Upbeat Compensation Landscape and Annual Recap

Financial Markets Total Rewards Group

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Johnson Associates

- Independent financial services compensation consulting firm providing informed advice and data with real customized solutions. Expertise developing aligned and successful programs. Common services include annual and long-term incentive designs, market data, Board Committee advice, performance measures and goals, equity and partnership considerations
  - Real subject matter experts. Experienced, opinionated and informed
  - Balance market/best practice with firm dynamics
  - Both Board consultant and company programs

- Diverse clients and issues
  - Asset and wealth management
  - Hedge funds/private equity/real estate/alternatives
  - Investment and commercial banks
  - Insurance companies
  - Brokerage firms
  - Trading organizations

Changing Compensation Landscape

- Trump election and Republican domination
  - Americans, and many developed countries, feel strong need for economic change
  - Broad belief financial regulations overdone
  - Unpredictable priorities and outcomes

- Rising interest rates and low unemployment
  - Increased inflation and economic growth
  - High stock prices

- Strong perception regulatory burdens will lessen
  - Short-term application
  - Longer-term rule changes

- Competition from technology firms
  - Focus on higher-end talent

> - Industry optimism justified across multiple dimensions. However, impact uneven across sectors and requires careful analysis of situation and information

2016 Compensation Recap

- 2016 continued weakness from 2015
  - Fee and revenue pressures
  - Incremental cost reductions inadequate/late

- Mounting fee pressures and uneven markets
  - Asset management: -5% to -10%
  - Wealth management: -5%
  - Private equity: flat
  - Hedge funds: -5% to -15%

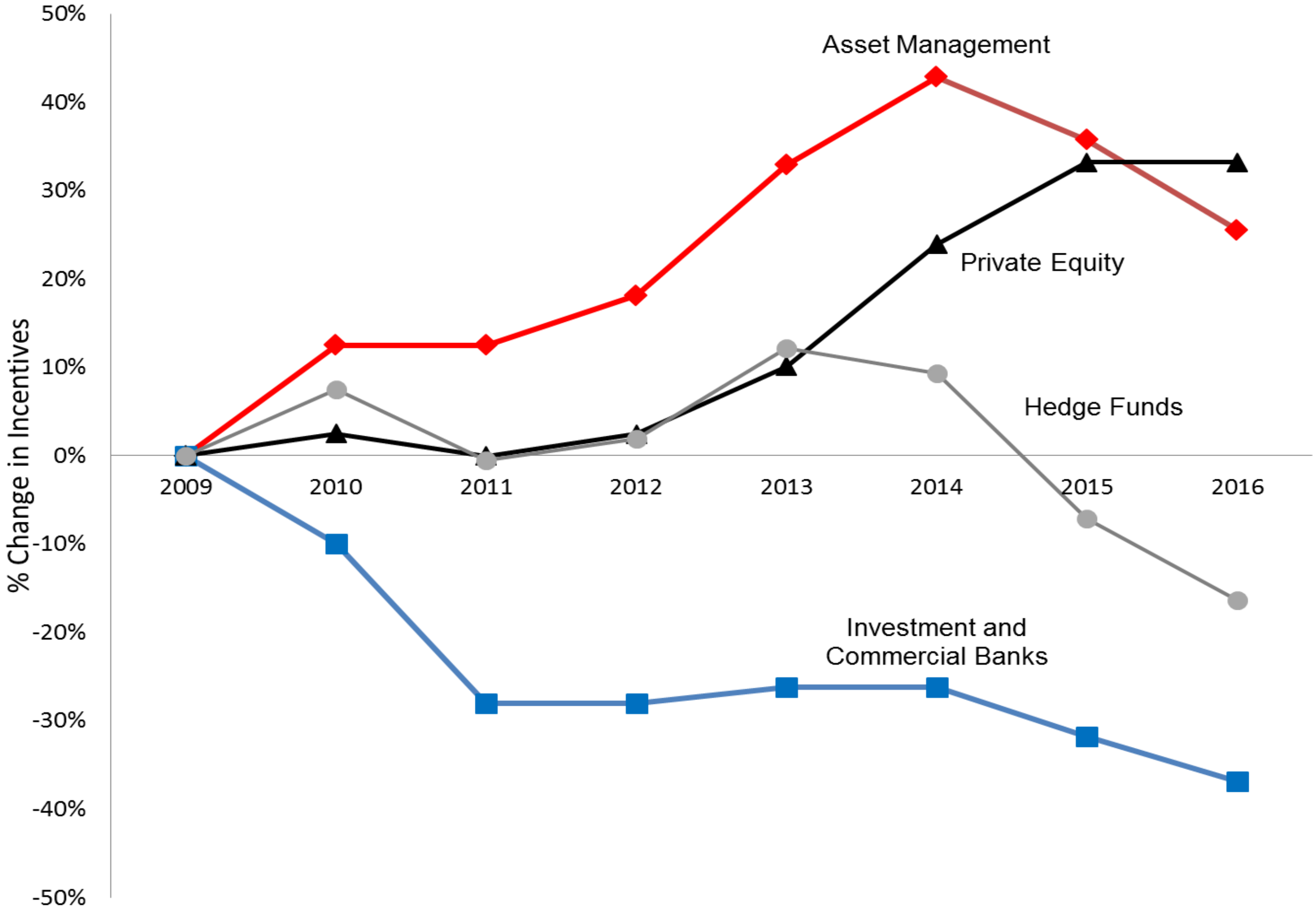
- Major bank incentive compensation down
  - Fixed income: flat to -10% (with improving trends)
  - Equities: -5% to -15%
  - Investment banking,
    - Advisory: flat to -5%
    - Underwriting: -10% to -20%+

