2012 U.S. Asset Management Compensation Report

Q4 2012

Executive Summary

Incentive compensation levels in the asset management industry are projected to increase about 0–10% this year, following a period of flat compensation from 2010 to 2011. Those results reflect an industry that, like the economy and financial markets in general, is slowly regaining strength but lacks conviction and awaits a more robust recovery.

Amid relatively restrained hiring activity and industry uncertainty, we have identified the following trends for consideration by investment and trading professionals as they evaluate their current compensation levels and contemplate career choices:

Fixed-income incentive growth surpassing equities, for now: Although this trend might reverse if a sustained economic recovery takes hold next year, markets have been awaiting just such a turnaround for the past two years.

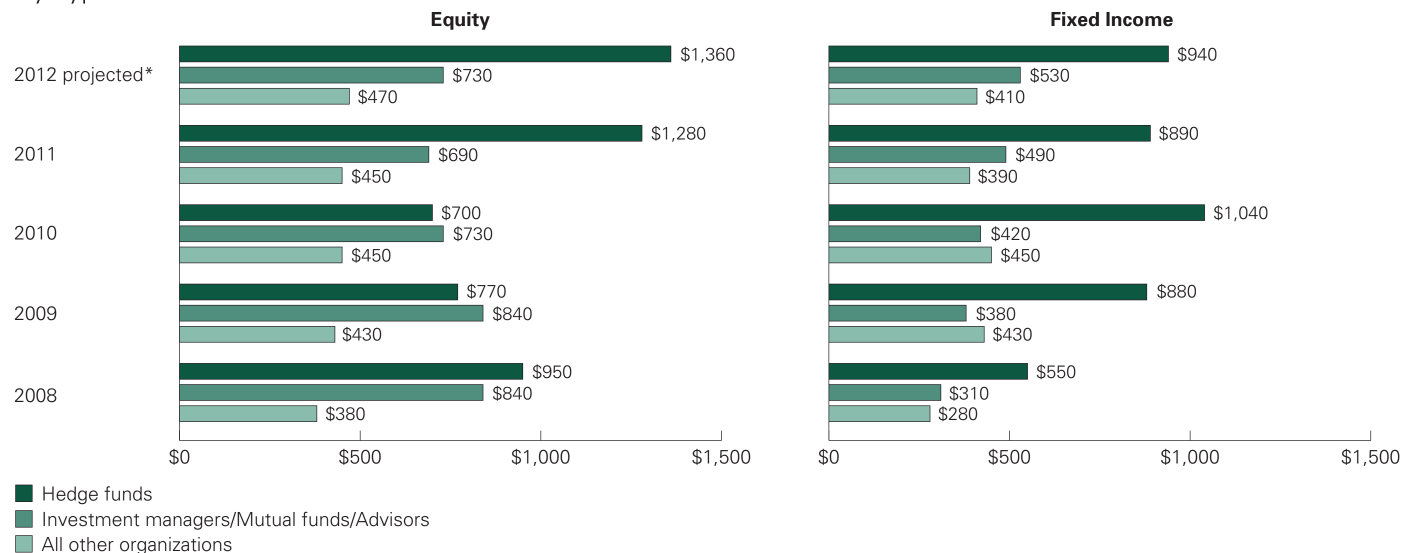
Private and independent managers face less regulatory scrutiny than captives: Regulations imposed on bank-owned asset managers, also known as "captives," have created an important divide in compensation practices within the industry.

Hedge funds offer risk lovers higher pay potential: Hedge fund professionals in both equity and fixed income earn nearly twice the amount paid to their counterparts at traditional management firms. Of course, the performance of some hedge fund strategies and managers in 2012 has served as a reminder that the big paychecks earned by hedge fund professionals come with big risks.

Demand increasing for specialized funds; decreasing for core funds: In the new, low-return environment, investors are shifting assets away from traditional core and domestic asset classes to more international and specialized funds perceived as having a better chance of delivering alpha. The lesson for investment professionals: Specialize, specialize, specialize.

