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Competitive Challenges Best Practice Report: Compensation

March 2008

Compensation accounts for nearly 65% of total operating expense for the typical management firm — making it managers' single biggest expense. As both the industry's biggest cost center and the foundation of investment and overall performance, it is hardly a stretch to label compensation structure as the primary driver of asset management business strategy. As such, creating and maintaining an effective compensation structure should be at the top of the list of strategic priorities for owners and senior management.

Competitive Challenges Top 10 Best Practices for Compensation

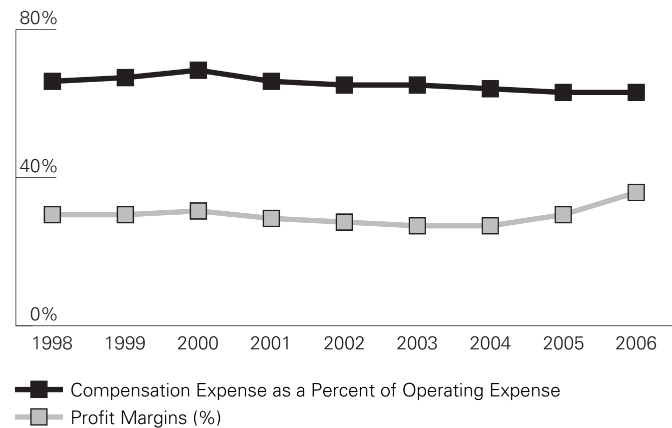
Few factors will have as much influence on the success or failure of an asset management firm as its compensation structure. In an industry in which business is won or lost on the basis of performance, the way a firm attracts, rewards and retains professional talent is perhaps the key determinant of its ability to win and keep clients and assets.

Greenwich Associates and Johnson Associates have compiled an outline of 10 compensation best practices to assist clients in building and maintaining effective compensation structures.

Best in class firms:

1. Align compensation structure with firm culture — both the culture they have and the culture they desire.
2. Recognize the need to provide high levels of compensation to high-performing employees in every department and up and down the org chart.
3. Create a culture of fairness across all employees including investments, sales and client service in compensation and all other measures of recognition.
4. Create detailed compensation structures that clearly communicate to employees what they must achieve in order to maximize their compensation.
5. Leave room in their compensation structures for discretion.
6. Use equity incentives to align the interests of employees with those of the firm and its clients.
7. Acknowledge the differences between alternative and traditional management businesses instead of downplaying them.
8. Avoid broad asset-based targets when designing compensation packages for sales professionals and do not go too far in limiting sales "trailers."
9. Use non-compete agreements to protect their businesses — not to punish departing employees.
10. Create compensation structures to meet long-term strategic goals and review compensation structure on an annual basis.

Compensation as a Percent of Operating Expense
U.S. Asset Management Firms



Note: Data above represents the average for each year.

To assist asset management firms in this critical task, Greenwich Associates Competitive Challenges examined the compensation practices and policies of 60 U.S. investment management firms. Working with compensation consultant Johnson Associates, we compared findings from the industry's top performers in terms of overall business results with those of the rest of the market. Through this process, we identified 10 compensation strategies common to "best-in-class" asset management organizations.

Greenwich Associates Competitive Challenges can provide asset management firms with detailed benchmarks on all the compensation issues discussed in this report. Our benchmark data cover every professional position within the typical asset management organization through a variety of metrics spanning investments, sales, client service, technology, firm management and other aspects of the business. The data is based on the results of the Competitive Challenges Study — the industry's most comprehensive annual research program — and allow Greenwich Associates' clients to benchmark their own compensation/total firm expense ratio and other key measures against those of peers and peer groups. Benchmark reports can be customized to peer groups based on size, strategy, product emphasis, location or other characteristics requested by our clients and study participants.

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"Each of the 10 strategies identified in our research represents an industry best practice that helps to drive the performance of the country's top investment management firms," says Greenwich Associates consultant Rodger Smith.

Many of the compensation practices presented in this report reflect broad strategic and philosophic guidelines that, if followed, help firms improve the effectiveness of their compensation structures in terms of attracting talent, retaining key employees and — perhaps most importantly — in aligning the interests and behaviors of employees with client interests and the strategy and goals of the firm. However, it is essential that firms understand there is no single template for an effective compensation structure. Because every asset management firm is unique in terms of culture, size, product mix, and business strategy, every organization must determine what compensation structure best meets the needs of the company, its people and its clients.

