

Reflections on 2005 Compensation and the Mix for 2006

Wall Street Compensation and Benefits Association

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Johnson Associates

- Boutique compensation consulting firm specializing in financial services. Annual and long-term incentive plan designs, market levels, and performance goals/measures. Significant independent expertise and in-depth knowledge cutting across comparator groups and labor markets
- Diverse Clients
 - Investment and commercial banks
 - Asset management firms
 - Insurance companies
 - Hedge funds/Private Equity/Alternatives
 - Brokerage firms
 - Trading organizations

2005 Broad Re-Cap

- Increased compensation levels versus 2004
 - Fixed income/trading strength and clearly improved investment banking
- Continuing slow increase in staffing
 - Focus on high-end talent
- Steady compensation accrual rates. Significant subsidies to investment banking and equities along with geographic build-outs
- Selective bubble compensation pressures at associate/VP levels
 - Hedge funds and private equity providing select outlier amounts
 - Temporary situation through 2006 but must be managed
- Much heavier restricted stock use
 - FAS 123R takes full effect
 - Unsustainable lack of stock options...
 - Almost no equity creativity exhibited by major firms (exception of Merrill Lynch)

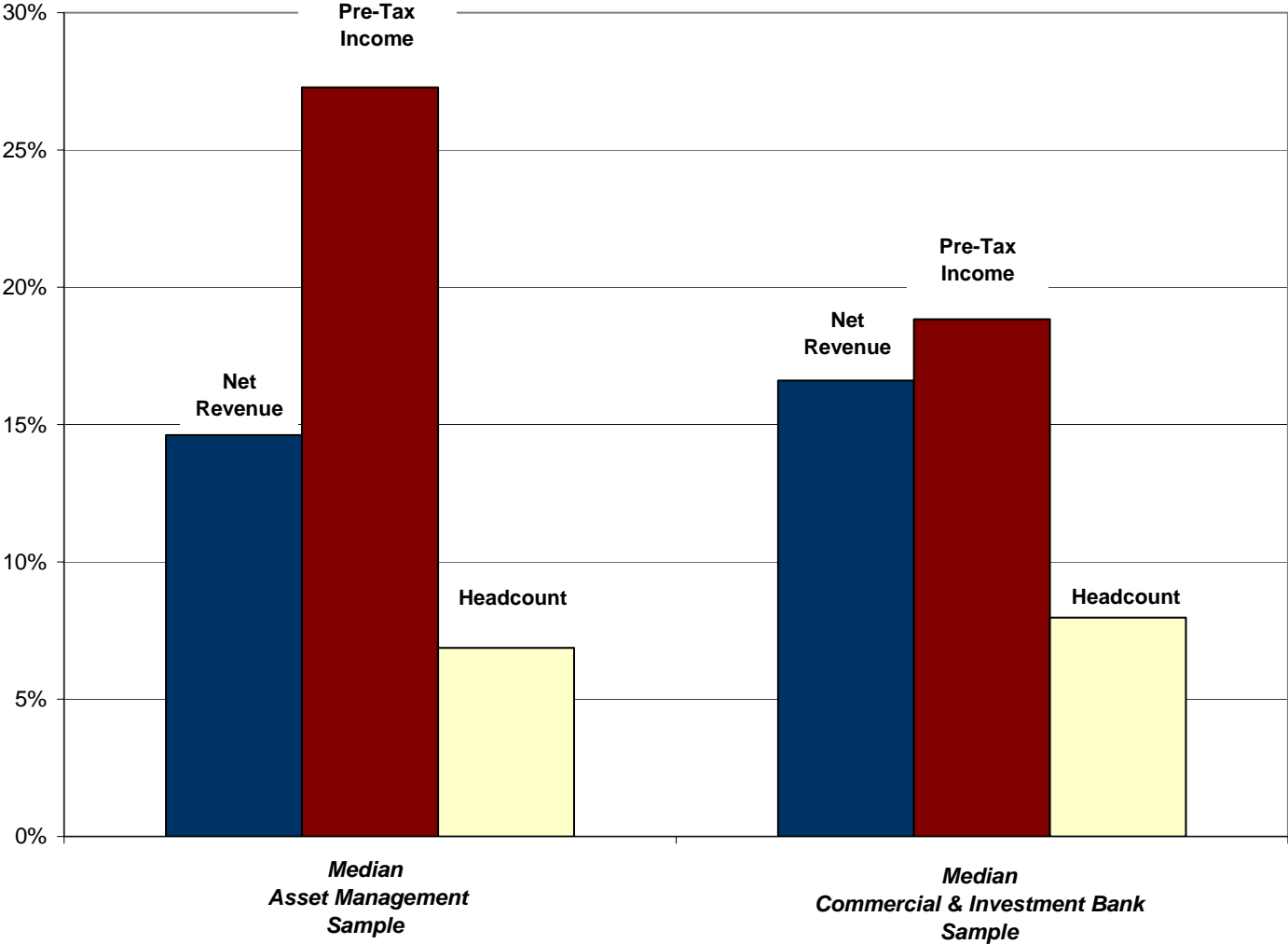
2005 Broad Re-Cap

- Greater 2005 divergence between major firms and other comparators
 - Careful thinking/analysis more important due to group differences
- Strong competition across high-net worth and asset management
 - Unfortunate DNA and compensation conflicts with core businesses make future progress problematic
- Independent Hedge funds/Fund-of-Funds/Private Equity serious talent threats at margin. Broad view alternatives established as long-term asset class
 - Hiring for both front and back-office
 - Increasingly their compensation analyses include broader firms
- Cost-of-living differences clearer issue in compensation
 - No need to provide same compensation in Dallas vs. New York
 - London costs driving perception of higher compensation in Europe
- MGMC has clearly emerged as credible data provider
- Diverging benefit models in marketplace
 - Pension vs. no pension
 - Medical costs gain traction as issue

