2019 Financial Services Compensation

Uneven Compensation Reflects Changing Market Fundamentals

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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 solutions to help clients achieve their goals

- **Broad Range of Consulting Services**
  - Competitive market benchmarking (magnitudes and composition)
  - Annual and long-term incentive designs (amounts, terms, mechanics)
  - Funding rate / fee allocation assessments
  - Turnover and headcount analyses
  - Partnership structures / generational planning / leadership transitions
  - Special situations (transactions, bankruptcy, litigation, etc.)
  - Employment agreements

- **Clients across Financial Services Industry**
  - Asset and Wealth Management
  - Hedge Funds / Private Equity / Real Estate / Other Alternatives
  - Investment and Commercial Banks
  - Institutional and Retail Brokerages
  - Insurance Companies
  - Fintech

Evolving Market Fundamentals Impact Compensation

Market Fundamentals Impacting Compensation

Lower Revenue	→	Price competition, efficiencies, product shift
Lower Headcount	→	Impact of technology and focused strategies
Higher Product Quality	→	Costs for product development and innovation
High-End Talent	→	Increased demand across entire economy; expensive

Changing Calculus: Difficult to fund increases for average performers

Business changes complicate comparisons and norms

Cost of great talent and accompanying challenges

2019 Industry Incentive Changes

2019 incentives uneven despite strong economy and markets, reflecting longer-term dynamics

- Asset Management: -3% to -4%
  - Slowing revenues and product shifting
  - Cost pressures and challenges demonstrating value
  - Wealth management flat

- Hedge Funds: Flat to +5%
  - Mildly positive with stronger performance
  - Quant funds struggling
  - Continued consolidation and pessimism

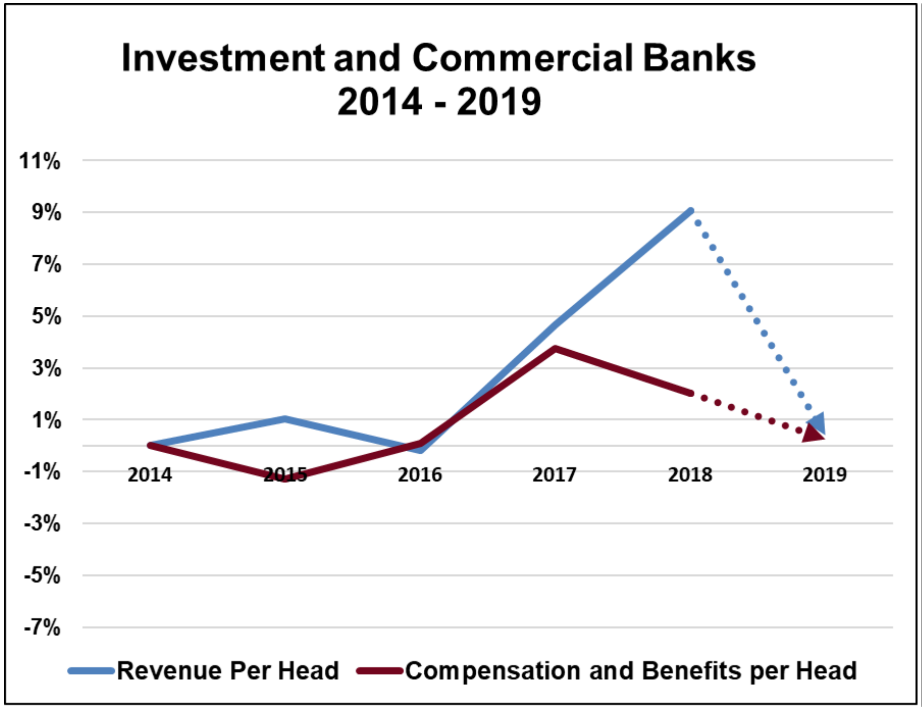
- Private Equity and Real Estate: Flat to +5%
  - Positive fundraising but slowing realizations
  - Economies of scale dominate

