Executive reward and retention strategies for family offices

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Foreword

Family offices are known for their desire for confidentiality. What they do, and how they address the needs of family members, are often closely guarded secrets.

Consequently, one area of particular opacity is the compensation structure of family office executives. Although there has been increasing global demand for well-qualified executives to manage family office activities such as investments, financial, legal matters and other family services, there has not been a corresponding growth in the understanding and adoption of reward and retention strategies.

This lack of understanding has given rise to an inefficient market for human capital in the industry. As in the market for financial assets, human capital assets – in this case, family office executives – can become arbitrarily over- or under-valued, as both families and executives struggle to establish optimal reward and retention plans owing to insufficient information.

Ironically, the absence of accurate data, process and a common language around reward and retention often makes it difficult to broach the subject constructively. It is not uncommon for family members to express concerns about how to retain a key executive, only to learn that the subject has never previously been broached, but also that the executive shares the same concerns. So, how might a family go about creating effective reward and retention strategies?

Citi Private Bank's Global Family Office Group has the privilege of serving some of the world's wealthiest individuals and families. Our Family Office Advisory team has deep experience guiding on family office creation and management.

In our experience, a constructive approach to attracting, retaining and motivating senior family office executives includes two key elements – the process and the structure.

We hope that these best practices are beneficial, and we welcome the opportunity to partner with you and discuss the particular needs of your family office.

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Process: Understanding the importance of equilibrium

Arguably, the optimal outcome of any effective reward and retention strategy is one that achieves equilibrium between the parties; i.e., it addresses the needs of the family as well as of the executive, with both parties achieving their desired outcomes.

How, then, might a family and an executive establish a process that produces the desired outcomes in such a way that identifies and navigates the core tenets of behavioral science?

UNDERSTAND FAMILY VALUES AND EXECUTIVE MOTIVATIONS

Foremost among key behavioral factors is an alignment of "values." When problems occur, it is often due to misalignment and poor communication of values, and both parties making assumptions about the other's intent with respect to reward and retention.

It is therefore essential that executives understand the family's values and their views on executive compensation. Similarly, the family needs to understand the executives' compensation needs and expectations. Executive recruitment firms as well as specialized compensation consultants might be able to provide a fair assessment based on current market trends.

Navigating these issues requires delicate action. Consultants, search executives and advisors can help by asking candid questions of all parties. It is important to look for how the family embodies its values; e.g., how the family spends money or compensates executives in their family business.

At the end of the day, being able to articulate attitudes concerning how much the family is willing to reward the executive for a given commitment and range of outcomes is essential. This includes repeating to the family head or board a series of "if/then" statements to affirm their understanding and agreement.

An example of such a statement would be: "if the family office executives exceed the plan, then their total compensation will be in the range of $X – are you comfortable with that?" Even then, circumstances and attitudes may change, hence repeating this process may be necessary over time.

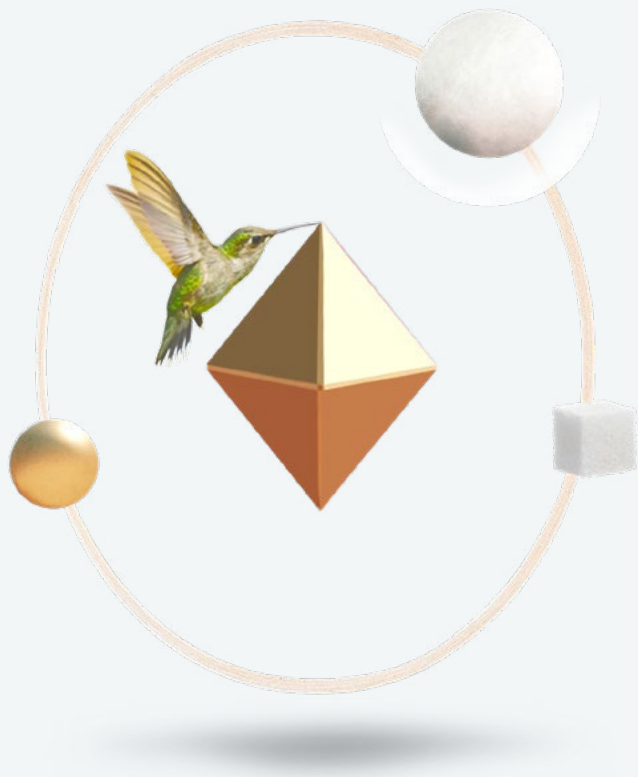
DEFINE OUTCOMES

An effective reward and retention strategy must be based upon a clear understanding of desired and potential outcomes. While some families have explicit investment expectations, this is neither universal nor does it always cover outcomes in other areas such as family services, finance or governance. Although this does not necessarily have to involve strategy by management of objectives, some specificity is required to anchor the executive's year-end performance appraisal.