- Insurance companies impacted by low interest rates

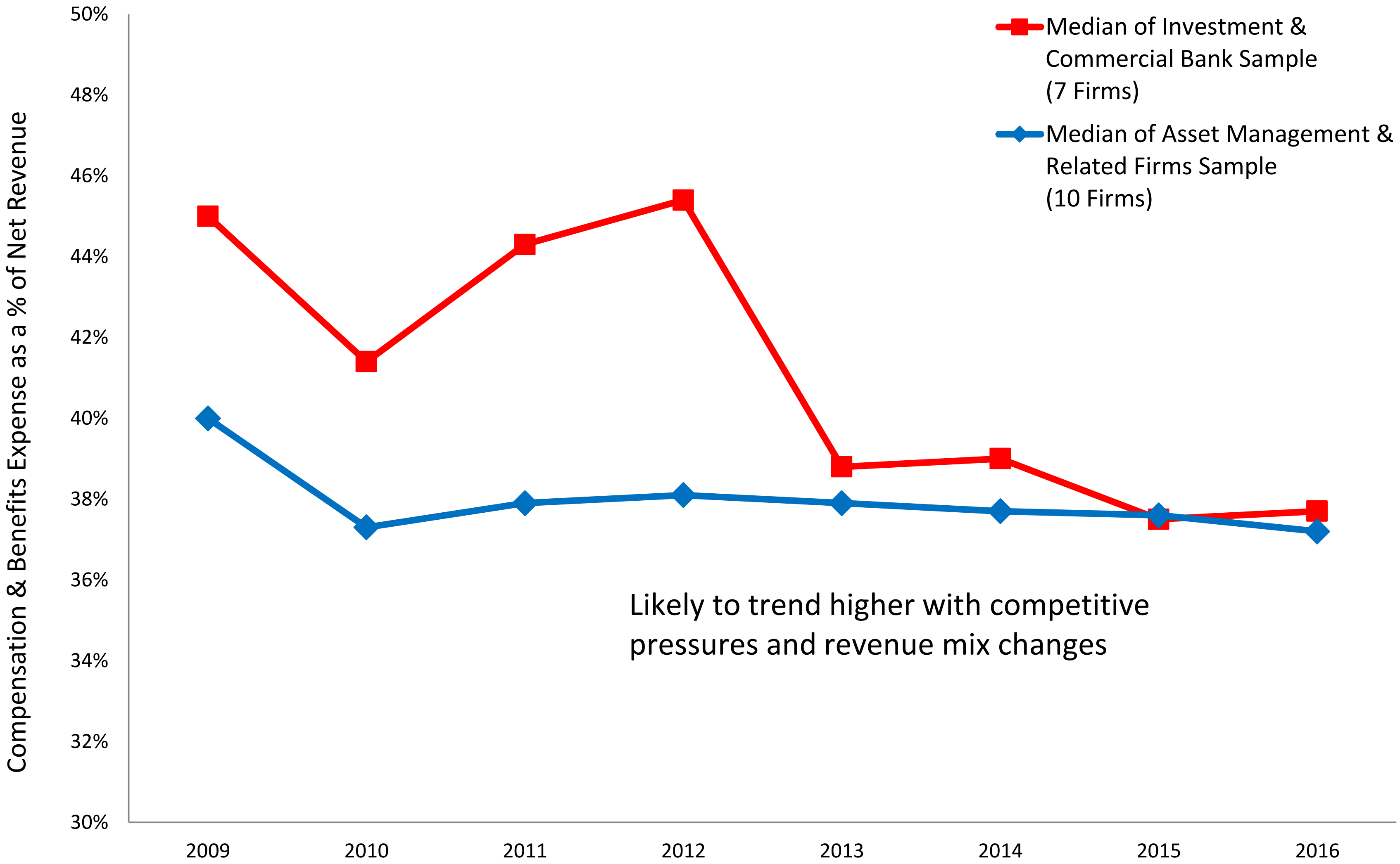
- Increased progress on differentiation

Incentive Divergence Across Industry Sectors

