at major banks
  - Several major bank CEOs with 5% to 10%+
  - Divorced from absolute business results and driven by plan / KPIs
- Investment banking generally flat but vary across segments
  - Advisory down 10% to 15%+ off of poor results in 2022
  - Equity underwriting incentives up 5% to 15% off low 2022 levels
  - Equities and fixed income trading generally flat
  - M&A off to stronger start in 2024
- Wealth and asset management prioritized for more predictable fees
  - Major banks continue resourcing wealth management
  - Cross-selling for UHNW clients
- Regional banking crisis builds as commercial real estate stagnates
  - Silicon Valley Bank, Signature Bank, First Republic, NYCB, etc.
  - Weaker risk controls and outsized commercial real estate lending
- Layoffs across major banks
  - Structural headcount changes
  - Technology efficiencies and artificial intelligence drive staffing lower
  - Higher capital requirements force cost cutting

Stronger Compensation
Life & Annuities
Select High Demand Support

Standard Compensation
General Corporate Staff

Weaker Compensation
Property & Casualty

- Major insurance company 2023 incentives flat
  - Business transformation stands out
- Property & Casualty had top-line growth in 2023
  - Rising claims cost from inflation and climate change pressuring profitability
- Life & Annuities outperforming on higher interest rates, offset by lower sales
- Growing impact of asset management on the overall insurance company
  - Asset management a key identified growth area
  - Cultural differences can be a roadblock
- 2024 outlook brighter than some other areas of financial services
  - P&C right sizing costs amid slowing inflation after 2023 challenges
  - Interest rates remain above recent norms
  - Transformation efforts begin / continue to pay off
  - Focus on expense management and efficiencies

Final Thoughts

Optimistic on 2024 economy with both downside and upward potential

Opportunities:

- Potential for competitive advantage on compensation design / headcount
  - Continued pressure to expand / grow new segments - need business-specific designs
  - Focus on aligning / retaining high-end talent
  - Increasing importance of differentiation
- Optimizing sales compensation design
  - Trend towards higher objectivity even as fully formulaic less common
  - Emphasis on cross selling has had uneven outcomes
- Communication of hybrid work strategies
  - Slow trickle continues to moderately higher on-site

Challenges:

- More pronounced talent market bifurcation
  - Impact of AI / technology, industry consolidation, cost cutting affecting talent differently
  - Disproportionate impact on support / mid-level professionals
- Salaries remain in focus even as inflation subsides
  - Felt impact to vary by geography
- Focus on benefits slows down from pandemic / war for talent highs
- Headcount management more difficult as talent market remains cool
  - Reduced voluntary turnover and difficulties around top tier talent