One essential element that is often overlooked by families is not "what" they expect to be accomplished but also "how" they expect their executives to achieve the results. Issues around the volatility and distribution of returns and illiquidity, manner and frequency of communication with the principal, executive autonomy, interactions with extended family members, and spending practices can cause greater problems than poor portfolio performance.

Recognize the executive's interests and passions. While money is the foundation of most reward and retention strategies, families should not overlook other ways in which their family office executives could be rewarded. Families could reward executives by utilizing their resources and networks to offer their executives opportunities that they might not otherwise enjoy.

For example, in the course of trying to retain a long-serving family office executive, a family learned of her desire to publish a novel. Using their network, they supported her writing efforts and introduced her to a publisher. Other examples include families providing access to their vacation homes, facilitating membership of corporate and non-profit boards, providing access to family-owned aircraft, or making an annual charitable donation as a way to enrich the relationship further, in addition to rewarding and retaining the executive. Tax and legal matters notwithstanding, most families have extensive flexibility to craft a personalized package that addresses the personal interests and motivations of the executive, thereby augmenting financial compensation.



STRIVE FOR EQUILIBRIUM

An effective process will strike a balance between the values and interests of the family and the needs and motivations of the family office executives. Skewing the arrangement too far in favor of one party over the other invariably results in dissatisfaction, mistrust and an ultimately poor outcome for all parties. The aim, therefore, should be an outcome in which both parties are satisfied, albeit not to the extent that either or both feels aggrieved.

Reward strategies mostly fail at the extremes. For example, when general market conditions produce exceptional portfolio results that trigger unforeseen levels of Chief Investment Officer (CIO) compensation, it is not uncommon for the family to feel resentment despite the high portfolio returns. Conversely, when executives effectively protect against downside losses during a protracted bear market but nevertheless miss targets and thus receive diminished compensation, they may feel unappreciated. Therefore, best practice would be for families and executives to discuss a wide range of outcomes and their implications.

Structure: An analysis of practical compensation frameworks

Having established the basis of a reward and retention strategy, it is important to examine the structural elements that may be implemented. A benefit of family control over their office is the flexibility to customize or craft virtually any incentive scheme that achieves the desired outcome.

BASE COMPENSATION*

Salary amounts vary by geography, active assets under management, whether the family office is investment focused or full service, and by the executive's industry and experience.

The table below illustrates the reported median base salary for key positions in full service family offices in the US.

Full service family office - Median base compensation for key positions

	AUM <$1B	AUM >$1B
CEO	$375,000	$660,000
CIO	$350,000	$583,000
CFO	$250,000	$475,000
COO	$254,375	$419,894
GENERAL COUNSEL	$332,500	$418,361

Generally, base salaries paid by family offices are estimated to be ~20% lower in Europe.* It is also not uncommon for the CIO to be paid higher bonus percentages than the CEO and other positions owing to the role's specialist responsibilities.

Base salaries reflect two primary factors: comparable amounts paid by similarly located family offices and executives' salary history. Search firms, private banks and family office associations are a reliable source of survey data, although care should be taken to make like-for-like comparisons between offices. Families should expect to pay at market levels in today's highly competitive environment for quality and outstanding talent.

*Compensation Trends: U.S. and Europe, Family Office and Family Investment Firms. Prepared by Botoff Consulting for Citi Private Bank. November 2023.

EXECUTIVE BONUS

Bonuses are the key performance-related incentives to reward and retain top family office executive talent.

While 93% of all US firms report that employees are eligible for annual incentives or bonuses, 80% report that executives and staff were awarded for 2022 performance.* Cash incentives and bonus percentages range from 15% to 90% of base compensation and come in two basic forms - discretionary and objective.