"Because of the key role that compensation will play in determining the success of any firm, it is important that owners and senior managers — most of whom do not have extensive experience with these issues — do not make strategic decisions about compensation structure in a vacuum," says Johnson Associates Managing Director Alan Johnson. "One trait common among many best-in-class firms is their use of external benchmarks, best practices and advice that improves the effectiveness of their compensation structures at both a tactical and strategic level."

1. Best-in-class managers align compensation structure with firm culture — both the culture they have and the culture they desire.

Best-in-class firms design compensation structures to produce the organizational culture they desire:

Compensation provides incentives. Incentives drive behavior. Behavior determines culture.

But high-performing firms also understand the risks and consequences of allowing compensation policies to deviate from culture as it currently exists. Too often, companies fall into the trap of claiming a certain culture but practicing something quite different. The most common example: professing a dedication to "teamwork" and "partnership" while maintaining compensation structures designed to reward individual performance.

"Most organizations would strongly deny that their culture or compensation practices are based on a 'star system,' but in reality, there is nothing wrong with a structure that encourages and rewards entrepreneurialism and individual success," says Johnson Associates Managing Director

Compensation Plan Structure and Transparency for a Unified Firm Culture

Compensation Aspect	*Formulaic (Fully Transparent)*	*Discretionary (Not Transparent)*
Desired Behavior/Culture	Firm or team focus; sharing of ideas with individual accountabilities	Firm or team focus; collaborative/franchise emphasis
Risk	May not fully reward top performers in years of poor firm performance; may over reward lower performers	Poor performance evaluation process can hurt credibility and can discourage entrepreneurial behavior; may not match predominant market practice among select products/areas (i.e., sales compensation); significant stress around year-end compensation
Incentive Funding	Firm results (i.e., % of profits); top down	Firm level - discretionary or % range (multiple factors can influence final funding)
Allocation	Profit units or individual % based on contribution; adjusted annually; allocated at beginning of year	Discretionary; established process for performance evaluation and consistency in rewarding high performers
Discretion	Little to none	Above average amount tied to firm/team
Equity	Broad participation; variation for individual performance	Broad participation
Communication	Funding formula and/or unit values fully communicated	Often opaque; individual goals/performance objectives may be determined; culture and consistency in process provides indirect communication

Francine McKenzie. "Asset management organizations have many variations on compensation structure and firm culture, ranging from individualist cultures in which compensation structures are entirely discretionary to unified or holistic cultures in which compensation processes are fully transparent. The important thing is to be realistic about what the firm wants and what the firm is. Employees are smart — they see through talk and understand what it is they are being rewarded for. When management says one thing and does another, its credibility is eroded and the compensation structure becomes less effective."

2. Best-in-class firms recognize the need to provide high levels of compensation to high-performing employees in every department and up and down the org chart.

We will put this plainly: Investment management is a business in which the quality of the people you employ determines the quality and success of your firm. It is always a surprise to see that some firms fail to grasp this truth and, while paying well in investments, try to skimp on salaries in sales, client services, marketing, and firm management. While asset management firms will always be portfolio manager-oriented to some extent, some firms are weighted much too far in that direction, resulting in organizations with two classes of employees.

There is no way around it, asset management firms must pay their people — all their people — well. However, there is one important caveat to this rule. As Greenwich Associates consultant Andrew Klebanow notes, "Best-in-class firms do not make it their goal to provide across-the-board top-quartile compensation; rather, they provide every employee in the firm with the opportunity to earn top-quartile compensation with top-quartile performance."

3. Best-in-class firms create a culture of fairness across all employees including investments, sales and client service in compensation and all other measures of recognition.

Regardless of the function in which they work, employees should receive compensation comparable to the value

Compensation Plan Structure and Transparency for a Silo/Individual Culture

Compensation Aspect	*Formulaic (Fully Transparent)*	*Discretionary (Not Transparent)*
Desired Behavior/Culture	Entrepreneurial or Star culture; individual performance with little/no link to firm (works best for highly measurable products / businesses)	Individual focus (without formulaic commitment or fixed cost)
Risk	Over reward hot product; little collaboration (sharing of risks)	Lack of firm or even clear focus; can be perceived as political instead of performance driven; under performing areas often subsidized at expense of producers
Incentive Funding	Individual formulas; bottom up	Budget based; bottom up; not clearly linked to corporate performance metrics
Allocation	Individual formulas	Management discretion; significant and often acrimonious year-end negotiations
Discretion	None	Above average
Equity	Founders/narrowly defined group which may vary over time (i.e., high performers)	Little to no equity beyond founders
Communication	Formulas and individual metrics clearly defined and communicated	Often little/poor
Other		**Not typically representative of high performing firms**

they create for the firm in their assigned roles. If you do not provide the opportunity for top quartile pay in client services or any other department, you will end up with a function that is below top quartile in quality. If you pay below the industry average, you will eventually achieve below average quality.