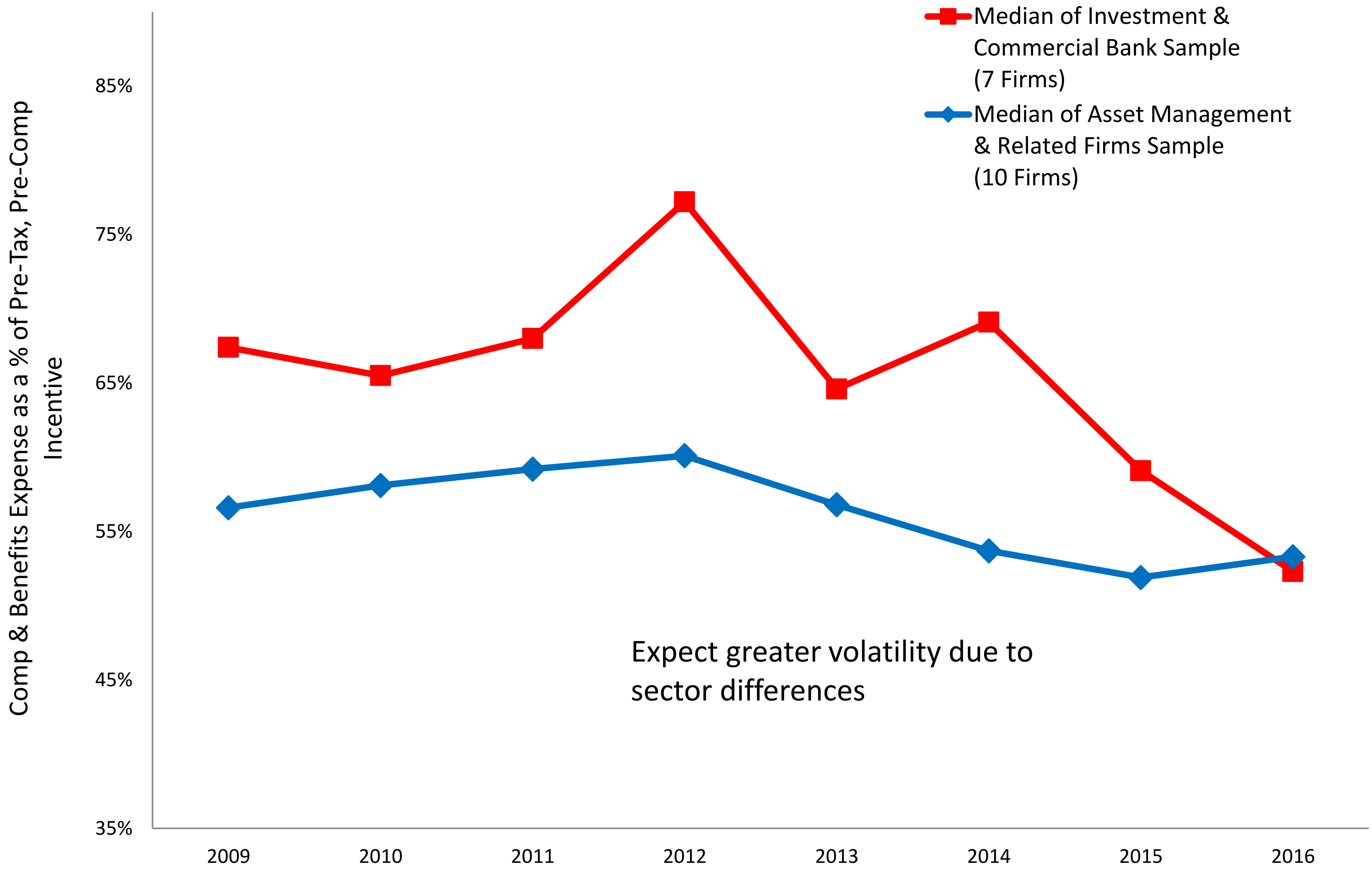
- Since financial crisis, industry sectors have not moved in lockstep
  - Expectation 2017 provides greater opportunities and volatility