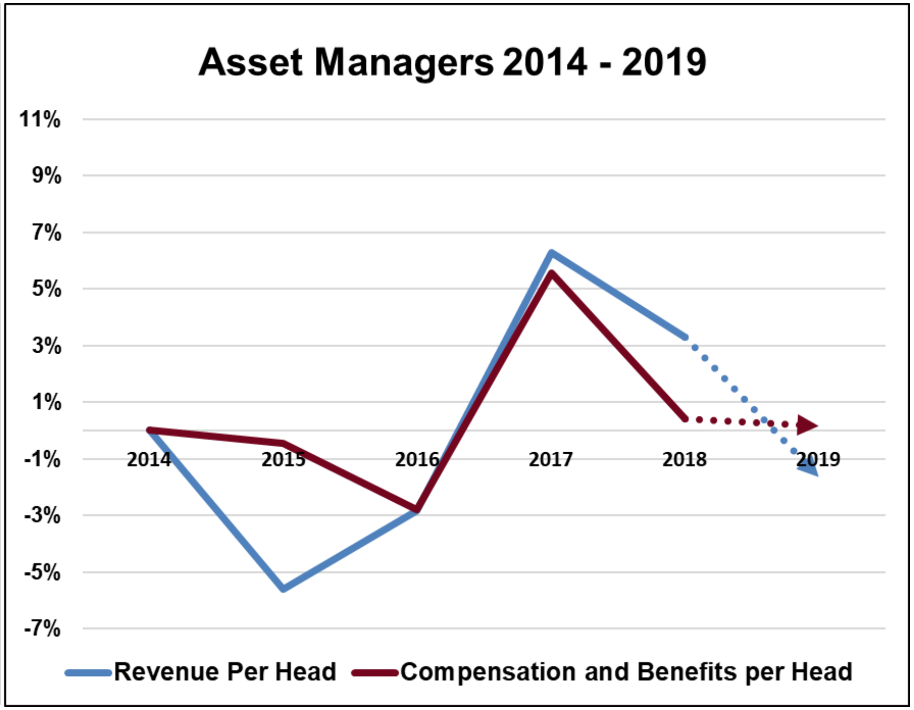
- Major bank incentives driven down by equities and underwriting
  - Fixed income and other areas also negative

% change from 2018 "same store"

Year-Over-Year Aggregate Changes Per Head

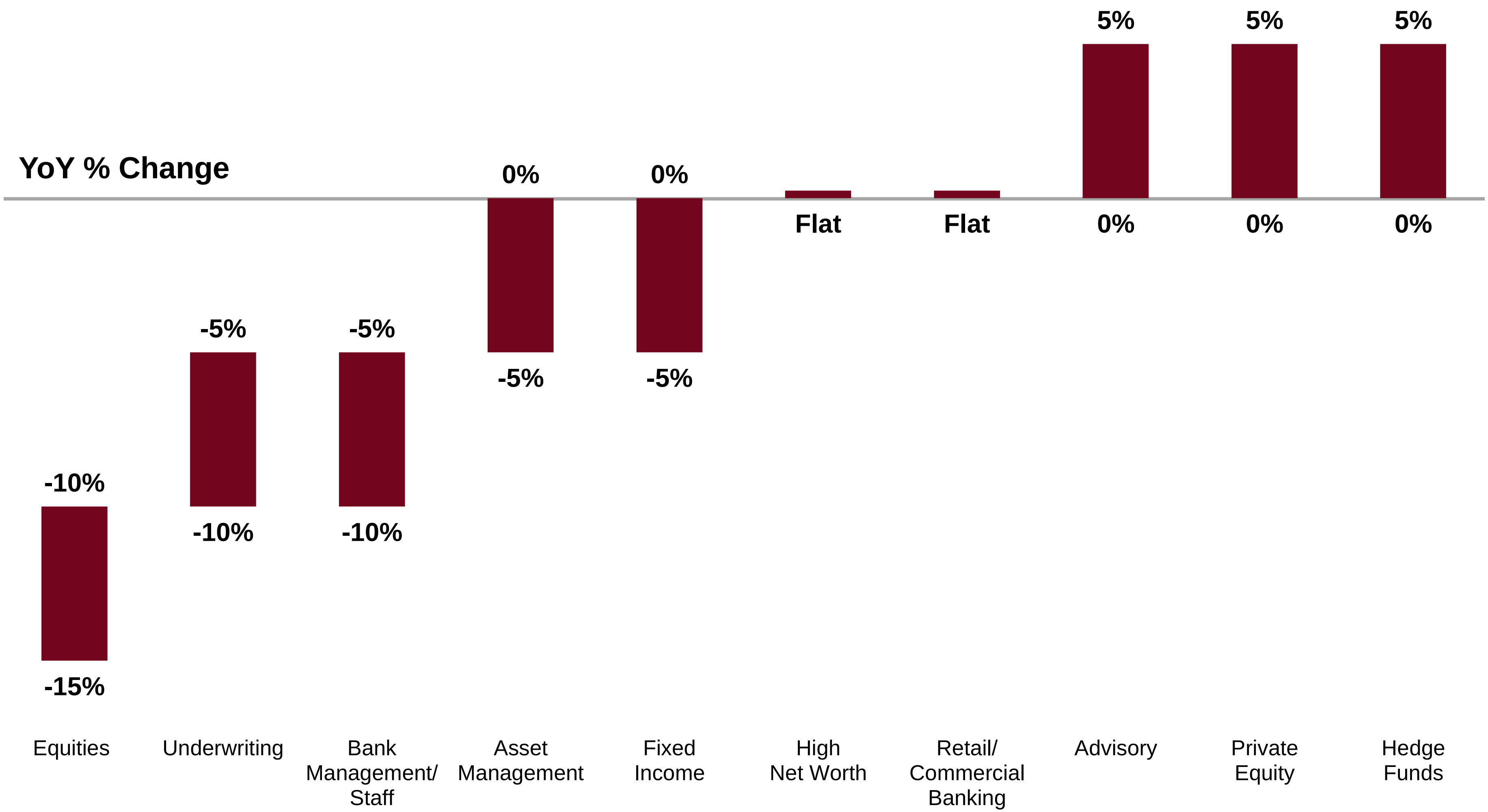
- Major banks and traditional long-only asset managers from 2014-2019
- Driven primarily by technology initiatives, banks with large retail presence methodically cutting headcount. Additionally, some asset managers over-hired with layoffs as revenues fall





