

# A Changing Compensation Landscape

## Year-End 2007 & Significant 2008 Implications

### *Presentation and Discussion*

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**JOHNSON ASSOCIATES, INC.**

**19 West 44th Street, Suite 511, New York, New York 10036**

**(212) 221-7400 • Fax (212) 221-3191**

# Introduction

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- Key 2007 compensation directions and issues for financial firms and 2008 Indications

Johnson Associates	3
2007 Year-End –First Shoe Drops	4
2008 Fearless Predictions – Second shoe drops	6
Illustration of Conflicts	7
2007 vs. 2006 Changes in Key Indicators	8
2007 vs. 2006 Compensation as % of Net Revenues	9
2007 vs. 2006 Compensation as % of Pre-Tax Pre-Comp Income	10
2007 Typical Incentive Changes (Value of Cash Bonus and Equity)	11
Base Salary Levels	12
Long-Term Incentives	13
Compensation Exchange Rates Major Issue	14
Executive Compensation Funding	15
Sales Compensation	16
Investment Banking	17
Asset Management	18
Private Equity – Turmoil	19
Hedge Funds	20
Summary and Final Thoughts	21

# Johnson Associates

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- Independent compensation consulting firm specializing in financial services. Pure advice, annual and long-term incentive designs, market levels, agreements, and goals/measures. Equity and partnership considerations. Expertise and in-depth knowledge across comparator groups and labor markets
  - Experienced, opinionated and informed
- Diverse Clients
  - Investment and commercial banks
  - Asset management firms
  - Hedge funds/Private Equity/Fund-of-Funds/Alternatives
  - Insurance companies
  - Brokerage firms
  - Trading organizations

# 2007 Year-End – First Shoe Drops

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- First 7-8 months excellent, final 4-5 months on average down versus 2006
  - On average flat versus 2006
  - Strength in derivatives/Investment banking/Asset management/Equities
  - Fixed income flat
  - Down significantly in mortgages and select structured products. Weakness in commercial and retail banking
- Soft unofficial hiring freeze
  - Uncertainty for 2008
  - Lessons learned from technology bubble
  - Pressures at associate/VP level reduced
- Year-end 2007 driven by mortgage/structured product positioning
  - Clear winners and losers
  - More firm variations than for previous several years
- Steady compensation accrual rates.
  - International now prominent and self-sustaining
- Heavy restricted stock use continues
  - Stock options return in 2008

# 2007 Year-End – First Shoe Drops

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- Exchange rates/living costs major compensation issue
  - London costs/productivity driving higher compensation in Europe
  - No need to provide same compensation in Dallas vs. New York
- Importance of firm scale apparent and pronounced
  - Large firms outpace/outpay competitors
  - Across investment banks, alternatives, and asset management
- Competition across high-net worth and asset management/alternatives
  - Compensation and cultural conflicts with core businesses difficult
- Independent Hedge funds/Fund-of-Funds/Private Equity talent threats
  - Hiring for both front and back-office
  - Their compensation analyses include broader firms
- Massive credit overhang entering 2008
  - Valuation and liquidity of mortgages , and structured products
  - LBO loans and commitments
  - Retail book
  - Additional real estate expense