Compensation as % of Net Revenues



Compensation as % of Pre-Tax, Pre-Comp Income



2017 Fearless Predictions: Uneven Positive Change

- Bank compensation increases significantly (i.e. +15%)
  - First real uptick since 2009
  - Market volatility drives trading upsurge
  - Interest rate increases improve spreads

- Asset management flat
  - New disconnect between markets/AUM and revenues due to fee changes/products
  - Require strategic changes and aggressiveness/cost management

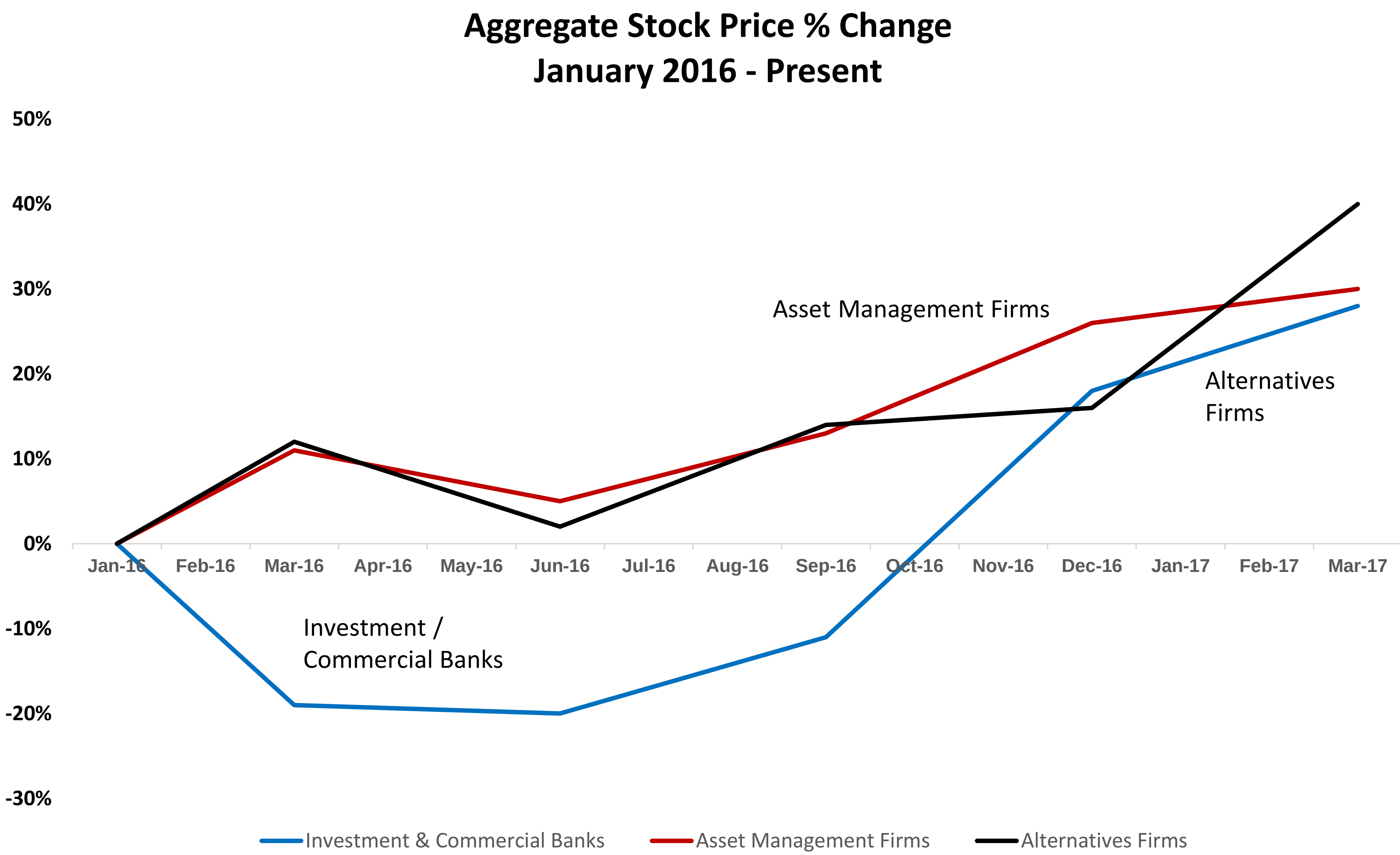
- Hedge funds up significantly from volatility and dislocations
  - Greater opportunities across credit, equities, and real estate