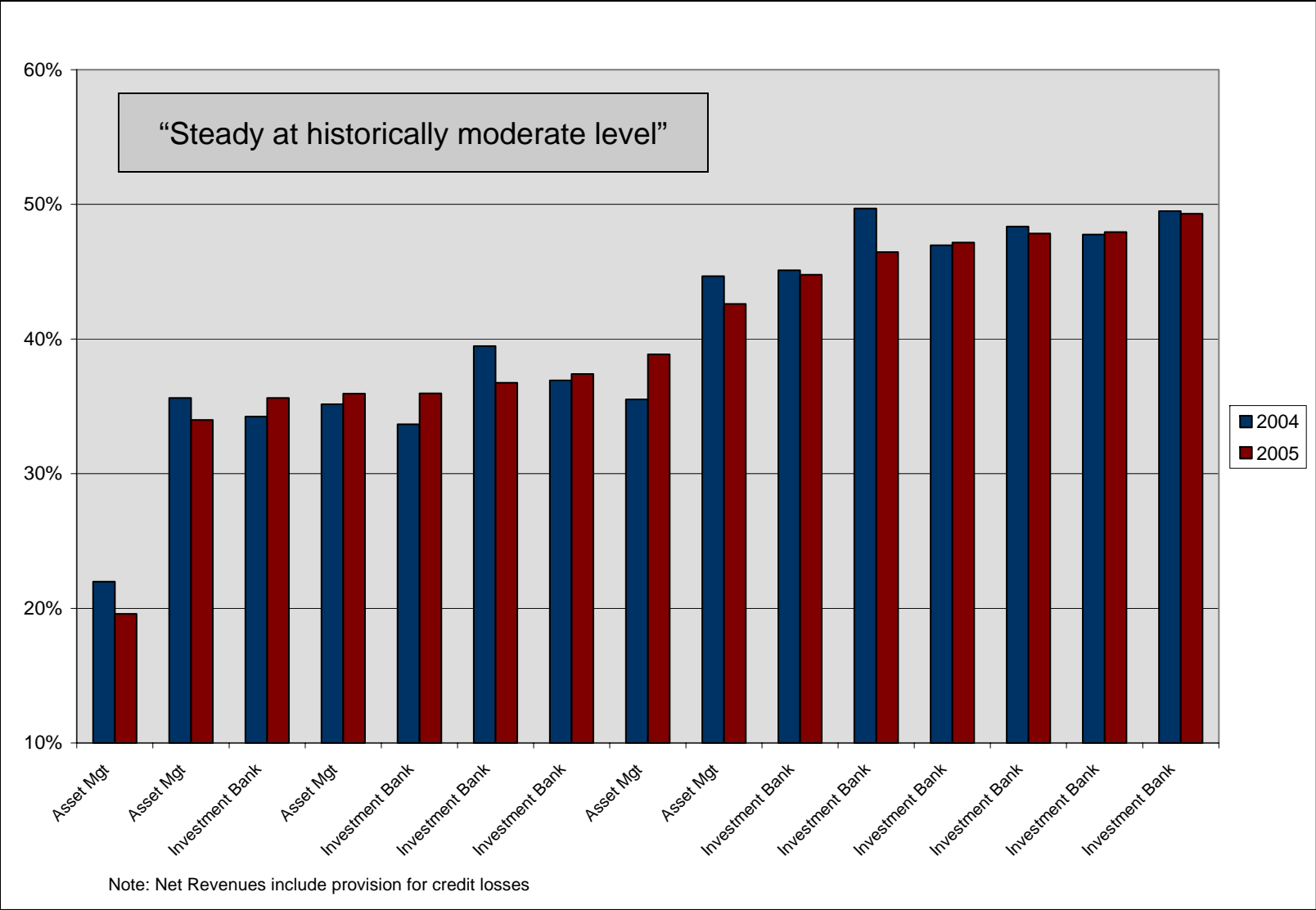
2006 Fearless Predictions

- Business improvements moderate through 2006
 - Rebound in investment banking and equities continues
 - More difficult trading (i.e., yield curve, spreads, and risk)
 - Retail brokerage stronger
 - Asset management environment better, but institutions lag
 - Commercial/retail banking continues strong
 - Pell-mell rush to alternatives continues
- More obvious that leverage needed in equity programs
- Slow headcount increase (i.e., 3-5% net above year-end 2005)
- Outsourcing from high cost areas continues – particularly away from New York City. London will likely be next...
- Investment Banking pay increases significantly again (i.e., 20%+)
- Retreat from asset management continues, while private equity returns as offering and hedge funds grow
- Broadened use of gardening leave and selective non-competes