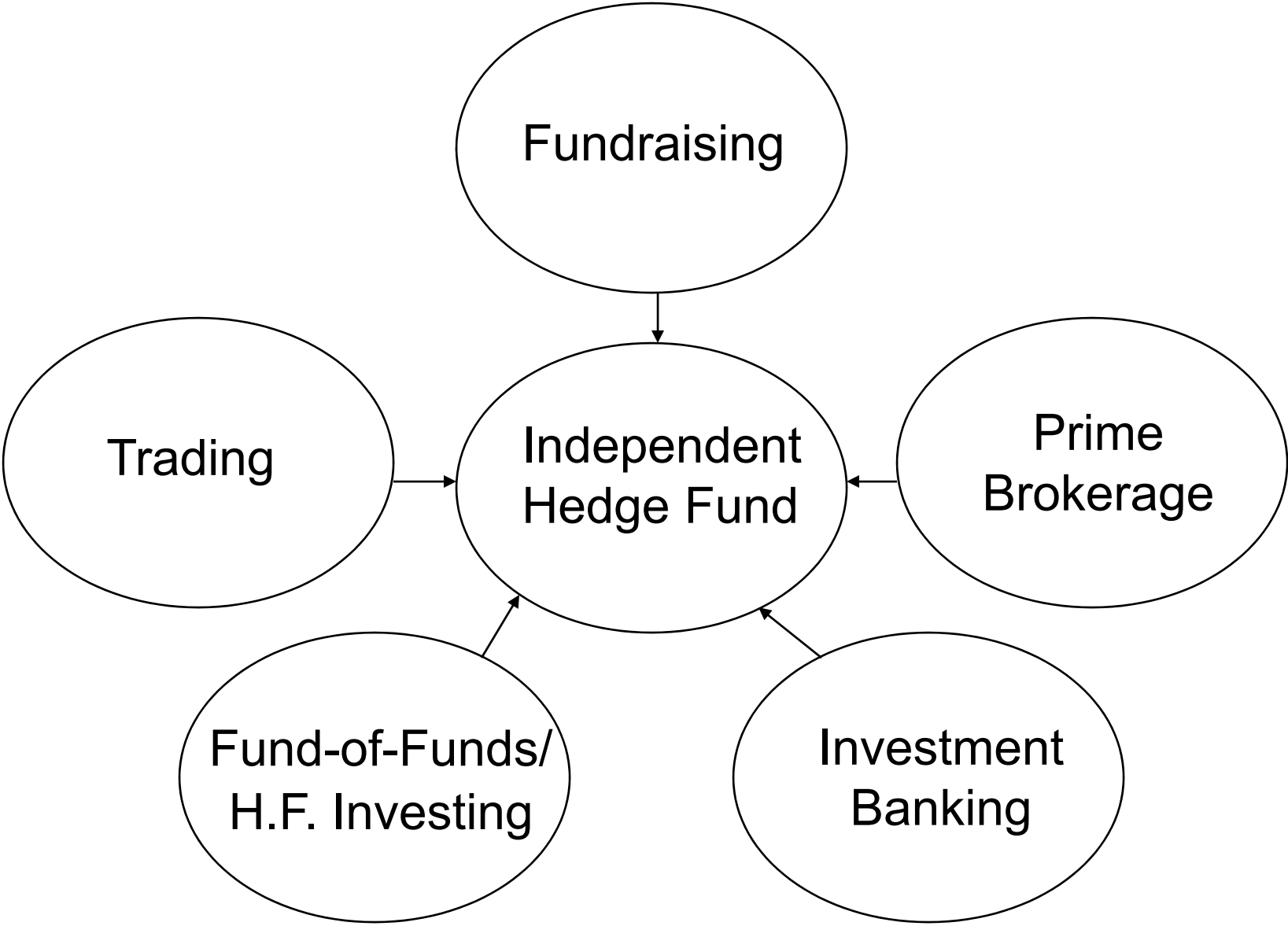
# 2008 Fearless Predictions – Second Shoe Drops