While most firms recognize the close connection between investment professional compensation and the long-term success of the organization, fewer seem to realize that pinching pennies on compensation in client service and other non-investment functions is dangerous in the long run. You cannot ramp up client service when performance starts to fall; by then it is too late. You must build — and pay for — long-term excellence in client service and all functions. And remember, there is more to compensation than money. Internal recognition, titles and responsibility are important rewards that also help drive employee behavior.

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4. Best-in-class firms create detailed compensation structures that clearly communicate to employees what they must achieve in order to maximize their compensation.

In every position in every function, management must define clear goals on both an annual and multi-year basis. These goals must be measurable and results must be quantifiable if they are to be useful in determining performance awards. A common pitfall is inclusion of too many goals. To be most effective, include three or four simple measures.

While performance metrics will obviously include business fundamentals such as sales numbers and investment results, they must also include the myriad of steps required for success in each business function and promote specific behaviors identified as essential to long-term success. For example, annual goals for the sales force should include progress in asset classes, products, approaches, and strategies designated as critical to the firm's growth, as well as progress with important prospects — even if no sales were achieved that year.

Similar metrics should be developed for all functions, including those like marketing, client service and consultant relations, in which objective performance can be more difficult to quantify. Most importantly, the results of these goals — on both an annual and multi-year basis — must play a key role in determining employee compensation.

Below is a sampling of some of the performance metrics used by best-in-class asset management organizations to determine compensation:

Sales

- New assets/revenues per professional
- Number of prospects targeted per professional
- Number of calls/visits with prospects per professional
- Percent of prospects solicited
- Percent of solicitations considered effective
- Number of finals presentations made/won per professional
- Percent of finals presentations won
- Client retention
- New product traction

Client Service

- Number of clients served per professional
- Retention rate of current clients
- Client satisfaction
- Client service quality rating from third-party source
- Manager capability rating from third-party source
- Percent of clients where cross-sale opportunities are identified
- New assets/revenues on cross sales
- Percent of cross-sale finals won

Consultant Relations

- Number of consultants targeted per professional
- Number of meetings per consultant covered
- Number of searches including firm
- Percent of finals won
- Manager capability rating from third-party source
- Consultant service quality rating from third-party source

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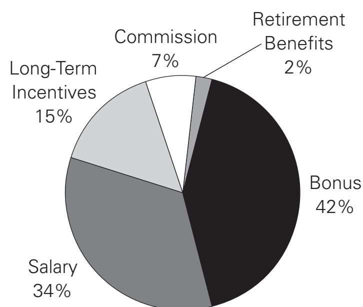
5. Best-in-class firms leave room in their compensation structures for discretion.

While quantitative performance metrics will help to align employee behavior with firm goals, it is essential that firms not make their compensation award process a purely mathematical function. While the typical firm devotes about a third of compensation expense to salaries and 42% to bonuses, best-in-class firms leave room for subjective adjustment that takes into account variables such as changes in the business environment, investment performance, special value-added contributions, and other

unique circumstances. "As just one example, it doesn't matter what performance metrics drive your compensation plan, if you had a single employee who kept your firm out of mortgage-backed securities and CDOs last year — pay that person immediately, and pay him or her well," says Alan Johnson.

Breakdown of Compensation Expenses
U.S. Asset Management Firms



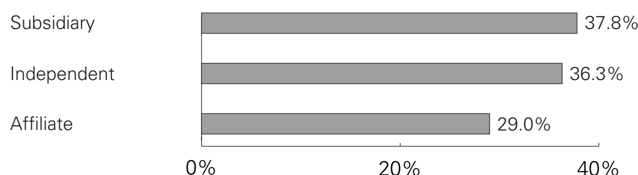
Total Compensation Expense

Note: Average expenses are represented for the entire Competitive Challenges universe.

