Helping Investment Leaders **Leverage Their Talent**

Compensation: Getting it Right

A Focus Consulting Group White Paper

By:

Keith Robinson

James Ware, CFA

Michael Falk, CFA

"He that is of the opinion money will do everything may well be suspected of doing everything for money."

Benjamin Franklin

A Story about Money?

(The following is a true story. Only the names have been changed to protect the entitled.)

It was a clear, crisp January day in the city that never sleeps. Anticipation hung in the air at ABC Alternative Investments. It was bonus day. ABC just had its best year ever, and the team of thirty had high expectations for great rewards. To say the bonus pool was robust would have been a grand understatement. The two Sr. Portfolio Managers (Sam and Joe) were in line for some serious cash.

Sounds like a great story with a happy ending. The lesson learned from this experience fundamentally changed the way Focus Consulting Group and this CEO think about compensation.

The lesson*: compensation can be a bigger dis-satisifier than satisfier.* (Regardless of the number of zeros)

The CEO of ABC was pleased to reward Sam with a very large bonus. After all, he had put up some remarkable numbers and was a key contributor to the success of ABC. He anticipated the joy on Sam's face, the discussion about how this would motivate Sam to work harder and the prospects for the upcoming year. He was excited and anxious to give him this great reward.

FCG happened to be onsite at ABC that day and asked if we could join the CEO on this momentous occasion. He was happy to oblige. He called Sam to his office to give him the good news. The conversation went something like this:

"Sam, I am pleased with the wonderful performance you have had over the past year and in prior years. You have made a big difference for our firm and in the lives of our clients. It is my pleasure to reward you with this bonus."

Sam responded: "Wow, are you serious? Fourteen million dollars? This is wonderful, thanks."

There was some additional small talk and Sam left the office. The CEO was satisfied, although disappointed that there wasn't more excitement. He never dreamed of what would happen next.

Five minutes later Sam stormed back into the CEO's office, "are you kidding me? This is f'n ridiculous, I can't believe you're screwing me this way! This is a joke! I might need to think about other options given my track record. You give me fourteen, yet Joe gets fifteen? I've put up better numbers, contributed more and been here longer! How can this happen?"

And there it was.

The lesson was learned. Once you have passed a certain point it is no longer about the money. It's about perceived fairness… keeping score.

Sam didn't leave ABC. The CEO managed the discussion, although it cost him more money. Afterward we sat with the CEO, "unpacked" what had just happened and what needed to happen going forward.

Three Key Principles

Since that time FCG has refined our view of compensation; how to design it, what matters, and three key principles to success:

1. Fair is in the eye of the beholder
2. Transparency matters
3. Simple is better

Fair is in the eye of the beholder

FCG has collected data from thousands of investment professionals on hundreds of teams. We have explored the question of compensation related to success. The successful firms that do this well have demonstrated the ability to get compensation "fair" so it no longer remains a distraction. Our data suggests that teams able to do this create an environment of less distraction and higher performance.

Table 1 illustrates our point. When measuring the perception of "fairness" we discovered that the "Focus Elite" firms scored much higher than the rest of the industry. To be clear, they are not the highest payers in the industry, but they have designed compensation approaches which remove the distraction of compensation by understanding and applying the principle of fairness. Not perfect, but better than most. (To understand more about the Focus Elite success see our white paper entitled: "***Linking Strong Culture to Success***")

Fifteen Factors of Team Success – FCG Team Scorecard: Industry Compensation

Table 1

Team Factor	**Focus Elite**	**Industry**	**Difference***
I feel fairly compensated for my contributions	**5.99**	**5.18**	**.81**

Teams were asked to rate each team factor on a 7 point Likert scale. (1 – strongly disagree, 4 – neutral, 7 – strongly agree)

Another key element of fairness is the construction of the plan. Conventional thinking has always been to hire an outside party to work with senior management to construct the plan, or senior management does it themselves behind closed doors. The outcome; organizations define fairness in the eyes of management or the market, not by those who will be the final judges, those affected by the plan.

Since fairness is such an individualized concept, the typical question we get from leaders is; *"we have fifty employees, how do you satisfy everyone's sense of fairness?"*

FCG has learned a few things about fairness:

1. When those affected are not included or don't have input it doesn't feel fair.
2. Control of ideas is important. Input helps create a sense of control and reduces uncertainty.

3. In general, employees affected by the plan are reasonable and not greedy.
4. Management does not give up their decision rights, but co-creates an important element of engagement.

FCG's process applies the above four points in a facilitated dialogue to increase the sense of fairness in compensation plan design. Participation in plan design is a voluntary exercise. There are no prisoners or passengers. Those employees interested are asked to attend a session(s) to begin to generate ideas for plan design. Parameters are established with management to provide a general direction such as the organization's compensation philosophy, values, strategic plan(s) and the pool parameters.