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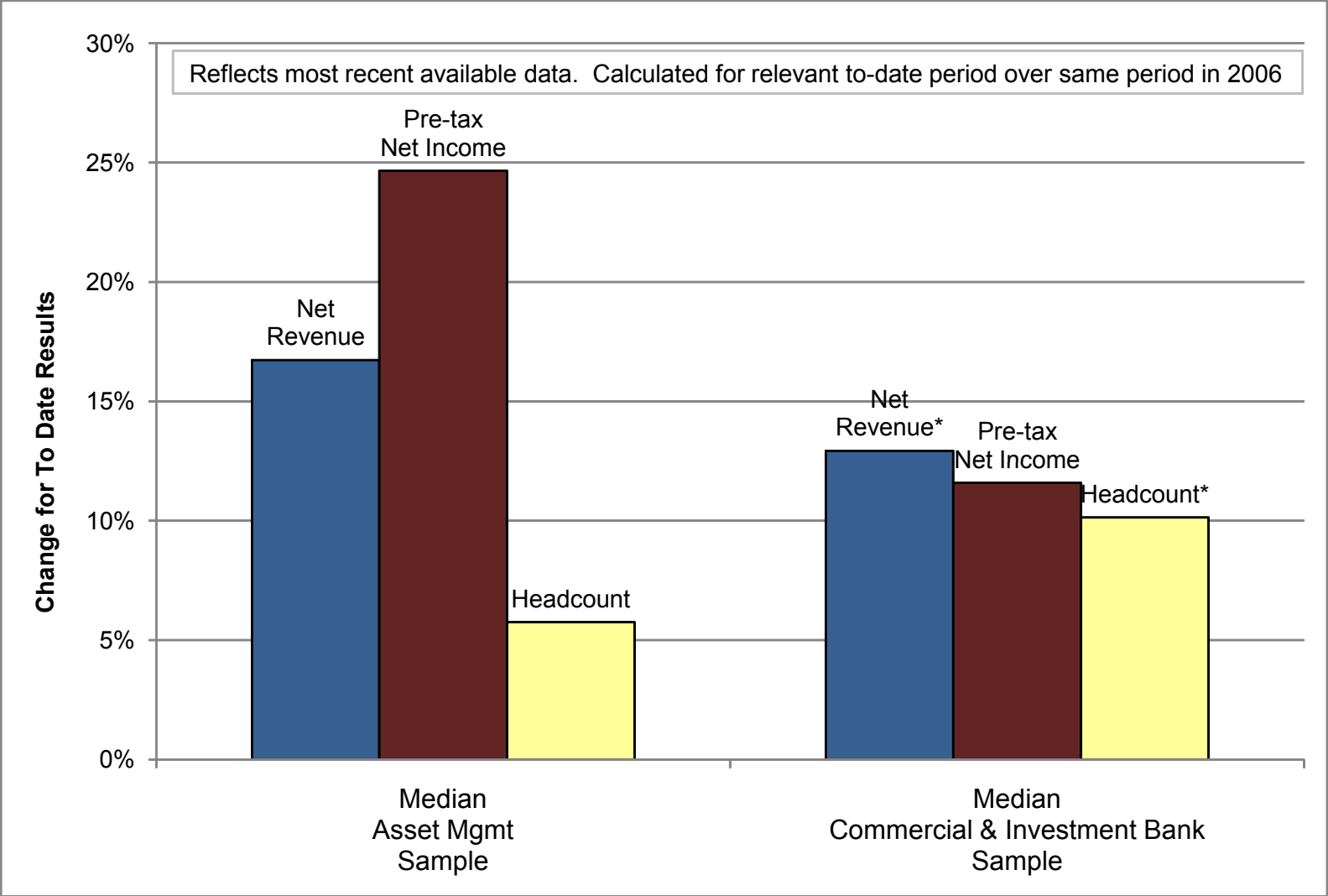
- 2008 difficult business and compensation environment
  - No momentum entering year
  - On-going credit and housing woes
  - More difficult trading environment
  - International opportunities positive
  - Asset management continues strong
  - Prime brokerage has first major test as hedge funds stressed
  - Pell-mell rush to alternatives abates
  - Retail and commercial banking under stress
- Major industry issue surrounding valuations on par with dot.com abuses
  - Potential for crushing financial and reputational impact, along with criminal prosecutions
- Conflicts continue for diversified firms
- Headcount flat (i.e., down 5-10% U.S., up 5-10% internationally)
- Outsourcing from high cost areas accelerates
- On broad basis 2008 incentives down 15-20% versus 2007
  - First down year since 2003

# Illustration of Conflicts

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# 2007 vs. 2006 Changes in Key Indicators