In this paper, we will provide further commentary and analysis around these trends, as well as:

- Present benchmarks on 2012 compensation, including analysis of trends in asset management salaries, bonuses and long-term incentives;
- Discuss pay differentials among hedge funds and other types of asset management firms;
- Analyze the impact of new financial service regulations on asset management compensation;
- Analyze changes in compensation structures.



Note: Rounded data in $000s. "All other organizations" includes weighted average results from banks, insurance companies, government agencies, and other.
Source 2008-11: Greenwich Associates U.S. Equity and Fixed-Income Investors Compensation Benchmarks Studies
Source 2012: Johnson Associates projections on changes from Greenwich Associates 2011 data

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> **About This Report**
> Greenwich Associates and Johnson Associates present the key findings of a joint 2012 Asset Management Compensation Study. Results are based on data collected by Greenwich Associates through telephone and in-person interviews with more than 1,000 financial professionals in equity and fixed-income investor groups at investment management firms, mutual funds, hedge funds, banks, insurance companies, government agencies, and pension and endowments.
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> Armed with this self-reported data as a baseline, Johnson Associates uses proprietary information on compensation and other industry data to project compensation levels and trends for 2012. Johnson Associates actively monitors compensation trends and issues through intensive research and ongoing client assignments. In select areas, the self-reported information from investment professionals may not necessarily align directly with overall market trends. Some of these variances can be explained by different sample sets of professionals year-over-year, or specific circumstances related to individuals (transfers, new hires, promotions, change of job, etc.).

Compensation Trends

Base salaries inch up, incentives better

A variety of factors affected investment management hiring activity and compensation in 2012, including:

- Industry AUM growth driven by market appreciation;
- Stagnant net inflows;
- Historically low interest rates;
- Low yields and inconsistent investment returns;
- Shifts in institutional investment strategies;
- New bank regulations;
- Public scrutiny on compensation for all publicly traded companies.

These conditions have led to a modest increase in base salaries and slightly stronger growth in incentives. Greenwich Associates and Johnson Associates project an average increase of 3.5% in base salaries (including merit-based increases and adjustments) and growth of up to 10% for incentives from 2011 to 2012. Following several years of growth in deferred compensation, the mix of pay among salary, bonuses and deferred compensation remained stable through the 2011 to 2012 period.

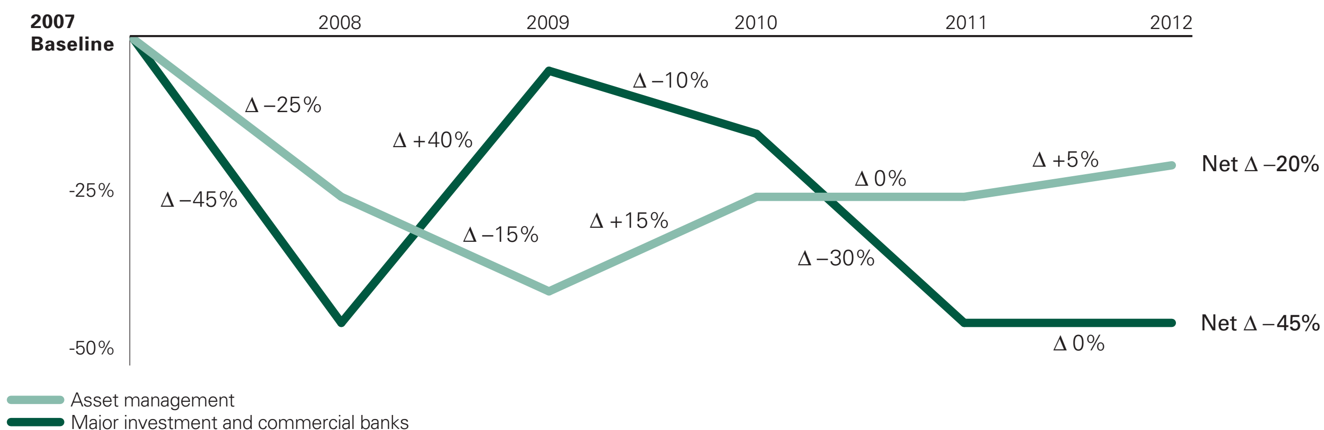
The relatively soft projected 3.5% increase in base salary growth can be attributed to two main factors: First, relative to other areas of financial services, salaries in the asset management industry are already quite competitive. Second, asset management industry bonuses have to this point largely avoided the eye of regulators and the investing public. Outside of captive management firms that continue to increase salaries at the expense of incentives and publicly traded firms that have come under fire for the make-up of senior executive compensation packages, asset management firms overall have felt little pressure to increase salaries and rein in bonuses.