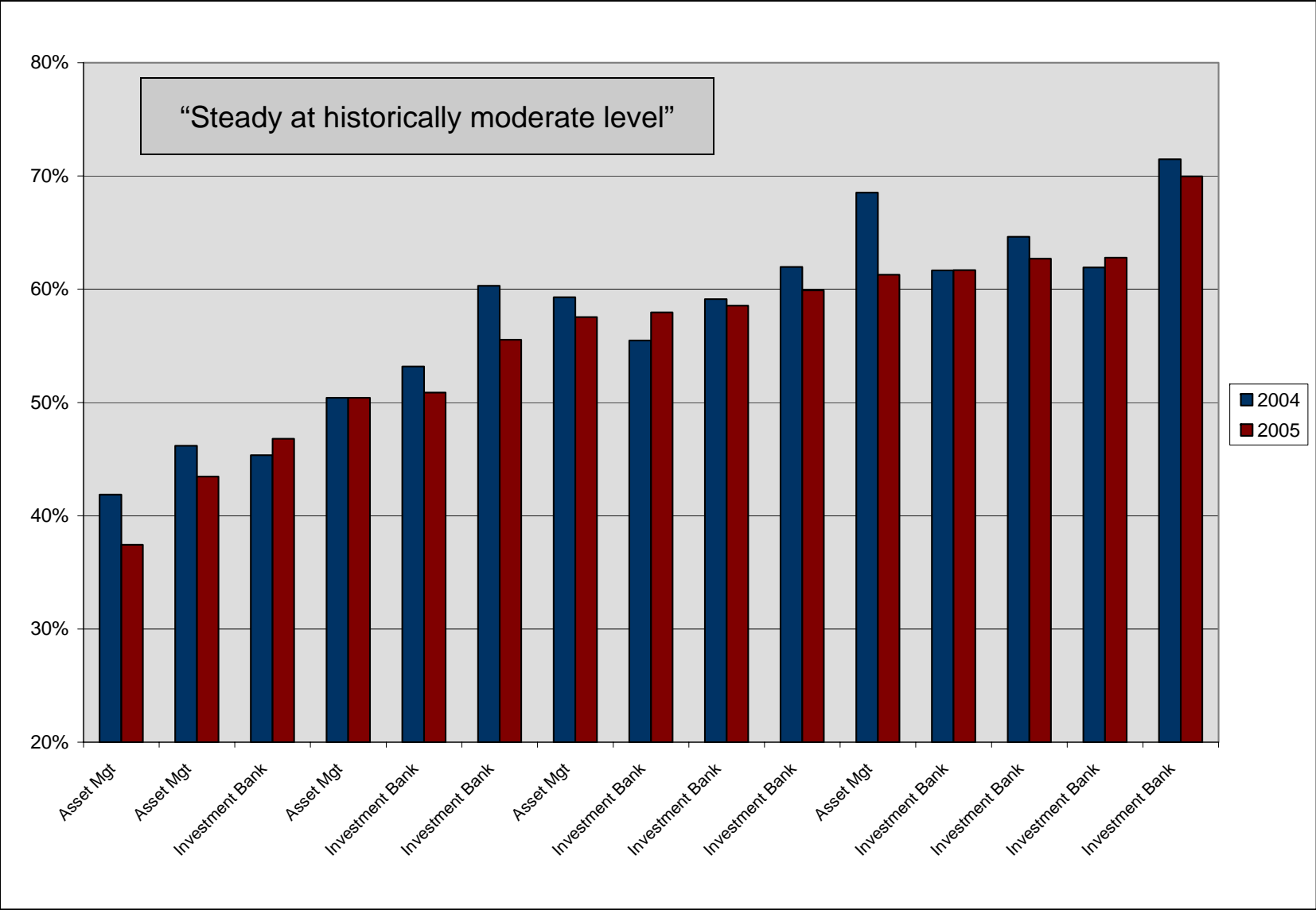
2005 vs. 2004 Changes in Key Indicators



2005 vs. 2004 Compensation as % of Net Revenues

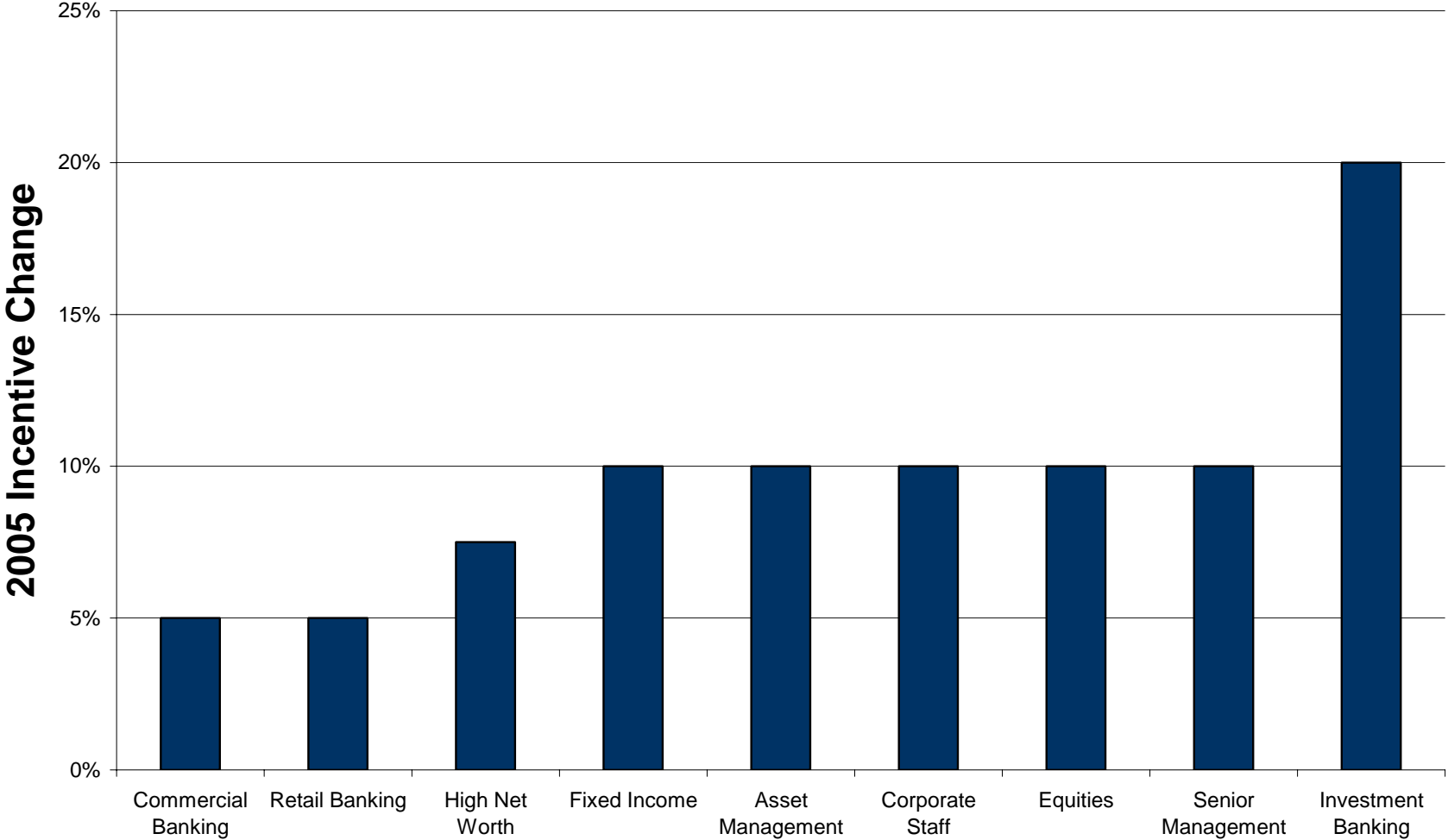


2005 vs. 2004 Compensation as % of Pre-Tax Pre-Comp Income