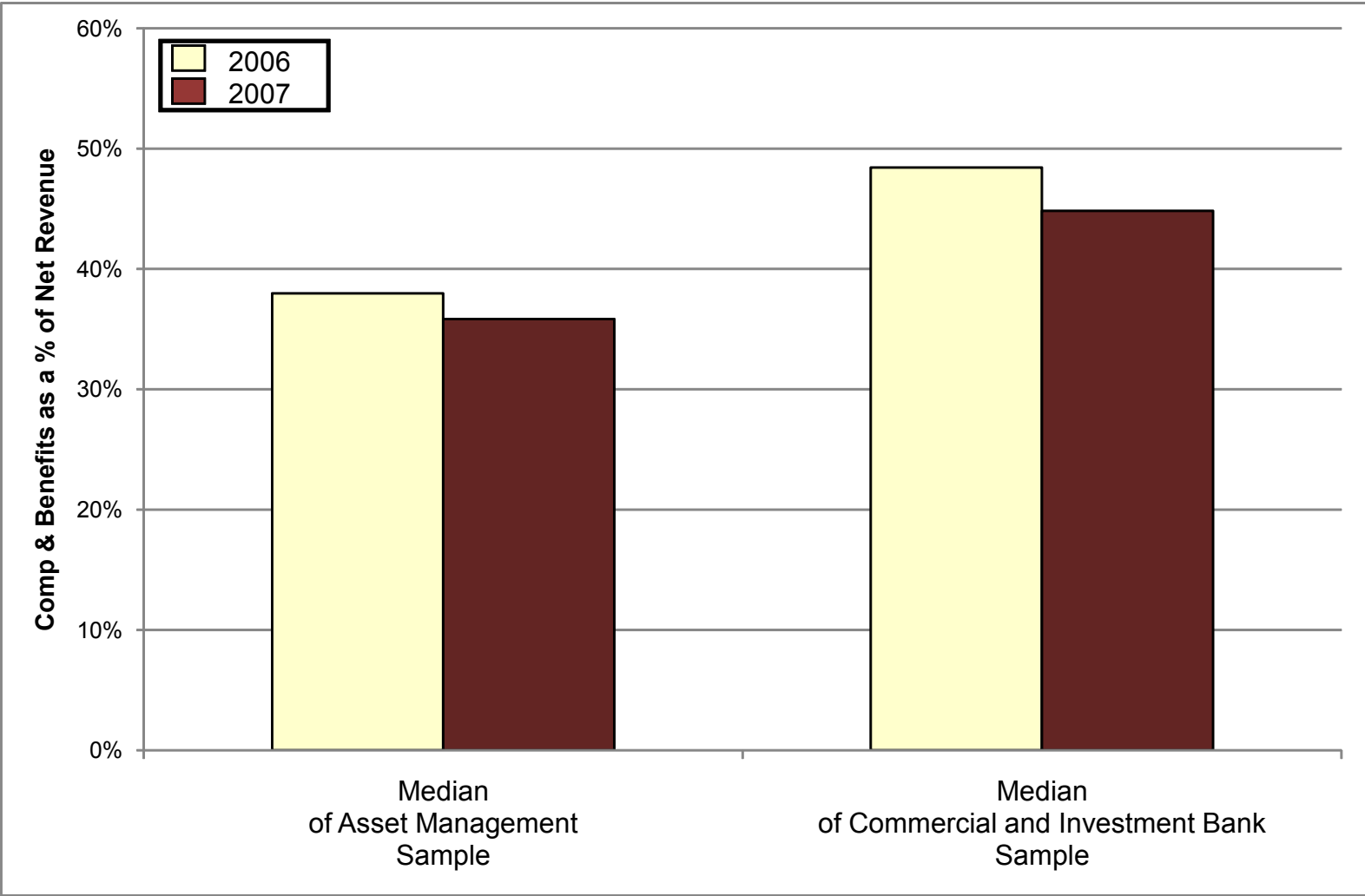


\* Expect results to decrease for full year



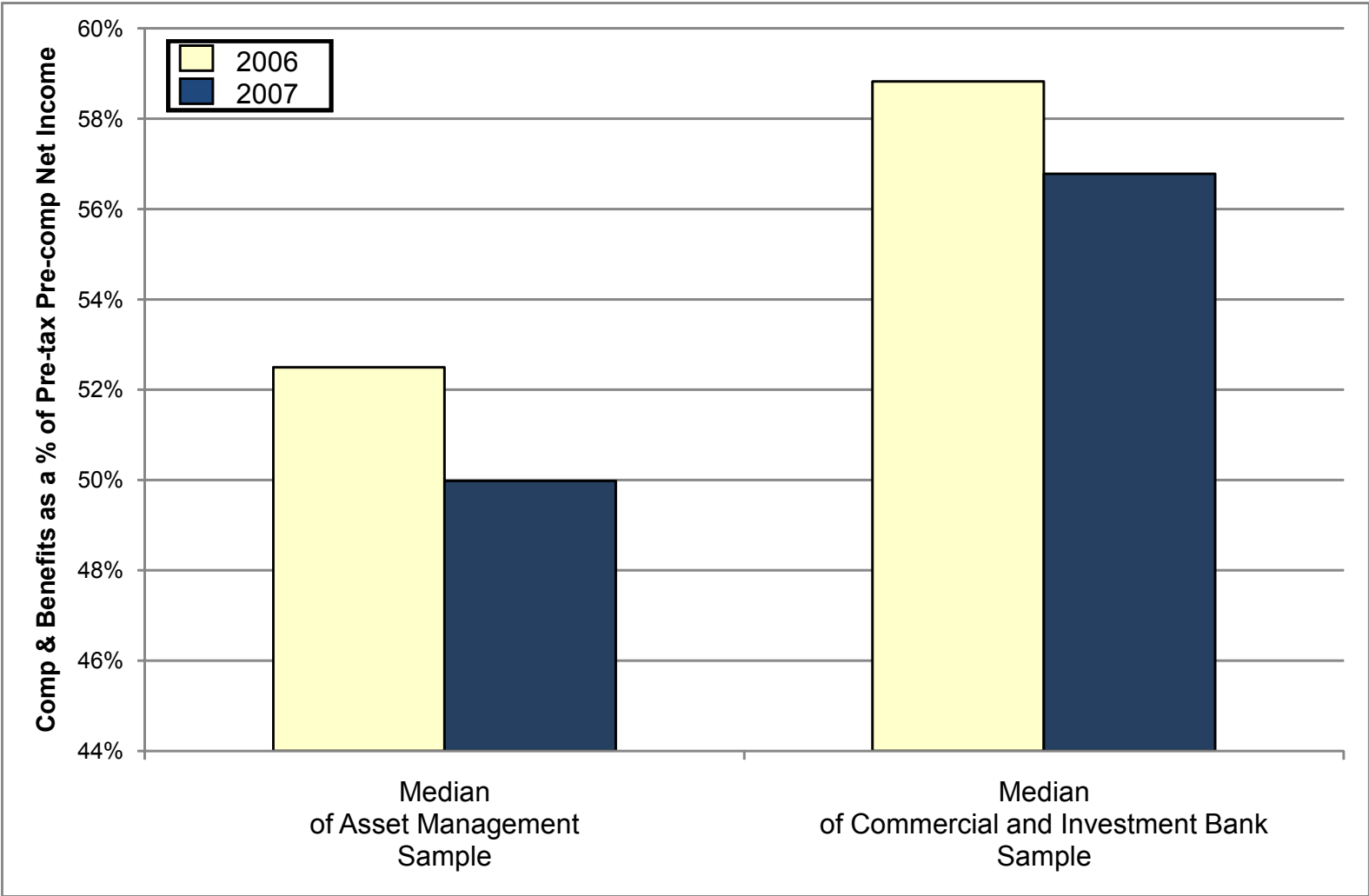
# 2007 vs. 2006 Compensation as % of Net Revenues

Notes:  
Reflects available year to date data  
Select ratios may be skewed high because of the incremental expense for retirement acceleration & SFAS 123R adoption