Fixed-income compensation growth surpassing equities, for now

Although buy-side equity professionals out-earn their counterparts in fixed income on average, incentive growth in fixed income is projected to outpace that in equities in 2012 due to the flow of funds into fixed income and the uneven performance of equity funds. In equities, buy-side professionals can expect the 3.5% base salary increase for 2012 to be coupled with incentive compensation that is flat to just 5% higher than 2011 levels. Fixed-income professionals can expect slightly stronger growth in incentives, with increases projected between 5% and 10% from 2011 to 2012.

Greenwich Associates and Johnson Associates expect demand for fixed-income talent to continue outpacing

Estimated Average Change in Incentives for Senior Investment Professionals, 2007 – 2012



Source: Johnson Associates

demand in equities for as long as current market conditions of historically low interest rates and a start-and-stop economic recovery remain in place. However, when an economic recovery begins to gain steam, hiring and compensation growth should begin to even out as equity professionals see pay levels climb in step with stronger inflows and overall AUM growth.

Private and independent managers face less regulatory scrutiny than captives

Captive asset managers have been hit by a range of regulatory dictates aimed at reining in risk and "excessive" compensation levels at parent banks and sister investment banks. Among the rules affecting employee compensation at captive investment management firms are mandates for high rates of deferred compensation and clawbacks. Together with the continuing balance sheet and performance troubles of some major banks and the ongoing public scrutiny of large financial service firms, these compensation measures have decreased the appeal of captive firms as employers for buy-side professionals.