- Private equity benefits from attractive exits
  - Investment discipline needed with new investments (age old story)

- Real estate bubble leaks intensify
  - Valuation, supply, and interest rates

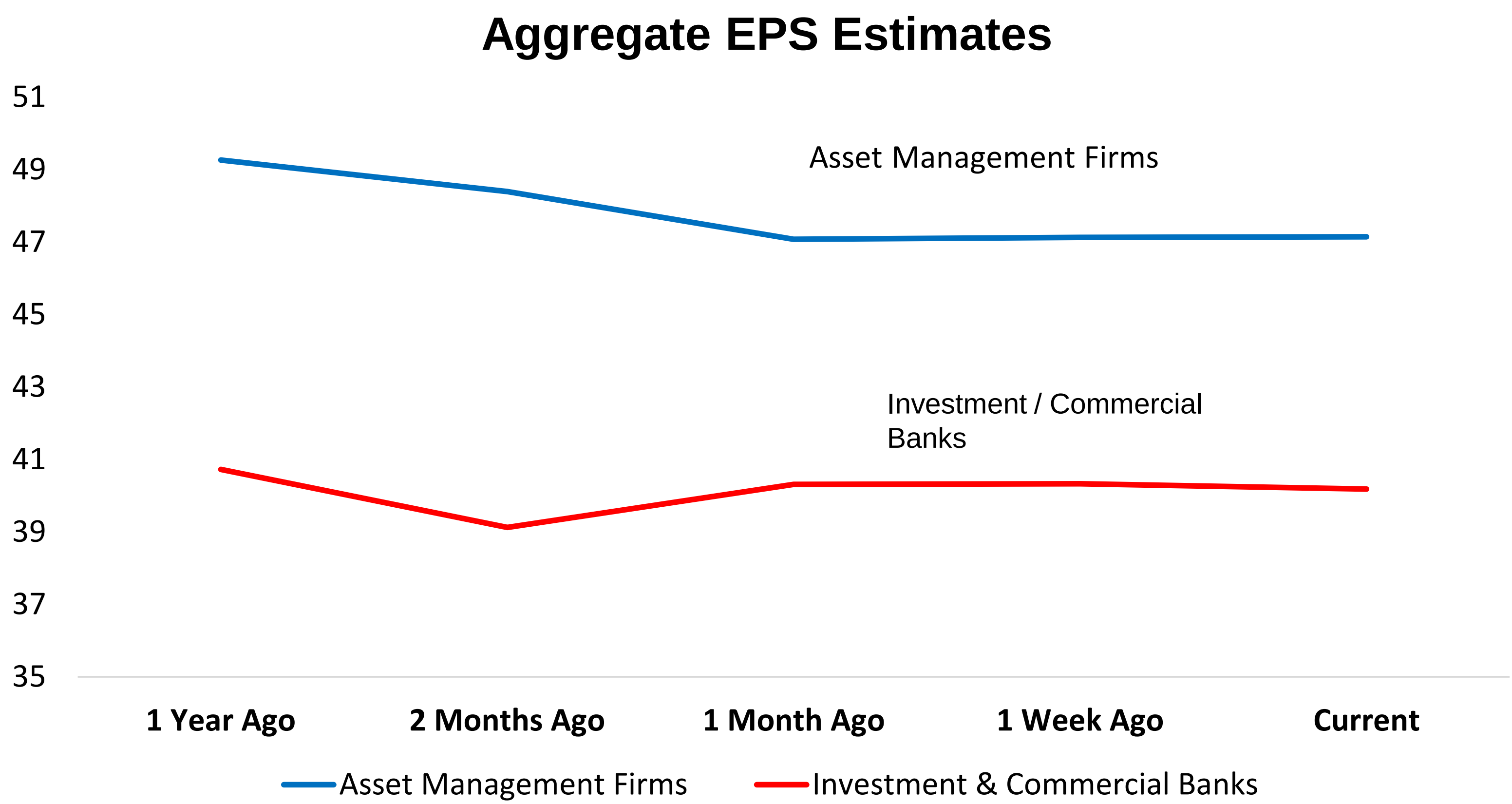
- Interest around new incentive designs, measures, and vehicles. Both pressure and freedom to explore new choices after long-period of stagnation.