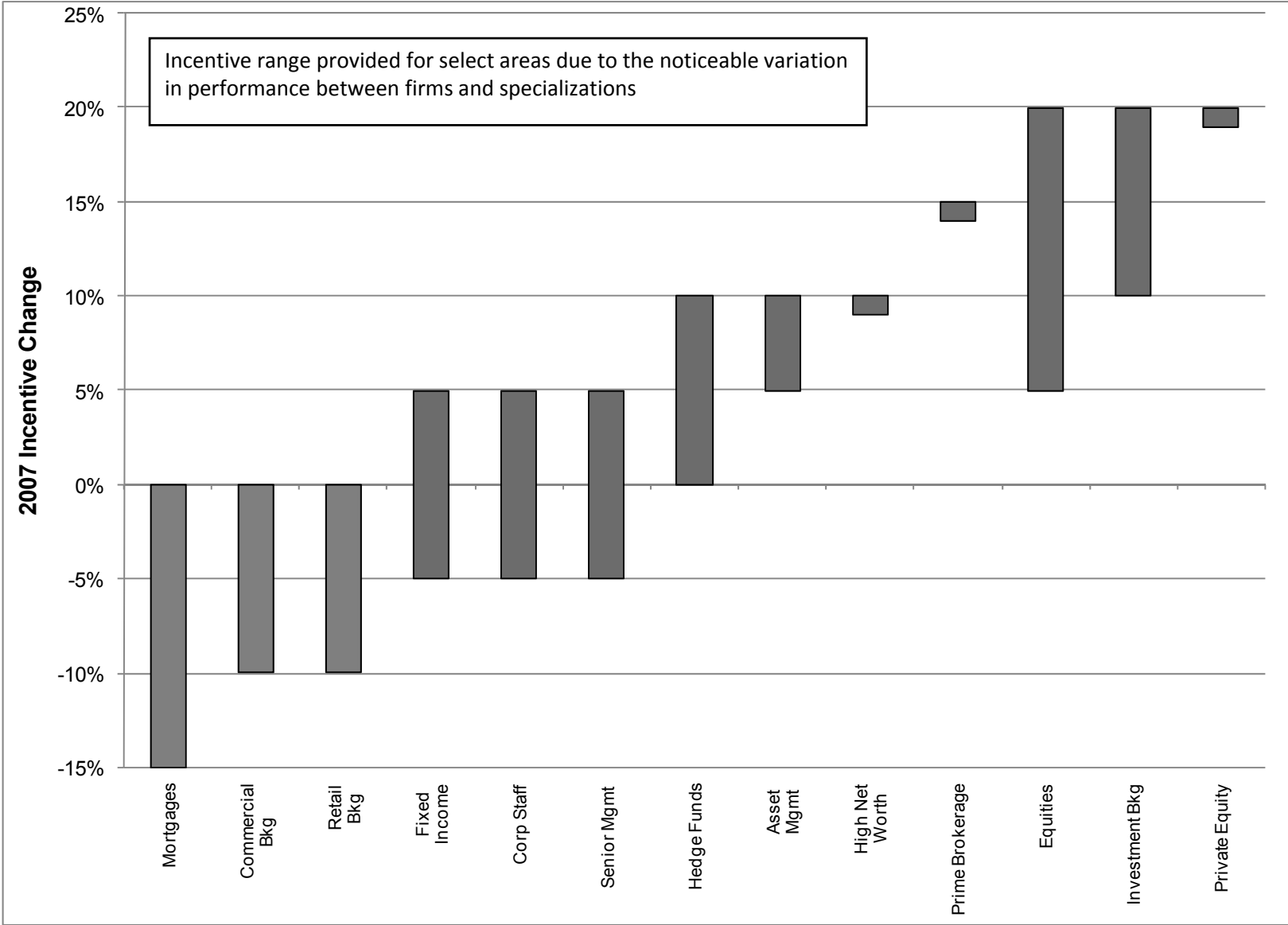


# 2007 vs. 2006 Compensation as % of Pre-Tax Pre-Comp Income

Notes:  
Reflects available year to date data  
Select ratios may be skewed high because of the incremental expense for retirement acceleration & SFAS 123R adoption