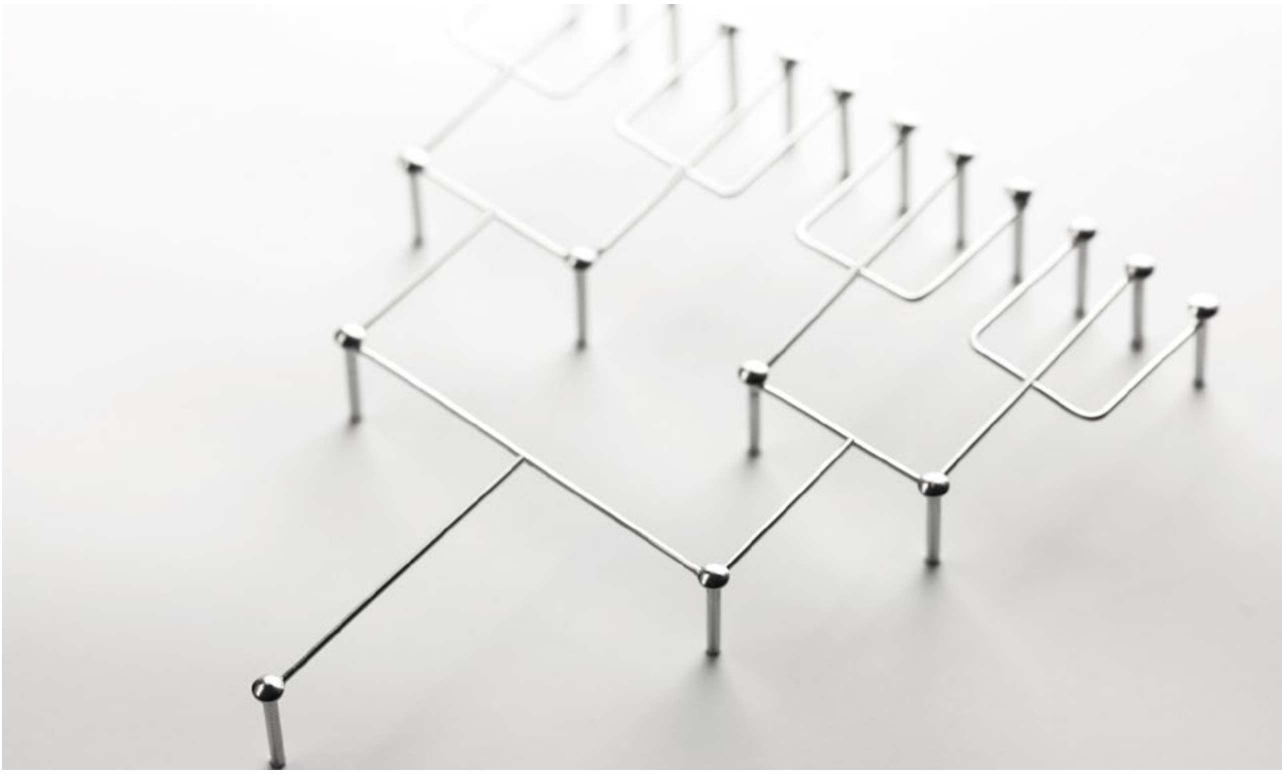
As the name suggests, the discretionary bonus is one entirely made – or not made – at the discretion of the family or principal. It affords maximum flexibility to the family and does not require a metric-based approach. To executives, however, this type of bonus often provides the least comfort as to what they may expect to receive at the end of the year. It also acts as a disincentive to outperformance of annual objectives.

To the extent that executives value predictability, year-to-year fluctuations may not achieve the desired result. Conversely, the same bonus awarded year after year often then becomes an expected component of compensation, possibly leading to executives becoming less motivated to outperform. An optimal payout process strikes a balance between consistency of compensation and incentivizing of performance.

Objective-driven bonus structures provide an opportunity to tailor incentive compensation according to the achievement of key metrics. It is best to keep these simple. Identifying a small number of metrics to guide executive actions is often more powerful than structuring an elaborate and overly detailed plan. The objective-setting process should be treated as an opportunity for meaningful dialogue between a family and executives to determine the goals for the following period.

Many families adopt a hybrid approach with a few key objectives and a discretionary compensation element that provides flexibility and the opportunity for upward or downward year-end adjustments.

*Compensation Trends: U.S. and Europe, Family Office and Family Investment Firms. Prepared by Botoff Consulting for Citi Private Bank. November 2023.



CARRIED INTEREST

Popular in the fund management business, carried interest or "carry" is a reward and retention arrangement that pays executives in some cases a specific percentage of investment returns in family portfolios above a hurdle rate or cost of capital. For example, if a net return of 14% is achieved and the hurdle rate is 11%, the manager is entitled to a share of the gain in excess of 11%.

Carry can be applied to a whole portfolio or to one or more major investments, such as a controlling interest in a company owned by the family. Most often, carry is made available to the CIO and CEO of the family office where active assets are over $500 million. In sizable investment organizations, team members may also receive some performance-related carry. The percentage of carry may vary from a modest 1-2% to a high of 10-20%.