The facilitated dialogue is designed to generate additional key components of the plan such as: what constitutes the metrics of success, how to reward behaviors and how to balance the rewards for behaviors versus investment success. FCG has learned that leveraging the wisdom of the team by including those affected by the plan generates a better design. It also creates transparency which is the next key principle of plan design.

Transparency Matters

This guiding principle generates a great deal of fear for many management teams. Recently we facilitated a dialogue with senior investment professionals and leadership in a firm. This particular firm was exploring a design change to its compensation plan. In a room with the management team and investment professionals, we asked what we thought was a very benign question: *"does the firm have transparency on what matters such as the firm's P&L?"* The CFO immediately addressed the question with a short and emphatic *"no."* The reason given; *"it's none of their business."*

This firm failed to realize two important leadership principles: if you treat people like adults, they amaze you and act like adults; and when you fail to share important information with your team, they make stuff up that's usually wrong. Compensation plans are inextricably tied to the financial health of the organization, and transparency about that health is important for those affected by the plan. Unless there are reasons regarding public disclosure or insider trading, management may want to keep an open mind about transparency of the following:

1. Mission, Vision and Values (usually this is known)
2. Financials (P&L)
3. Strategic Plans
4. Department Strategies and Tactics
5. Compensation Plan Design

Case in Point

Recently we did a compensation project with a very successful investment management firm. They have grown tremendously over the past few years, added strategies, talent and AUM. As we began our work we did the "transparency test" with them. They passed with flying colors!

What were some keys to their success regarding compensation?

- They had a well-defined and broadly communicated compensation philosophy that was aligned with their Mission and Values and drove their strategic plan.

- Their financials were open to anyone in the firm who was interested (this created realistic expectations about bonuses in any given year).
- The strategic plan was clear and understood from top to bottom.
- They were pro-active in addressing gaps in their compensation plan prior to them becoming dis-satisfiers in the firm.

Because they had grown so rapidly, they knew that an audit of the health of their compensation plan was in order. Adjustments were made applying the key principles of inclusion, transparency and simplicity. Communication was important for those not involved in the design (voluntarily) and the output was a compensation plan that prepared them for their next phase of growth.

Simple is Better

"Simplicity is the ultimate sophistication."
— Leonardo da Vinci

Be sophisticated. If you can't design a plan simple enough to be understood, you've wasted your time. In a world of Ph.D. mathematicians, black box quant models and supercharged analytics, when it comes to compensation and how/why people earn what they earn the KISS (Keep It Simple Stupid) principle still works best.

Compensation and rewards are based on one key principle - trust. I trust you to meet or exceed your performance expectations, and you trust me to reward you fairly. The most effective compensation models allow the recipients to have a clear understanding of how and why they received what they did. Not quite as simple as calculating on a napkin, but close. (Note: some of the best compensation ideas were created on bar napkins, usually after a pint or two.)

Simplicity of compensation and trust go hand in hand. In fact, our data also illustrates that teams scoring well on compensation, also scored well on trust. FCG's research on highly effective teams reveals that trust and compensation are key factors in successful organizations and teams. (See table 2 below).

Fifteen Factors of Team Success – FCG Team Scorecard: Industry Compensation and Trust

Table 2

Team Factor	Focus Elite	Industry	Difference*
I feel fairly compensated for my contributions	5.99	5.18	.81
There is a high level of trust among team members	5.98	5.30	.68

Teams were asked to rate each team factor on a 7 point Likert scale. (1 – strongly disagree, 4 – neutral, 7 – strongly agree)

Our experience regarding simplicity reveals the following important lessons:

1. Use the measurements that matter: Find a few things that are truly

reflective of the work product that support the firm's mission and strategy. A common mistake is to over engineer measurements down to the tenth decimal or attempt to measure everything on the job description. The results are confusion and focus on minutia. It is human nature to spend time doing what we like even if those things are less relevant in supporting the firm's overall mission or results. We have seen employees focus on these smaller components of their job only to be disappointed when they are not rewarded for it. The result is confusion and distrust.

2. Make the measurements financially impactful (upside and downside): We have seen many "clever" compensation models that measure everything, and in doing so drive nothing. Fewer but more impactful measures will drive focus and have a bigger impact on financial opportunity. They send a much clearer message on what is important at the firm.

3. Keep the measurements aligned with your firm's core values: The value of meritocracy is often desired, but not rewarded. Many firms state they practice meritocracy as a core value yet "spread the peanut butter" (i.e. bonus dollars) so thin that the value gets lost. The results are disenchanted investment professionals, especially those who have put up good numbers or had great ideas that paid off. If your firm believes in the value of meritocracy, then the compensation differentials should reflect that. We would expect to see much broader differentiation in total compensation numbers for firms that have meritocracy as a core value. Similarly, if collaboration and teamwork are core values, we would expect to see less differentiation inside an investment team. There may be greater differentiation from team to team, but not within.