# 2007 Typical Incentive Changes (Value of Cash Bonus and Equity)



# Base Salary Levels

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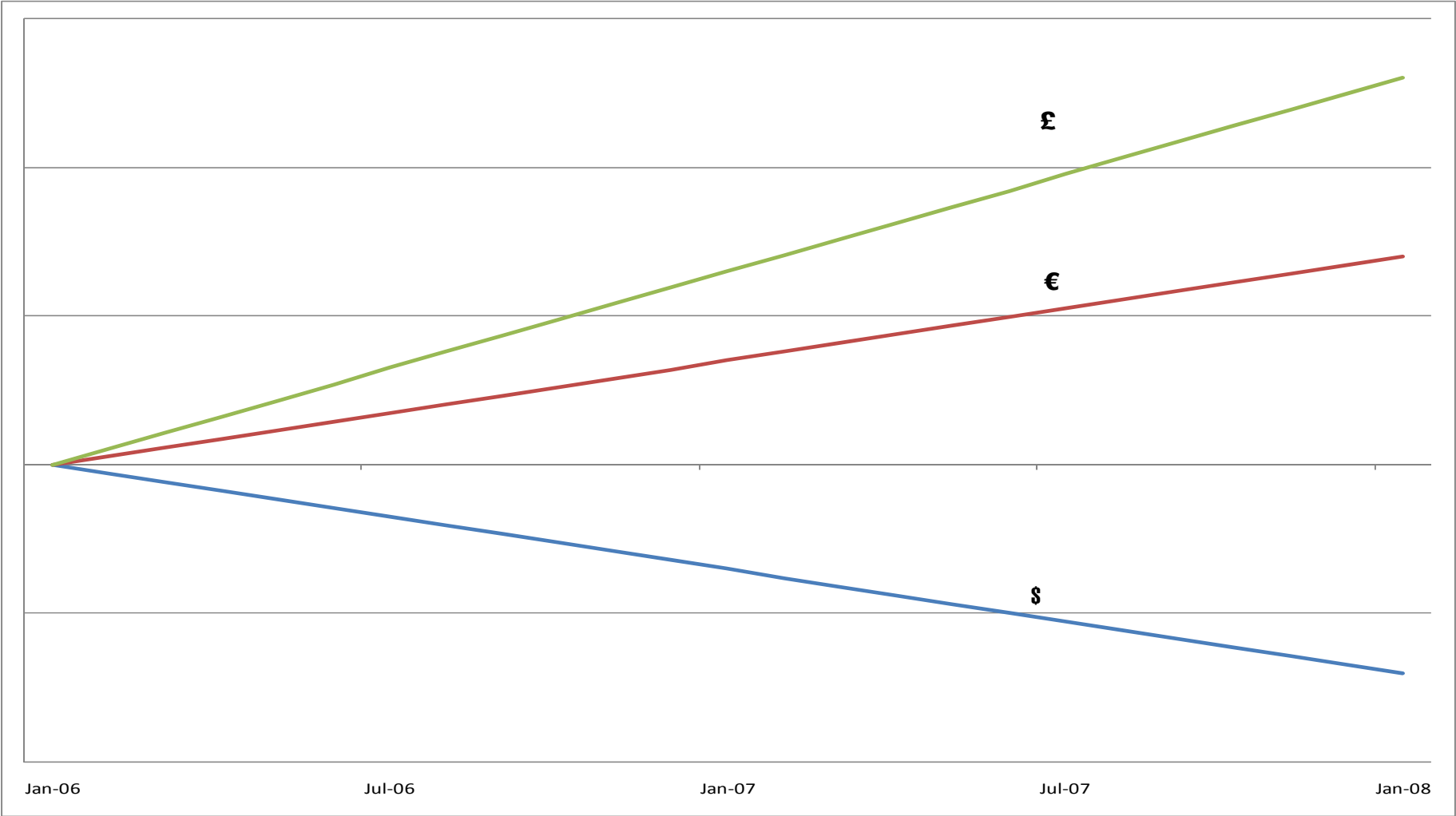
- Industry base salary levels continue at low level
  - $\cong$  4% increases continue as norm
- Low nominal base salaries do not mean reduced fixed compensation
  - Often other elements increased or expectations established (i.e., “salary portion of bonus”)
- Different market norms across businesses/units often not adequately recognized
  - Asset management and alternatives higher, along with some staff areas (i.e., technology and legal)

# Long-Term Incentives

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- Late summer “shocks” will result in continued heavy use of restricted stock, due to abbreviated time to consider choices
  - Expect greater 2008 use of stock options for more difficult compensation environment
- Heavy equity orientation program strength
  - Shareholder alignment key for senior professionals
  - To date minimized impact of ISS arbitrary guidelines
- For large diversified firms, effective single stock difficult
  - Deferrals into funds by asset management participants
  - Fund ownership by alternative professionals
  - Growth of subsidiary plans
- More sensible and specific termination provisions
  - Leaving industry receiving more favorable treatment