6. Best-in-class firms use equity incentives to align the interests of employees with those of the firm and its clients.

Equity ownership across a moderate to broad share of employees can provide asset management firms with a real competitive advantage, both in terms of retaining the employees who create value for the organization and appealing to clients and consultants who use equity distribution to assess managers' long-term stability. "It is important to remember that consultants evaluate firms not just on the basis of how much equity is in employees' hands, but also on how deep the ownership goes," says Greenwich Associates consultant William Wechsler. "They are looking to see if equity is held only by portfolio managers, or if it is spread more widely across upper-middle and senior professionals throughout the organization."

Percent of Employees Eligible for Long-Term Incentives, by Ownership Structure

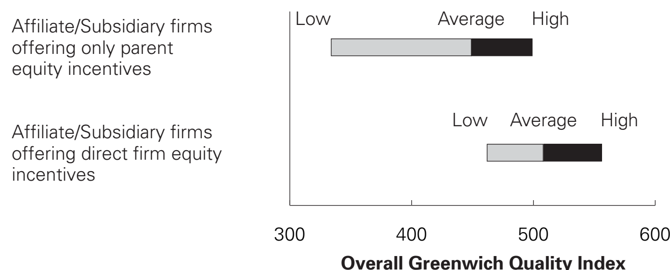


Note: Average scores are represented above. The universe consists of 15 subsidiaries, 5 affiliates, and 8 independent firms.

On average, slightly more than 35% of employees at asset management firms that are independent or subsidiaries of larger organizations are eligible for long-term incentives. In most cases, the equity awards process is most effective when integrated with cash payments into a total compensation package, rather than being awarded separately. This integration usually takes the form of a cash/equity ratio that kicks in at a certain level of compensation and shifts to a higher equity weighting as total compensation increases. In order to achieve a balanced distribution and to incent top performers across the organization, the compensation levels at which equity is first awarded and the thresholds at which the cash/equity ratio shifts should be set individually for each business function.

"If equity is awarded apart from the standard compensation process, firms must be very clear about the criteria used to determine who should get it and how much they should get," says Alan Johnson. "When equity awards are given as 'add-ons' to the standard compensation practice the process is less transparent and the incentive could be less effective."

Overall Quality of Firm vs. Equity Incentives Offered
(Parent Equity vs. Direct Firm Equity)



Note: Firms offering only parent equity consists of 8 firms. Firms offering direct firm equity consists of 6 firms. Overall Greenwich Quality Index scores are taken from Greenwich Associates' 2006 U.S. Investment Management research.

Asset management firms owned by larger organizations should be particularly careful about how they structure any equity incentives. In many cases, highly paid investment management professionals will not view stock in a large parent financial service firm as more valuable than cash; in some cases, forcing employees to take part of their compensation in these shares could be seen as a disincentive. "If the asset management unit does not have its own shares, management needs to think about creating an equity-like structure that can allow employees to participate in the performance of their business," says Rodger Smith. "Stock in the parent will not deliver the same type

of competitive advantage. The parent company benefits by owning a smaller part of a much larger business."

Any firm that offers equity incentives to employees should make the decision to do so with a full understanding of the long-term implications. Most plan structures will eventually force the firm to place a value on distributed shares to facilitate their transfer or simply in response to demands from their holders. "Once you have put a price on the stock, you have placed your firm on a certain course," says Francine McKenzie. "It is like a ski slope, at the top is book value and at the bottom is market value — and intense pressure to sell the company. It is very hard to stop once you start on your way down."

When structuring an equity compensation plan, privately held asset management firms should take into account another important factor: generational transfer. "The smooth transition of equity is an integral part of the succession process," says Rodger Smith. "But achieving a seamless transfer amid the disruptions that accompany the departure of the founder or current owner can be quite difficult. There needs to be a buy-in by the next generation before the transition begins."

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7. Best-in-class firms acknowledge the differences between alternative and traditional management businesses instead of downplaying them.

When traditional and alternative asset management business exist under the roof of the same organization, mismatches in terms of culture and compensation are inevitable. Best-in-class firms do not deny these differences. Rather, they create compensation structures that are competitive with best practices within sectors and link compensation to the performance of their business as well as the firm as a whole. In addition, these firms explain to employees on each side how the presence of both businesses will benefit the organization and the employees themselves.