4. Discretionary doesn't mean opaque: A common approach is to have a component that management uses to "top up" or penalize someone's bonus. It's typically used to send a positive or negative message. There are two general problems with this approach. First the discretionary component of the bonus is usually so small that it's not material to the overall compensation and the message gets lost. And second, the discretionary component lacks transparency ("why am I getting or not getting this?") so expectations are neither set nor met. The result, the message gets lost. FCG's position on the discretionary component: tie the dollars from discretionary to measureable or observable behaviors that are clear and can be understood.

A final lesson in trust – never change the rules of the game at the end. Believe it or not, we have seen firms change their compensation methods just prior to payment. This is done for a variety of reasons, but most have little to do with building trust or paying more. Usually the conversation goes something like this:

Leader #1: "Wow, we had a really great year!"

Leader #2: "Yep, bonus pool is going to be much bigger than last year."

Leader #1: "Hmmm, perhaps we should cut it. We don't want to set unrealistic expectations for future years."

Leader #2: "Yes, you're right. It might create a sense of entitlement."

This is the beginning of the end at some firms. The key to success is "fairness," so if it was earned, pay it.

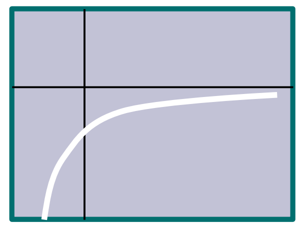
The M.A.P. to Success

This paper has focused on the extrinsic motivators of investment professionals. However our research, as well as many others, reveals the true key to motivating knowledge workers. We would be remiss not to briefly mention these important factors.

A key to success is to get the money "fair" and get it off the table. As we have learned, money is a bigger dis-satisfier than satisfier, therefore it's a distraction to what really motivates. In his book *"Drive"* Dan Pink helps us understand the true motivators for knowledge workers. These are the intrinsic rewards of Mastery, Autonomy and Purpose.

After working with many successful asset managers over the years we have learned through our own observation that the MAP to success begins with a culture which promotes and embraces mastery, autonomy and purpose.

Mastery is defined as the desire to continually become better at your craft. It has been described as an asymptote, a line that continually moves toward the "X" axis yet never reaches it. FCG's research and work with investment professionals is clear about the importance of mastery in the world of investing.



The value of "Excellence and Continuous Improvement" is at the core of the investment industry DNA. In fact, approximately 25% of all investment professionals we have surveyed have chosen this as a core value. With the Focus Elite, that number goes to 36%.

In his book Pink defines mastery as *"the desire to get better and better at something that matters."* The first landmark on the MAP of truly motivating knowledge workers is to create a firm culture that embraces mastery.

Autonomy is defined as the ability to focus on the work according to one's own desired approach. Much has been written about the virtues of autonomy and the power it can have in helping organizations achieve amazing results. In fact, in a research study conducted by Cornell University of 320 small businesses, the ones that gave employees autonomy grew at a rate four times that of those that managed using traditional methods.[1] We have yet to find a compensation plan that could drive that kind of result.

Pink suggests four factors that need to be in place to create an environment of Autonomy: Task, Time, Technique and Team. In our experience many firms struggle with Time and Team.

Time is more about the work than the location. Investment professionals are driven by their love of the work, so time shouldn't be an issue. At FCG, we believe that work is something you do, not somewhere you go. This satisfies the time autonomy. However many organizations require their professionals to be in during stated office hours. And believe putting in the time in the office is the key to success. We have yet to meet a firm that could demonstrate superior investment performance through "face time" in the office.

Team is also a key differentiator. In a talent business, the right mix of talent is critical to success. There is a clear link to success and working with the right team members. The table below suggests that firms that perform well and are successful have the right team members.

Fifteen Factors of Team Success – FCG Team Scorecard: Industry Compensation and Trust

Team Factor	Focus Elite	Industry	Difference*
We have the right team members to accomplish our goals	6.15	5.41	.75

Teams were asked to rate each team factor on a 7 point Likert scale. (1 – strongly disagree, 4 – neutral, 7 – strongly agree)

Precision is the key in getting team right. Be precise about the need. Not just skills or past results, but values, personality, and team fit. Many organizations simply stop at skill or track record and fail to realize the key to success goes way beyond technical inputs and outputs. The result of this approach can place a "Red X" on their MAP to success. For more information on this see our white paper entitled "The Red X, Managing the Outliers in the Investment Firm."