# Compensation Exchange Rates Major Issue



- Becoming increasingly complex to denominate world wide compensation in dollars and strive to have internationally consistency

# Executive Compensation Funding

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<b>Feature</b>	<b>Wall Street</b>	<b>Broader Financials</b>
Performance driver - Metrics	Absolute firm ROE financial	Budget and expectations financial and business bulding
Compensation perspective	Market rate	Target level
Business unit impact	Small impact	Moderate impact
Compensation Committee latitude	Significant latitude	Moderate latitude
Peer group	Small clear peer group	Broader generalized peer group
Equity/cash mix	Heavy equity	Heavy equity

# Sales Compensation

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- Emphasis on sales compensation across asset gathering businesses
  - Difficulty in attracting assets in competitive market
  - Frustration by firm management as sales cycles longer and less real understanding of driving factors
  - Less clarity on successful sales process and dynamics
- Little modeling of sales timing and predictors
  - Factors impacting timing and magnitudes
  - Real impact of sales professional vis-a-vis products/Firm
- Narrow focus on “stars” makes hiring difficult and expensive
  - Little real interest in development or training programs
  - Continued compensation reductions for lower level producers
- Objective compensation continues to dominate
  - Exception is alternatives where institutional sales often discretionary and problems with formula-based compensation



# Investment Banking

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- 2007 compensation for senior professionals higher
  - 2008 incentive compensation will decline materially (i.e., 20% or more down)
  - Subsidy from trading gone
- Reduced pipeline entering 2008 on built -out teams and resources
  - Capacity will exceed volumes
- Equilibrium in research
  - Two-tiered market of few visible seniors and number of lower-level. Increasingly few mid-level professionals
  - Buy-side research pays better with enhanced careers
  - Hedge funds continue to drive compensation equation
- Staff reductions reflecting excess capacity
  - Pattern of U.S. layoffs with hiring internationally

# Asset Management

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- Trying to jam asset management into Wall Street pay and business norms creates underperformance
  - Long-tailed business with heavy mix of structured pay
- Partner pay model common
  - Pre-agreed % of operating profit available for incentives
- Sales
  - “Commission” plans with weighting on new assets/retention
- 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
- More subsidiary equity programs evolving
  - Investor and consultant requirements
  - Lure of independent Firms

# Private Equity - Turmoil

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- Major structural problems in industry
  - Questionable transactions completed and huge funds raised
  - Wall Street has never really understood the business, shown sustained commitment, or been willing to walk away from the fees
- Long-tailed businesses and compensation
  - Appropriate carry design and governance crucial (i.e., vesting, investment and 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
  - Without perceived/real conflicts-of interest
  - Fund sizes provide ample compensation resources
- Scale major compensation consideration, particularly in London
  - Larger firms pay better/much better
  - Transparent compensation plans don't provide much cover

# Hedge Funds

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- 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
  - As sector matures, compensation norms become clearer
- New issue for institutional firms is potential for hedge fund liquidity. Increases significantly pressure for professional ownership
  - Independents who increasingly provide ownership beyond founders
  - Visible IPO's/transactions provide ready reference points (i.e., \$\$\$)
- 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
- Non-competes and non-solicits of crucial importance
  - Often fully appreciated by Wall Street Firms
  - Need aggressive stance to protect and stabilize key professionals

# Summary and Final Thoughts

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- 2007 is transition year to more difficult 2008
- Major upcoming issues surrounding valuations and conflicts
  - Potentially as significant as technology bubble concerns
- 2007 compensation for proxy executives down 15%
  - High 2006 and sensitive year for disclosure
- Stable headcount with domestic layoffs
- Wall Street struggling with asset management
  - Need market-based compensation and reward systems
- Hedge funds and alternatives
  - Increasing pressure as bubble deflates further
- Stock options will return in 2008
- Scale a major consideration
  - Across sectors and geography
  - Difficult to be “mid-sized”
- 2008 looks much more difficult
  - Little momentum entering year
  - Massive credit overhang
  - Slowing economy
  - Difficult comparisons to “good “ 2007
  - Additional housing exposures