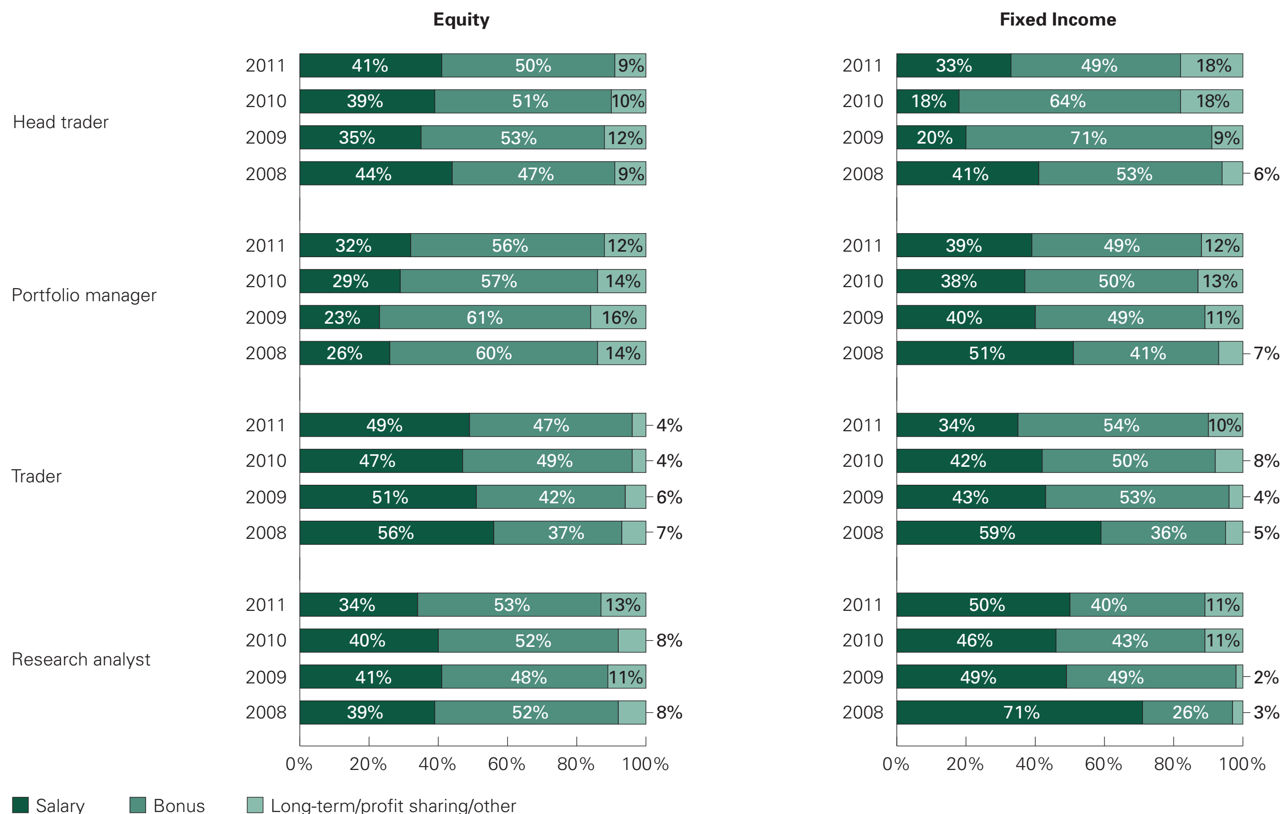
"Although the rest of the asset management industry has to this point not found itself directly in the regulatory crosshairs, independent firms find themselves hardly immune from pressure to reform compensation practices," says Greenwich Associates Analyst Kevin Kozlowski.

Indeed, industry compensation practices over the past 12 months continued to evolve in the direction of higher base salaries, increased use of long-term/deferred compensation and greater transparency in the design of incentives and sales compensation plans.

While some of this pressure to change compensation practices can be seen as a direct "spillover" from specific regulations imposed on other financial service firms, much of the change in compensation structure is being driven by demands from institutional investors, investment consultants and, in the case of publicly traded companies, activist shareholder groups.

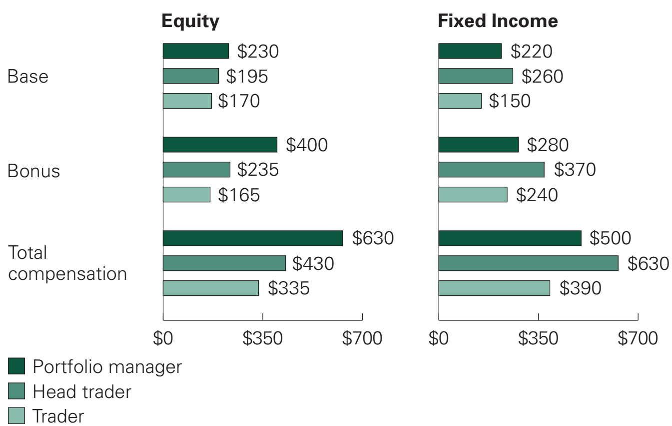
Proxy advisors have been pushing financial service companies of all types to reduce executive compensation and, in particular, to link executive compensation to clearly defined performance metrics such as net income, return on equity and total shareholder returns. Both public and privately-held asset management companies are also under pressure from institutional investors and investment consultants to adjust compensation and structures in ways that support long-term investment performance. More specifically, investor groups are asking investment firms to properly align interests and preserve continuity in the investment staff.