2005 Typical Incentive Changes (Value of Cash Bonus and Equity)

Note: In 2005 unusual variations between firms and across first/second tier



Base Salary Levels

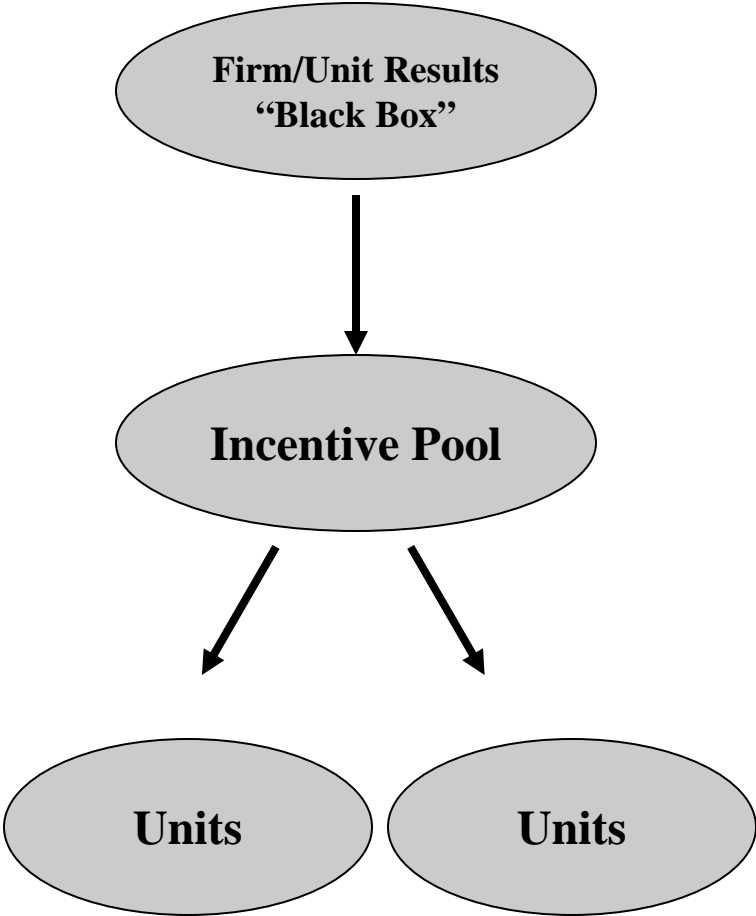
- Industry base salary levels continue at low level
 - \cong 4% all in increases continue as norm
- Low base salaries do not automatically mean reduced fixed compensation
 - Often other elements increased or expectations established (i.e., “salary portion of bonus”)
- Different market norms across businesses often not adequately recognized