In terms of compensation structure, it is essential that professionals in the alternative business — who will in all likelihood be paid more than their counterparts on the traditional side — have a reasonable share of their contribution tied to the business performance of both their own unit and the firm as a whole, whether through bonuses based on overall results or equity in the company. The same structures should be used on the traditional side of the business, and employees there should understand how profits from the alternatives business contribute to their own annual bonuses and equity dividends and appreciation.

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8. Best-in-class firms avoid broad asset-based targets when designing compensation packages for sales professionals and do not go too far in limiting sales "trailers."

Broad asset-based targets encourage salespeople to focus their time on the firm's best-selling products in order to maximize their annual numbers. Best-in-class firms link large portions of sales compensation to performance on measures related to the long-term success of the firm. For example, in order to receive the maximum compensation award, a salesperson might be required to sell a certain amount or percentage of a designated product or strategy. Measures can also be client-oriented: Achieving the highest payout might require a salesperson to get 25% of his or her sales in a given year from plan sponsors who have never before done any significant business with the firm. As discussed in the earlier section on performance metrics, these measures can also include achievements that are not linked to actual sales but serve to advance relationships with important clients or prospects.

At the same time, best-in-class firms resist the urge to cut back on salespeople's compensation "trailers," — or compensation tied to existing business booked in past years — more than is prudent. While time limits on trailers are perfectly appropriate, it has become common recently for asset management firms to reduce trailers on sales to four years, three years and in some cases, as little as two years. As a standard best practice, firms should use three years as the minimum length for trailers on sales, and longer is better in most cases. "The asset management business moves in multi-year cycles," says Andrew Klebanow. "In times of bad markets and poor performance, sales become much harder to make and the sales cycle lengthens considerably. It is in these periods that you need your salespeople to be most committed to the firm. If you reduce your sales trailers to two years, it is quite possible that sometime around the bottom of a market cycle your salespeople will find themselves with no economic incentive to stick with you."

As Alan Johnson concludes: "The goal is to find the right balance using straight formula trailers and discretionary bonuses. Several prominent asset management firms have become quite successful without paying their sales forces any commissions at all. There is no perfect formula, but there are many creative solutions: Some firms have built

effective sales compensation structures simply by rewarding difficult, multi-year sales with long trailers, while limiting trailers on hot products in which the sale takes minimal effort."

9. Best-in-class firms use non-compete agreements to protect their businesses — not to punish departing employees.

Requiring key employees to sign non-compete agreements is a standard best practice in the asset management industry. It is critical that companies use non-competes as protective measures, not punitive ones. All employees with an equity interest in the company should be covered by these agreements — including founders. "If you are presenting non-competes as essential tools for protecting the firm, it makes no sense to exclude founders and other large shareholders who could leave the company for a variety of reasons," says Alan Johnson.

Lower-level employees should be required to sign non-competes only when there is a compelling reason, and if there is, their restrictions should be as loose as possible while still protecting the firm. "In general, firms cover too many people with non-competes and the agreements are far too onerous," says Francine McKenzie.

Non-competes are most effective when they are coupled with deferred compensation and other provisions that give departing employees the incentives and financial wherewithal they need to stay out of the space for a designated period. Such provisions make the non-competes more palatable to employees by letting the firm's professionals know that they will receive a payout of some sort if they are fired. "It's simple — let departing employees know that you will pay them if they cooperate and fight them if they do not," says Greenwich Associates consultant Dev Clifford. "It is the combination of positive and negative incentives that work best to protect the firm."

10. Best-in-class firms create compensation structures to meet long-term strategic goals and review compensation structure on an annual basis.

What is an optimal structure at one point in the firm's growth might prove completely ineffective at another. Compensation structures must change and mature with the firm. "In general, asset management firms should build compensation structures for three to five year windows," says Greenwich Associates consultant Chris McNickle. "It is critical to retain the flexibility to adjust the compensation structure annually for some functions like sales, and at least every five year for others to account for changes in the business."

About Greenwich Associates

Consultants Andrew Klebanow, Rodger Smith, Chris McNickle, William Wechsler, and Dev Clifford advise on the investment management market in the United States.

About Johnson Associates

Johnson Associates is a boutique compensation consulting firm, specializing in financial services. Managing Directors Alan Johnson and Francine McKenzie advise high-end financial clients on an extensive range of compensation issues and practices.

Methodology

The Competitive Challenges research was conducted in the second and third quarter of 2007, and includes data collected from 45 participant clients and 15 public companies. Participant clients responded to a secure online survey, and were asked about calendar 2006 year results, compensation levels, and current business practices.

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