Estimated Mix of Pay for Senior Investment Professionals



Note: Estimated split of cash compensation between salary and bonus. Incorporated retirement across salary, bonus and long-term/profit sharing/other. May not total 100% due to rounding.
Source: 2012 Greenwich Associates U.S. Equity and Fixed Income Investors Compensation Benchmark Studies

Compensation Comparison, 2011
By Job Type
(in U.S. $000s)



Note: Rounded figures based on respondents reporting dollar figures to Greenwich Associates. May not be same respondents reporting percentage mix of pay.
Source: 2011 U.S. Fixed-Income and Equity Investors Compensation Benchmarks Studies

The upshot for buy-side professionals: For the foreseeable future, employees of captive investment management firms will see their pay affected by fluctuations in incentives, and possibly clawbacks, not necessarily triggered by their own performance — or even the performance of the asset management business — but rather by the overall performance of their investment banks and other units of parent banks. Asset management professionals should take this reality into account when assessing employment opportunities and comparing overall compensation packages. "Elsewhere in the industry, demands from investors and consultants will continue pushing compensation norms in the direction of incentives that link employee interests with long-term performance," says Johnson Associates Vice President Andria Cardillo."

Hedge funds offer risk lovers higher pay potential

Evolving compensation standards could widen the divide between traditional asset management companies and hedge funds. Hedge funds, without much pressure from investors or any external constituencies, will remain most flexible when it comes to setting compensation packages.

In 2011 hedge fund professionals earned approximately 1.8 times the amount taken home by their counterparts in traditional asset management firms. In fixed income, that differential was actually down from 2010, when hedge fund professionals out-earned employees of traditional management companies by 2.4 times. For equity professionals, the pay differential between hedge funds and traditional firms expanded over the period from a state of rough parity in 2010.

Currently, Greenwich Associates and Johnson Associates do not project increased variation in compensation between hedge funds and traditional firms in the short to medium term. It is important to note, however, that certain hedge fund strategies have experienced poor performance in 2012 — a result that will negatively impact the incentive-weighted compensation of investment and trading professionals employed by funds using these strategies.

At a broader level, an asset management professional should be aware of the high degree of risk that comes with moving to a hedge fund. While hedge fund payouts can appear tempting, there is the likelihood of huge swings in compensation. Any significant change to hedge fund net inflows, fees and investor redemptions — whether positive or negative — will impact incentive compensation.

Asset management professionals should consider other factors when weighing career opportunities, including the ability for large, traditional firms to afford portfolio managers full-time focus on their portfolios. In contrast, hedge funds frequently call on portfolio managers to more actively assist sales teams in prospect calls and presentations. "In our experience, it's the nature of the professional that determines the best fit," says Johnson Associates Managing Director Francine McKenzie. "People who are entrepreneurial will thrive in a hedge fund setting, while others do best with bigger firms that offer more stability and support."

Demand increasing for specialized funds; decreasing for core funds

Amid the slow hiring activity of the past year, demand for talent remained consistent among managers operating specialized investment funds. The reason: In both equities and fixed income, U.S. institutions are abandoning active core and core-plus mandates in favor of alternatives like emerging markets, high yield and global mandates.

In fixed income, the share of U.S. institutions employing core mandates declined to 44% in 2011 from 67% in 2010 and the share using core-plus mandates fell to 24% from 38%, according to the results of Greenwich Associates' most recent U.S. Investment Management Study. A similar "disaggregation trend" is playing out in international equities, in which institutional assets are flowing out of global and EAFE products and into ACWI ex-U.S. and seemingly more attractive emerging market mandates.

"Over the long-term, these trends will result in fewer opportunities for buy-side professionals in traditional core mandates — especially core U.S. equities," says Kevin Kozlowski.