2019 Common Incentive Changes (Cash & Long-term/Equity)

Represents typical market range; noticeable variations in performance between firms
Excludes proxy executives impacted by firm-specific circumstances



Differences Blur with Technology Firms

- Technology professionals increasingly differentiated
  - Positive impact
  - Skill sets
  - Wide compensation variations
  - Growing gap between high-end and middle level professionals

- Multiple and confusing reference points
  - Comparable/aspirational comparators
  - High-end technology firms
  - Fintech
  - Direct business competitors

- Greater professional movement velocity
  - Career opportunity <u>and</u> work content <u>and</u> pay
  - Visibility of positions elsewhere
  - Misalignment of skills and challenges

“Multi-Hatted” Jobs – Benchmarking Challenges

- More “multi-hatted” positions at all organizational levels
  - More individual skills/bandwidth than titles or organizational charts
  - Positions at all levels with combined duties (i.e. CFO and COO)
  - Increasingly common as firms become more efficient and less bureaucratic

- Single position data/benchmarking less accurate and often biased downward
  - “Multi-hatted” positions often excluded from data set. Creates artificial downward bias on real market for that position
  - Source of tension between HR and internal clients
  - Not surprisingly source of common disagreements

- Formal/informal data weighting and judgement as starting point
  - Time commitment, impact, headcount, direct reports, etc.
  - As an example, X% CFO and Y% COO
  - As additional check, internal relationships
  - Highlights need for nuance in data assessment

“Better to be open to being about right than knowingly wrong”

Retirement Treatment Alternatives

- Retirement treatment confounding topic (i.e. “mess”)
  - Lack of clear explainable objectives (i.e. retention, non-compete, succession planning)
  - Views shaped by experiences across both financials and industrials. However, no one cares if you retire as long as you don’t compete

- Treatment of deferrals/long-term is different from carry or other incentives
  - Investor expectations and market norms

- Common key elements
  - Notice of 6 months or 1 year depending on level
  - Sensible gradual schedule linked to age and service
  - Non-compete defined broadly

- Terms don’t have to be “cliff.” More akin to pension discount (i.e. 50% at age and service of 65 and pro-rata to 100% at 75)
  - Reduces design uncertainty and “all or nothing” approach

Broad Impact and Challenges of Alternatives

- Big and important enough to impact broader organization

- Different pay paradigms and timeframes
  - Formulaic and highly structured
  - Magnitudes and individual tax advantages
  - Vesting terms
  - Participation

- Performance measurements and management
  - Less impact of annual performance
  - Firm philosophy

- Hybrid products and crossovers
  - Professionals in both alternative and long-products
  - Different fee streams and sharing

- Sales compensation
  - Higher pay potential due to fees and AUM potential

- Impact on support compensation for broader firm
  - Support pay trends upward

Right Levels of Alignment

- Philosophical views on alignment
  - Emphasis on senior executives and professionals
  - Broadly through middle of organization
  - Entire firm participates

- Determining variables
  - Firm size
  - Number of key decision makers
  - Investment timeframe – short vs. long
  - Culture/succession needs

- Recognize multiple vehicles available
  - Alignment can come from bonus, equity/carry, or profit sharing

- Deferrals for retention and equity for alignment
  - Often intersect but are <u>not</u> the same thing

- Simple equity ownership often underweighted

Structured vs. Market Based Compensation Approaches

- Structured approach (i.e. base salary range, target bonus and long-term target)
  - More predictable compensation
  - Greater transparency but less volatility
  - Less flexible for systemic business changes (i.e. up or down)

- Market approach (i.e. no fixed targets, total compensation focus)
  - Less predictable, intensive year-end process
  - Less transparency and more volatility
  - Flexible response to business changes

- Increasingly approaches intersect (varying degrees)
  - Asset Management/Alternatives
  - Insurance/Asset Management
  - Hedge Funds/Private Equity
  - Significant communications and integration challenges. “Speaking two different languages”

- Board and Executives have to understand dynamics
  - Approaches impacted differently by market changes
  - Differing expectations

Compensation Transparency

- Strong desire for more transparency often reflects:
  - Perceived political/arbitrary process

    and/or
  - Don’t differentiate enough on performance

- Transparency is often a micro issue about individual allocations. Less frequently involves broader compensation funding or process
  - “How much does my contribution impact my compensation? How much will it in the future?”