Messages from Stock Price Changes



Change in Earnings Expectations

- Analysts have not revised estimates as rapidly as markets



Rewards Lessons from Technology Sector

- Importance of a few great people
  - Often worry about having too many people
  - Talent and contribution more important than hierarchy
- Broad turnover accepted and generally healthy
- Competitive base salaries. No excuses
- Substantial levels of differentiation on contribution
- Time in grade far less important/more aggressive tone
- Both restricted stock and stock options
  - In start ups, often performance-based vesting
- Flexible hours and dress code
- Often see player/coach roles
- Greater internal promotions

Base Salary – Important and Efficient

- Base salary both economic and cultural signal
  - Competitiveness
  - "Old Wall Street" vs. Global economy

- Available market information highlights deficiencies
  - Employees are better informed, especially younger professionals

- Tyranny of small increase pool (i.e. 3%)
  - Few adjustments for workforce demographics/static view
  - Math does not work with young talented workforce (i.e. treat separately)

- Structure levels vs. individual amounts
  - All MD's have $400k salary
  - Large portfolio managers are $350k

> • Johnson Associates rule-of-thumb: Each dollar low on base salary requires $1.50 - $2.00 of additional incentive. Low salaries can reduce firm income

Rise of the Hybrid Position

- Increasingly positions are a combination of roles (i.e. "Hybrid")
  - CFO and CAO, GC and compliance, business lead and technology, etc.
  - While most visible at senior levels, across the organization

- Many conventional surveys and anecdotal data points don't account for or even include hybrid roles
  - Creates unintentional downward skew in market perspectives
  - Discourages creation of hybrid/bigger roles

- Important to recognize differences, even if requires judgment for realistic market role
  - Consider premium on largest role to reflect additional duties or combination of market data for roles

- If not adequately addressed, will increase pressure for heavier staffing

Better Long-term Vehicle Utilization

Broad Sector	Vehicle	Refined Utilization
Banks	Restricted Stock	Less restricted stock, more stock options and products
Asset Management	Restricted Stock and Products	Less restricted stock, more stock options and products with creative outcomes*
Hedge Funds	Products	More products with leverage/creative outcomes*
Private Equity	Carry and Co-Investment	Differentiated carry awards, and greater co-investment

* Deferrals with higher upside for beating benchmark or adding alpha

Ownership and Partnership

- Increasingly important issue for private firms
  - Stage of maturity
  - Value potential
  - Opaque/shifting beliefs on ownership