"On the other hand, we are already seeing meaningful levels of demand for talent in international and specialized investments and we expect this demand to translate into increased compensation in these areas in coming months," says Francine McKenzie.

In Deferred Compensation, Firms Aim for Direct Line of Sight

Institutional investors and consultants are pushing asset management firms to implement deferred compensation structures that ensure the economic participation of senior professionals in the firm's investment funds or the business units they help run.

Among highly-paid senior professionals at publicly-traded asset management firms, 30–50% of incentives take the form of deferred compensation. While that share is generally smaller at private firms and boutiques, these firms still defer about 20–30% of incentive pay for senior professionals.

Corporate equity awards have long served as the standard deferred compensation vehicle. However, many firms are moving away from general corporate equity and toward instruments that give professionals direct participation in investment funds and/or equity in captive or subsidiary units. One main exception: Corporate equity remains the norm for top executives with direct responsibility for enterprise performance. "The industry is shifting in this direction because firms, investors and investment consultants have determined that participation in businesses in which the employee has direct line of sight are much more effective in motivating professionals, retaining key personnel and properly aligning long-term interests," says Andria Cardillo.

In the coming year, we expect asset management firms to continue experimenting with different blends incorporating participation in flagship funds, a representative set of the company's funds, corporate equity and/or captive or subsidiary equity. In addition to increasing staff motivation and retention, such blends provide professionals with important diversification as their deferred compensation awards grow.

Long-Term Incentive Plans Regaining Popularity

Long-term incentive plans (LTIPs) fell out of favor in the run-up to the global financial crisis as equity awards, particularly stock options, surged in popularity. The market downturn then knocked stock options out of favor as it plunged option packages under water. Asset management companies, however, did not initially choose LTIPs as an alternative component of executive compensation packages. The reason: In the immediate wake of the crisis, volatility and uncertainty about even near-term performance made it difficult to determine realistic goals and metrics. As a result, the industry gravitated to restricted stock, which has now become the main component of many deferred compensation packages.

Recently, shareholder advisory groups such as Institutional Shareholder Services and Glass Lewis have criticized simple time-vested restricted stock and pushed financial service firms to tie deferred compensation to performance. Financial service firms first responded to this pressure by implementing performance-linked vesting, or vesting contingent on the achievement of specific financial targets or stock returns.

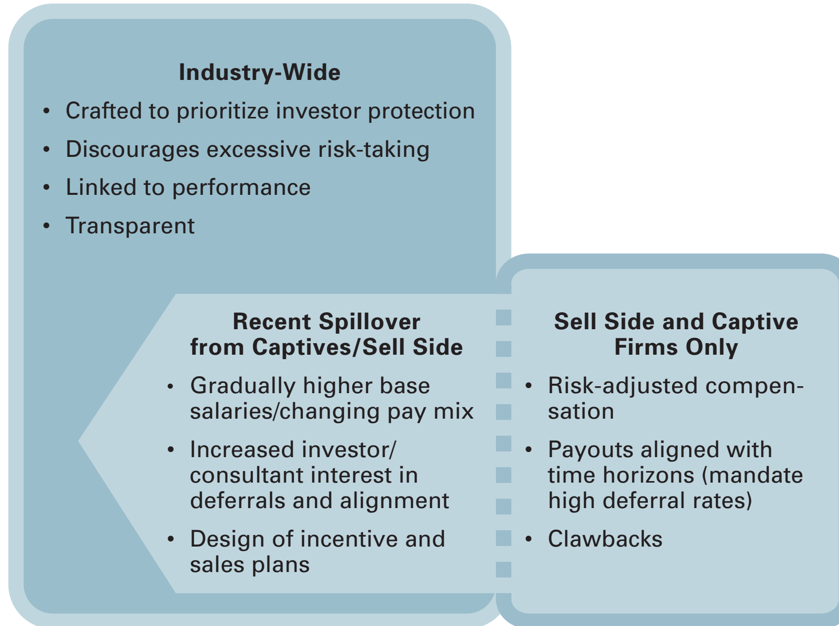
More recently, many firms have moved to separate programs with scalable awards based on performance as defined by specific metrics such as net income, returns on equity and shareholder returns. "While such structures are not required in a private setting, we expect similar practices to take hold among privately held asset managers, perhaps with more creativity in design, such as linking compensation awards to strategic goals in addition to financial performance," says Francine McKenzie.