Purpose, the reason we do all this stuff anyway. FCG has spent many hours with C-Suite executives discussing organizational purpose. In fact at a recent FCG CEO roundtable, 25 of the best and brightest industry leaders engaged in this discussion. *"What is your firm's purpose?"*

While no common answer was declared to be right. Each of these leaders understands the importance of having a compelling reason for serving clients and investing. Some of our most successful clients have a deep, clearly defined purpose which propels the organization far beyond generating alpha. One such example is the investment division of Teachers Retirement System of Texas (TRS). While working with TRS we asked many of their talented investment professionals the purpose question. The answer we received was strikingly similar (and succinct): "to ensure the financial future of those who educate our children."

Many of the investment professionals who work at TRS could earn much more on Wall Street. Their compensation is viewed as "fair"; the focus is on the work which serves a very compelling purpose.

It's Really Simple

If you have a teenager that's driving, you likely require them to put away the cell phone so they're not distracted. This lowers the probability that they will have an accident and helps them perform better behind the wheel. Similarly, you want to remove distractions from your investment professionals so they can focus on doing their best to navigate challenging and unforgiving markets. One of the biggest distractions can be compensation, if not managed properly.

Our solution, get them involved and give them a MAP.

1. "*Drive*" by Dan Pink

Serving over 200 clients in 18 countries…

OUR MISSION: To help investment leaders leverage their talent worldwide.

OUR APPROACH: Customized, we discuss the engagement with your firm's leadership, design a custom approach, and bring in content experts when appropriate.

OUR SERVICES:

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- Foundational off-sites (vision, values, strategy)
- Strategic planning
- Succession planning
- Compensation & incentive structure
- Firm integration: eliminating silos
- Acquisition and team lift out due diligence for cultural fit
- Hire for fit

CULTURE

- Analysis & management
- M&A analysis, integration, implementation
- Culture sustainability and process

TEAM

- Enhanced decision making
- Assessments & dynamics
- Conflict resolution
- Personality typing & application

LEADERSHIP

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- Personality typing & application
- Genius and strengths

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James Ware, CFA is the founder of Focus Consulting Group, a firm dedicated to helping investment leaders leverage their talent. James is also a highly acclaimed industry author and international speaker on the subjects of investment leadership, culture and building high performing teams. A frequent keynote speaker at CFA Institute, Mutual Fund Educational Alliance, Investment Adviser Association, U.S. Institute and other major industry conferences, James is recognized for his insightful, inspiring and entertaining presentations. His recent books, "Investment Leadership: Building a Winning Culture for Long-Term Success" (Wiley, 2003) and High Performing Investment Teams (Wiley, 2006) identify those elements of leadership and teamwork that lead to sustainable success for investment firms. James has 20 years' experience as a research analyst, portfolio manager, and director of buy-side investment operations. He has been a guest lecturer on the topic of investment firm management at the Kellogg Graduate School of Management at Northwestern University. His educational background includes a Masters in Business from the University of Chicago and a degree in philosophy from Williams College, where he graduated Phi Beta Kappa.

Keith Robinson is the Managing Partner of Focus Consulting Group and brings over 27 years of global investment experience to his consulting and coaching work at FCG. As an expert in human resource and talent management at Allstate Investments, UBS, and Marsh & McLennan, he was selected to develop a cutting edge leadership development program for Northern Illinois University. His specialties include: Management and Leadership Development, Education and Training, Organizational Design and Performance, and Business Strategy. He is the co-author of the highly acclaimed white paper, "Investment Tribes" co-written with Jim Ware, and was recently published in Smart Biz magazine for his work on "Managing the Human Portfolio." Keith holds an MBA from University of Illinois and graduated Summa Cum Laude with a business degree from Western Connecticut.

Michael Falk, **CFA**, is a partner of Focus Consulting Group and is passionate about the singular principal of providing value-added asset consulting. He is also partner and chief strategist on a global macro hedge fund, and was a former CIO in charge of manager due diligence and asset allocation for a multi-billion dollar advisory. His background includes extensive asset allocation research and portfolio development expertise along with a multi-faceted understanding of behavioral finance and retirement issues. The asset consulting perspective acknowledges that the wisdom of crowds can denigrate into madness at times. Assets should be managed with the serenity to accept the market's realities; the courage to pursue its opportunities; and the ongoing pursuit of wisdom to understand the difference. Aside from his consulting work, Michael is part of the CFA Institute's Approved Speaker List, a contributing member of the PDDARI group within the Financial Management Association (FMA), the Vice Chair of the Profit Sharing 401(k) Council of America's Investment Committee, teaches as an adjunct professor at DePaul University in their Certified Financial Planner (CFP) Certificate Program as well as on behalf of the CFA Society of Chicago and is frequently quoted in the financial press. He graduated from the University of Illinois with a B.S in Finance. He also holds the Certified Retirement Counselor (CRC) designation.