- Greater issue with structured pay programs
  - Especially if perceived as zero sum outcomes (i.e. fixed pool)

- Uncertainty in future compensation for average/good performers
  - Limited/declining pools with business challenges
  - Need to reward great performers
  - Increasing issue as markets evolve

2020 Fearless Predictions

- 2020 incentives down moderately (i.e. 5%)
  - Competition, product shifting, fee levels
  - Continued squeeze on average/good performers
- Downsizing continues at gradual pace
  - Operations, low/mid-level technology, middle management
- “Bubble” in pay of high-end technology and analytics
  - Some firms realize difficulty in creating value
- More intersections between structured and market based approaches
  - Cultural and communication challenges
- Increasing impact of alternatives
  - Crossovers, hybrids, and support
- Effective base salary increases continue at 4% - 5%
- Movement accelerates out of NYC, San Francisco, and Boston
  - High business costs
  - Individual taxes and housing

Hedge Funds – Pay Models and Choices

- Tailored to the business model and context
  - Single PM vs. Multiple PMs
  - Founder role and level of involvement
  - Capital allocations
  - Decision making
- Discretion vs. Formula
  - Flexibility and certainty
  - Trust and credible return crediting
- Impact on firm performance
  - Netting risk
  - Firm linkages
- Individual vs. Team
  - Value creation
- All current pay vs. standard deferrals
- Target vs. market for support compensation
  - Business impact
  - Desired volatility

Private Equity – Increasing Motivation

- Mindset around evaluating performance and staffing
  - Continue to push against "resume bias". What is the likely future contribution?
  - Normal turnover is a positive

- Annual incentives can be a signaling mechanism, even if pay differences are not large
  - Consideration of investment opportunities generated
  - Investment insights
  - Portfolio company management assistance

- Promotion decisions increasingly important
  - Clear criteria and expectations

- Growing practice to delay and differentiate Carry allocations
  - Typical: Award 80 – 85% upfront
  - Alternative: Award 20 – 25% per year
  - Requires different/thoughtful processes and mindset

Asset Management – Focus and Discipline

- Business fundamentals drive continued pressure
  - 2020 / 2021 brings needed focus and consolidation

- Headcount remains too high. Overly optimistic hiring in 2017 / 2018
  - Meaningful reductions in operations, support, and management layering

- High-end skills remain in high demand
  - Value added technology
  - Data analytics
  - Product development
  - However, examples of indiscriminate hiring and excessive pay

- Focus on historical margins not helpful
  - Lower fee products may generate profits but not great margins. Focus on retaining high margins can hinder product differentiation

- Advice continues as strong point
  - Clients continue to pay well for advice. Advisors surprisingly have bright future
  - Personal relationships difficult to replace with technology

Sales Compensation – Hybrid Model Dominates

- Hybrid sales programs dominate
  - Often mix of formula, team, and discretion
- Effective sales efforts more important than ever
  - Difficult to differentiate products in crowded market
  - Longer sales cycles requires closer relationship management
- Evolution towards sophisticated content in sales process
  - Different profile in people and process. Smarter, younger, and more diverse talent
  - Content changes not fully recognized by all firms
- Sales compensation design requires thoughtful perspective on business dynamics
  - Key drivers are desired behaviors, timeframes, and metrics

Board of Directors – Sizing Compensation

- Analysis of public Director’s compensation often straightforward
  - Comparators visible
  - Full disclosure on pay elements
  - Nuances understood around board size, meetings, committees, etc.

- Private company analysis more involved
  - Wide variations in responsibilities, governance, and time commitments
  - Differences between family businesses, and Director selection criteria

- Two key variables are time commitment and daily rate
  - Not precise but tends towards reasonableness
  - Daily rate approximates market value using public company references, consulting fees, intensity of role, etc.
  - For example, board requires ≅ 15 days X $5,000 market daily rate = $75,000 starting point

Final Thoughts

- Movement out of business comfort zones
  - Impacts compensation, culture, and communications
- Need more entrepreneurial vs. corporate approaches
  - Tied to results and ownership
  - Less socialism
- Difficultly paying both average and excellent performers
  - Headcount matters
  - Focus on total spend vis-à-vis individual changes
- Importance of brokers and personal relationships
  - Clients will pay more for advice
- Communication with Board and Executives
  - Changing reference points and norms
- Complicated compensation mindset requires clearer philosophy/analysis and less focus on past practices
  - Opportunity to differentiate yourself