Incentive Funding Evolution

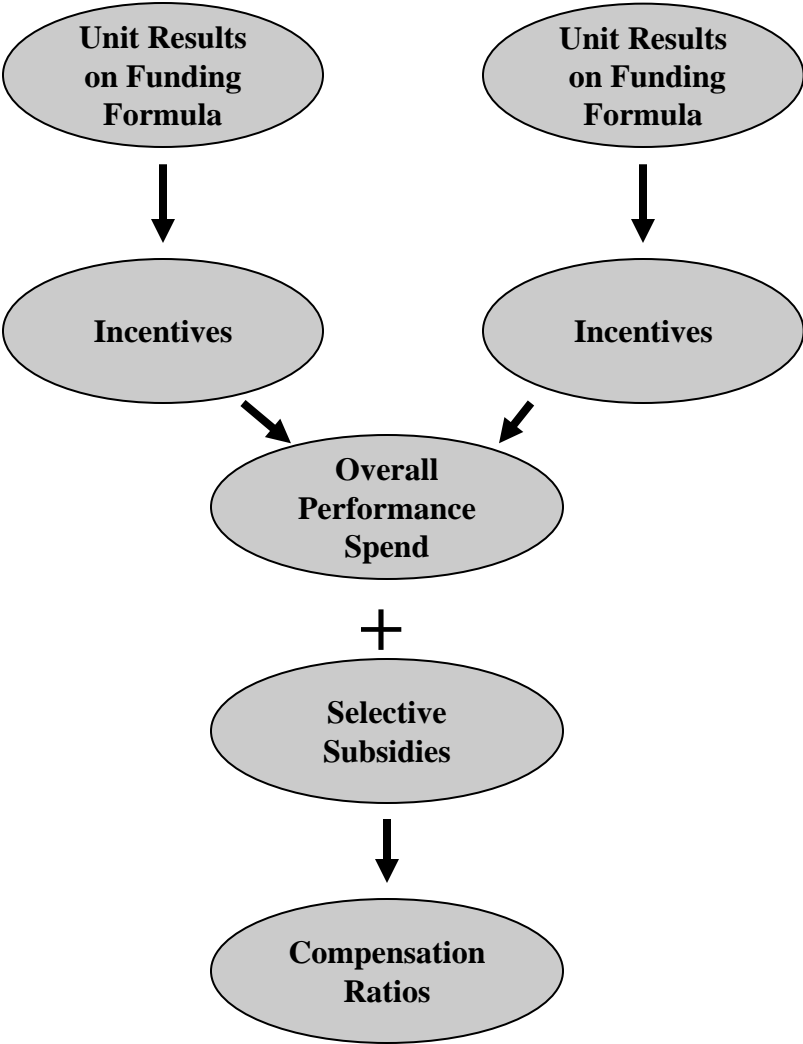
- Movement away from classic discretionary investment banking model
 - More explicit funding on business/unit
 - Increased information need on comparator practices
- Firm size and business diversity driving changes
 - Need clear understanding of dynamics recognizing capital and cost allocations
- Ensure sensible designs and recognize “netting risk” (i.e., commitments not linked to overall firm results)
- Often lack of clear understanding of changing dynamics by Compensation Committee
 - More difficult to compare aggregate ratios between firms
- Alternatives and asset management increase need for objective programs
 - Need increasing for more leveraged pay curves to recognize results (i.e., not pay great for so-so returns on large AUMS)

Illustration of Funding Evolution

Traditional Model



Evolving Model



Long-Term Incentives and FAS 123R

- Unfortunate pattern of taking leverage out of equity
- Overly heavy use of restricted stock reflecting accounting advantage elimination for stock options
 - Stock settled SARs overtime replace stock options
- Heavy equity orientation program strength
 - Shareholder alignment key for senior professionals
- For diversified firms, effective use of single stock difficult
 - Importance of line of sight vs. joint effort
 - Deferrals into funds by asset management participants
- Continuing towards more sensible termination provisions
 - Leaving industry receiving more favorable treatment