Deferred Compensation Vehicles

	Market Practice	Analysis
Corporate Equity	Common: Traditional deferred compensation vehicle	Potentially sensible for executives/heads within captive units of broader firms, recognizing a role in the overall enterprise
Investment Funds	Common: Flagship fund or representative set of funds	Clients/consultants increasingly require fund professionals to invest in funds for alignment and retention
Blend of Corporate Equity and Fund Investment	Increasingly Common: Combination of fund investment and firm equity to provide varying motivations	Helpful for diversification as magnitude of deferral increases
Cash Deferral	Less Common: Cash deferrals earn a market rate of return or a return consistent with the business	Firms should consider providing enhanced return such as (i) money market rate + (ii) moderate premium
Captive/Subsidiary Equity	Less Common, but Best Practice: Effective as long-term/deferral tool for captive units	Direct ownership stake in a captive business helpful for motivating, retaining and aligning professionals over the long term (i.e., encourages maximum value creation and entrepreneurial mindset)

Note: Usage typically varies depending on public/private firm status.

Evolution of Compensation Best Practices



Conclusion

In aggregate, the compensation structure practices and changes discussed in this paper point to an industry moving toward a new set of best practices. These industry standards are being shaped by managers adapting to a changing business environment and to the demands of regulators, investors, consultants and shareholder groups who are calling for compensation practices that:

- Prioritize the protection of investor/client assets above all else.
- Discourage — or at least not encourage — excessive risk-taking.
- Link pay to performance.
- Provide transparency regarding drivers of compensation and effective governance/oversight.

At the current juncture in this best practices evolution, asset management professionals can potentially find better income opportunities in the less-scrutinized private and independent firms, but we expect compensation standards to continue spilling over into these firms in the coming years.

Contributors include Analyst Kevin Kozlowski and Senior Director, Relationship Manager Jennifer Litwin from Greenwich Associates and Managing Director Francine McKenzie and Vice President Andria Cardillo from Johnson Associates.

Methodology

Every year, Greenwich Associates collects data on buy-side compensation levels and practices through interviews with more than 1,000 financial professionals in equity and fixed-income investor groups. The data is based on the individual responses of study participants and is self-reported. Interviews are conducted by telephone and in-person.

Johnson Associates' 2012 projections reflect estimated changes from 2011 Greenwich Associates data. Johnson Associates uses proprietary information on compensation and other industry data to project compensation levels and trends for 2012.

Johnson Associates actively monitors compensation trends and issues through intensive research and ongoing client assignments. A long history consulting across business cycles provides Johnson Associates with a wealth of information to assist firms in navigating challenging markets and issues.

About Greenwich Associates

Greenwich Associates is the leading international research-based consulting firm in institutional financial services. Greenwich Associates' studies provide benefits to the buyers and sellers of financial services in the form of benchmark information on best practices and market intelligence on overall trends. Based in Stamford, Connecticut, with additional offices in London, Toronto, Tokyo, and Singapore, the firm offers over 100 research-based consulting programs to more than 250 global financial services companies. Please visit www.greenwich.com for more information.

About Johnson Associates

Johnson Associates is a boutique compensation consulting firm specializing in financial services. The firm has extensive experience advising high-end global and regional financial clients on an extensive range of compensation issues and practices. For additional information or background, please visit www.johnsonassociates.com.

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