- Common objectives
  - Mutual commitments and succession planning
  - Alignment and transparency
  - Wealth building
  - Be more than an employee

- Solvable issues
  - Founder economics vs. new partners
  - Dilution flexibility
  - Grant timing
  - Governance (i.e. founders)
  - Profit share and tail
  - Valuation
  - Clear termination provisions
  - Details really matter

Asset and Wealth Management: Aggressiveness Needed

- 2015-2016 down after consistent positive results
  - Forcing reassessment as future more competitive
  - Need to rekindle entrepreneurial spirit
- Disconnect between market levels/AUM and revenues
  - Fee pressures on active products
  - Index and ETF products
- Need for investment spending
  - Often Asia and new products
- Refined incentive plans and measures
  - Greater line of sight and growth focus
  - Motivational leverage across scenarios
  - More products/less corporate stock
- Evolution of sales compensation designs continues
  - Commission vs. hybrid vs. subjective
- Rule of thumb: If ISS/Glass Lewis like it, probably not good for you

Hedge Funds – Seize the Opportunities

- Enhanced opportunities in 2017 and beyond (no excuses)
  - Volatility and dislocations (i.e. rates, equities, housing, China, etc.)

- Two workable investment compensation models (with caveats)
  - Formulas can work in more siloed frameworks and capital allocation
  - Objective/discretion workable with broader decision making

- Recent improvements in performance management
  - Progress in identifying quality idea generators
  - More discipline in process
  - Less tolerance for mediocrity

- Technology and statistics infusion (i.e. "Big Data")
  - Compensation data challenges
  - Focus on real excellence

- Continue work on investment measures
  - Risk
  - Rates of return vs. cost of capital
  - Cooperation

Private Equity – Build on Gains

- 2017-2018 favorable exits into attractive markets
  - Inevitable challenge of not overpaying for new investments
- Two ways carry considered
  - Dollars at work
  - Realizable carry (assumptions/projections)
- More carry should go to outstanding vice presidents/associates
  - With “waterfall” early awards more important
  - Relatively little cost
- Annual compensation impacted by carry realizations/prospects
  - Market trend requiring communication
- Carry vesting continues to evolve
  - Moderately longer (i.e. more 5 years)
  - More on realizations (i.e. 20% and growing)
  - Vesting should reflect initial awards and reserves

Banks – Freedom to Innovate

- 2017 finally positive compensation year
  - Rebuild market competitiveness
  - Resist pressure to backslide on performance differentiation
- Clearly link compensation to business units/norms
  - Blend of discretion/structured incentive plans
- Grant restricted stock and stock options to senior management
- Stop overusing company stock
  - Limit participation and equity mix
  - Replace with products/risk proxies
- Increase senior management stock ownership guidelines
  - Limit liquidity after leaving bank
- Heavier use of real analytics
  - Need deeper insights between business economics and market compensation across professional levels
  - <u>Far more</u> than year-over-year changes with existing headcount

Inevitable and Important Political Reactions

- Bank compensation levels are increasing
  - "Clear sign of lack of controls/excessive risks"
- Fiduciary rule is gutted
  - "Over time real examples of customers disadvantaged/ripped off"
- Dodd Frank modified in messy fashion
  - Set up for more regulations later
- Continued carry capital gains advantage
  - Politicians taking care of the rich/connected
- Decline in impact of ISS/Glass Lewis
  - Needed advisors have been marginalized
- Housing bubble leaks in New York, Boston, and San Francisco
  - Lessons not learned from financial crisis
  - Signal of future issues

Final Thoughts

- Most positive overall compensation dynamics since crisis
  - Banks, hedge funds, private equity
  - Less so for asset management today but past gains significant
- Need an opportunity for creativity/appropriate aggressiveness
  - Incentive structures and line-of-sight
  - Long-term vehicles and application
- Considerable improvements in performance management
  - Hopefully progress continues
- Political backlash and volatility
  - Need for preparation and communication
- Ownership and partnership continues as major theme
- Smartly avoid and monitor bad behaviors
- Real chance for industry to move forward across businesses, compensation, morale and talent management