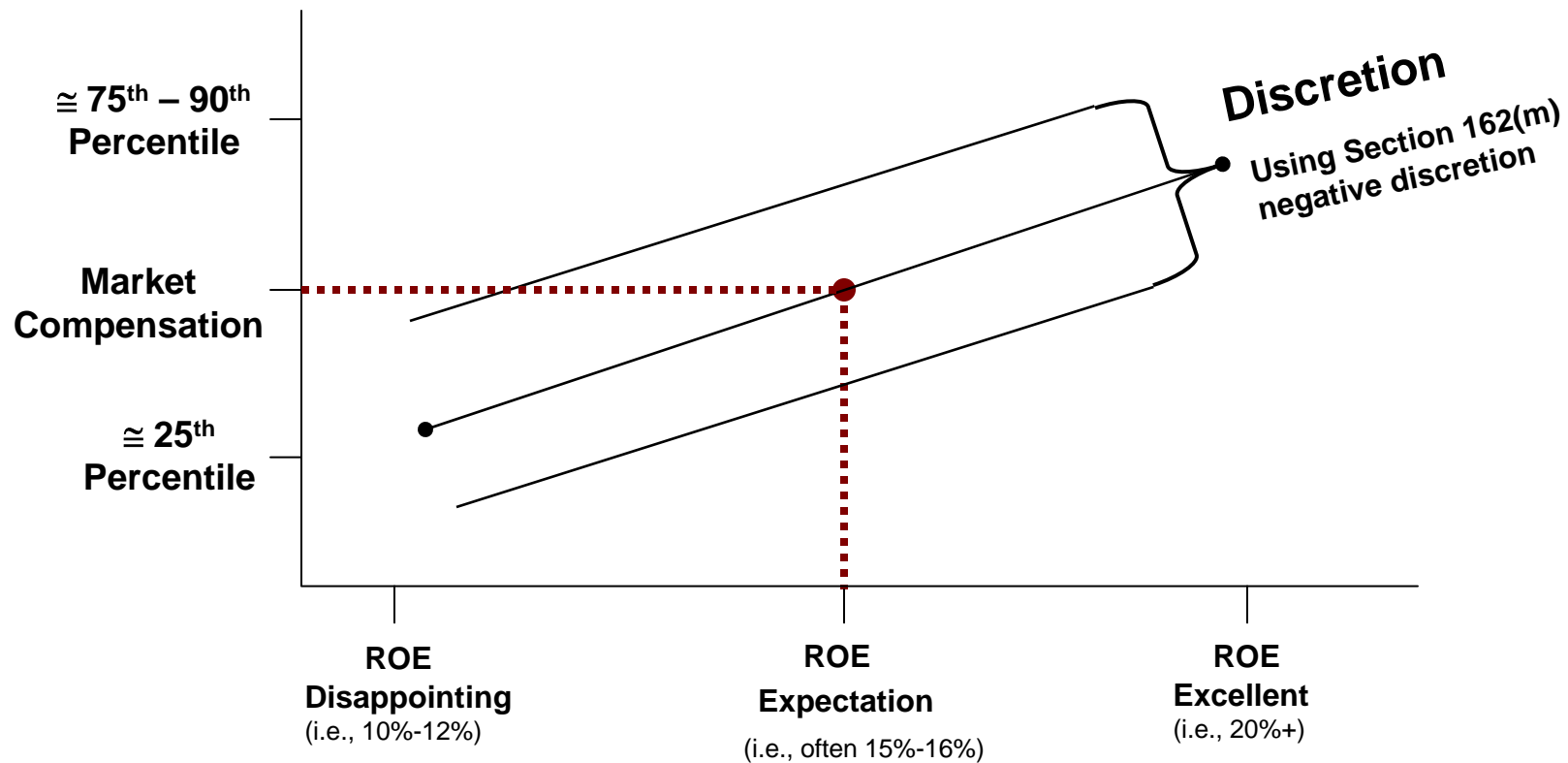
Equity Alternatives Providing Enhanced Leverage

- Indexed stock options
 - Exercise price adjusted up or down, for movements in prices of comparators
 - Receiving 2x+ number of options provides leverage and reduces impact of broad market movements
 - Requires clear comparator group
- Barrier stock options
 - Grants not exercisable until a high future price achieved
 - For example, current market price \$125 and barrier of \$240. If and only if \$240 reached, can realize gain back to \$125 original market
- Performance restricted stock (ala recent Merrill Lynch)
 - Earn variable number of restricted shares on absolute or relative financial results (i.e., ROE)

* Examples of alternatives being explored under new accounting parameters

Executive Compensation Driven by Absolute Returns

- Wall Street firms determine executive compensation primarily by absolute ROE
 - Absolute returns considered better than projections or budgets
 - Large changes in total compensation considered normal



- Predict 2006 compensation for proxy executives will be flat (or down)
 - One-time impact of new proxy disclosure and more inclusive format

Sales Compensation

- Emphasis on sales compensation across brokerage/high-net worth/asset management sectors
 - Difficulty in attracting assets in competitive market
 - Frustration by firm management as sales cycles become longer and less real understanding of driving factors
- Firms providing aggressive up-front payments for proven talent
- Narrow focus on “stars” makes hiring difficult and expensive
 - Little real interest in development or training programs
 - Continued compensation reductions for lower level producers
- Major producers increasingly concerned about retirement liquidity
 - “Book” monetized by incentive split with new professional
- Objective compensation continues to dominate
 - Exception is alternative products where institutional sales often discretionary and problems with formula-based compensation
- Increased deferral levels more akin to firm wide plans

Investment Banking

- 2005 compensation for senior professionals significantly higher
 - 2006 compensation will also increase significantly (i.e., 20% higher)
 - Declining compensation subsidy from trading
- View businesses are becoming “good” again even at reduced scale from peak
 - No longer enough to drive overall firm economics but key strategic element
- Reached equilibrium in research
 - Two-tiered market of few visible senior professionals and number of lower-level. Increasingly few mid-level professionals
 - Buy-side research can now pay better with enhanced careers
 - Unbundling of trading and research. Inevitable failure of regulator driven independent research
- Meaningful hiring (i.e., 10%+) reflecting capacity constraints
 - Examples of exaggerated compensation in hiring attractive entry professionals

Asset Management – Compensation Problems

- Trying to jam asset management into Wall Street pay and business norms creates underperformance
 - Asset management long-tailed business with heavy mix of structured pay
- Unit senior management
 - Income based incentive with discretion
 - Budget achievement and “partner” sharing of profits common
- Sales
 - Formalized sales plans with heavy weighting on new assets/retention vs. client service
- Investment management
 - Structured and leveraged program at individual/team level focusing on multi-year returns against benchmarks and peers
 - $\cong 20\%$ to recognize broader contributions and sales support
 - Deferral into funds in lieu of firm equity
- With three separate approaches difficult for institutions trying for broad incentive funding or comparability

Private Equity - Belated Rebirth

- Increasing emphasis, from low point, on private equity and venture capital
 - Lag in compensation vis-à-vis independent competitors
 - Real and perceived conflict issues hard to overcome...but firms now recognize they need product for high-net worth
- Long-tailed businesses and compensation
 - Appropriate carry design and governance crucial (i.e., vesting, investment decisions, business decisions, etc.)
 - Carry at institutional firms often 10-15 points reflecting firm economics and importance of fund raising support
- Viable independent competitors drive market
 - Have long time frames and lack pressures of public reporting
 - Without perceived conflicts-of interest

Hedge Funds

- Hedge funds and Fund-of-Funds have different compensations norms
 - Owners/Firm receive greater proportion of economics in F-o-Fs
 - More hierarchical structure in F-o-F, with few key professionals
- New issue for institutional firms is potential for hedge fund liquidity. Increases pressure for ownership by professionals
 - Business dominated by independents who increasingly provide ownership beyond founders
- Design details such as measuring results at fund/product/firm level has crucial impact on potential risk profile and culture
 - Need to have blend of transparency, stability, and flexibility
 - Fundamental business practices
 - Consideration to leveraged compensation curves
- Management fee and carry provide impressive economics

Illustration of Independent Hedge Fund Dynamics

- \$2 billion hedge fund (medium sized)
- 15% net return with 20% carry
- Senior partner total compensation = \$25 million
- 8 others partners = \$3-\$15 million

Summary and Advice

- 2006 will be another year of moderately increasing compensation and results
- Use and explain compensation data more thoughtfully/aggressively
- Overly heavy mix of restricted stock wrongheaded
 - Need continued leverage in equity compensation
 - FAS 123R valuations not always intuitive, no clear incentive to creativity/risk
- More explicit unit incentive funding formulas
- 2006 compensation for proxy executives flat
 - One-time impact of new more inclusive disclosure requirements
- Aggressive sales compensation plans and expectations
- Wall Street bungled asset management and private equity
 - Need market-based compensation and reward systems
- Hedge funds and alternatives
 - Increasing importance but dramatic work needed on compensation and business practices. Non-linear compensation considered
- Gardening leave and variations should be aggressively applied recognizing firm cultures and equity provisions
- Wall Street is clearly on upswing but hampered by lack of compensation flexibility and at times insular thinking...