Family office executives may be tempted to seek the +/-20% carry often earned by private equity and venture capital funds. However, there are meaningful differences between such funds and family offices that make such arrangements difficult for most families to accept.

The managed assets are, by definition, captive family capital, and the executive team is neither compelled to raise funds nor commit a meaningful proportion of their own wealth to the fund or each investment. By contrast, general partner or manager capital contributions will frequently amount to as much as 10% of a private equity fund, something rarely seen in family offices.

Also, general partners in funds are often locked into multi-year commitments that extend for the life of the fund – often 10 years or more – where payouts are back-loaded after capital and imputed interest are returned to limited partners.

More common than carried interest arrangements are structures that create a "pool" in some cases of phantom equity from which the executive and select staff can benefit from long-term returns, subject to their continued employment and favorable investment returns. This and other "synthetic" forms of carry are more commonly adopted by families. Such pools may be modest in size and provide a payout only after the return of capital and an acceptable pre-tax rate of return.

The benefit of having some form of carry is the executive retention element, as investments in venture capital, real estate and private equity often require many years to increase in value or exit. Executives eligible for such payments will be incentivized to remain with the family office if continued employment is a condition of participation, and to deliver the desired risk-adjusted returns by diligently striving to meet those goals.

However, the downsides of such programs are numerous and increase with the complexity of the structure. They should only be applied to "actively managed" assets where the investment acumen of the executive directly leads to the sourcing, management

and returns of the investment. Simply put, managers of managers, asset allocators and passive investors are not suitable candidates for reward via a carry structure.

If families choose a synthetic carry structure, they should keep in mind the following:

- Actively managed assets such as single-name securities, real estate, private equity and venture capital are most appropriate for this structure. There must be a direct link between the executive's skill and efforts and the resulting returns to the family.

- The structure should be kept as simple as possible as disagreements and litigation are not uncommon.

- Beware of unintended consequences such as creating asymmetric risk taking behavior. This is where executives take outsized risks in pursuit of reward since they have no downside risk (unless they are required to contribute meaningful amounts of their capital to the "fund") and only the family loses if things go wrong.

- One best practice is to start off slowly, creating a synthetic tracking pool and offering professionals a small percentage of net returns, which are essentially gains after both the return of family capital and the cost of family capital.

- Isolating the executives' alpha contribution is especially important where the asset class or investment has a significant "beta" component to its returns.

Co-investment & loans

A less complicated and increasingly popular method of rewarding key executives is to offer a carve-out of shares or ownership interest in real estate ventures, private equity and venture capital investments, allowing executives to make a personal investment.

Approximately 40% of family offices indicated they have a co-investment agreement with the family.*

Some families expect their CIO or CEO to join in their investments, believing that "what is good for the goose is good for the gander." This may set too high a hurdle, as even a modest co-investment may be disproportionate to an executive's net worth relative to that of the family.

Other families allow for co-investment only if executives come up with the investment idea and will play a key role in managing it. More common is the practice of treating co-investments case by case, with some pre-determined rules, such as:

- considering co-investment only if the dollar exposure level of the family can be satisfied first
- no conflicts of interests with family interests, particularly around the timing of liquidity/exits
- family belief that the time horizon and investment amount on the part of the executives is appropriate relative to their net worth

Where co-investment opportunities exist, the individual executive commitment amounts are typically 1-2% of the notional investment amount or up to $200,000 annually, depending upon each executive's net worth.** When negotiating co-investment deals, families should grant executives tag-along benefits, which are intended to protect minority investors. For example, tag-along rights would allow the executives to sell their investment if a majority shareholder decided to do so.

In the same spirit, anti-dilution rights aim to protect executives from equity dilution if subsequent share issuance in a venture are priced at less than what they originally paid.

A variation on the co-investment model is where the family makes a loan to their executives for them to put up as co-investment capital. Such loans may be with or without recourse in the event of default and are collateralized by the investment.

Typically, loans made to executives are modestly sized and may include a prepayment provision that is triggered if they leave their employment. This mechanism may serve to reinforce both strong investment performance as well as retention.
If employment is terminated, families may waive repayment as part of the severance arrangement.

Loans can take an elaborate form – where the equity is held in the executive's name and a loan agreement is in place – or a simpler form where the equity is held entirely in the family's name and collateralizes the loan to the executive. Overall, simplicity and clarity most often trumps complexity in compensation matters.

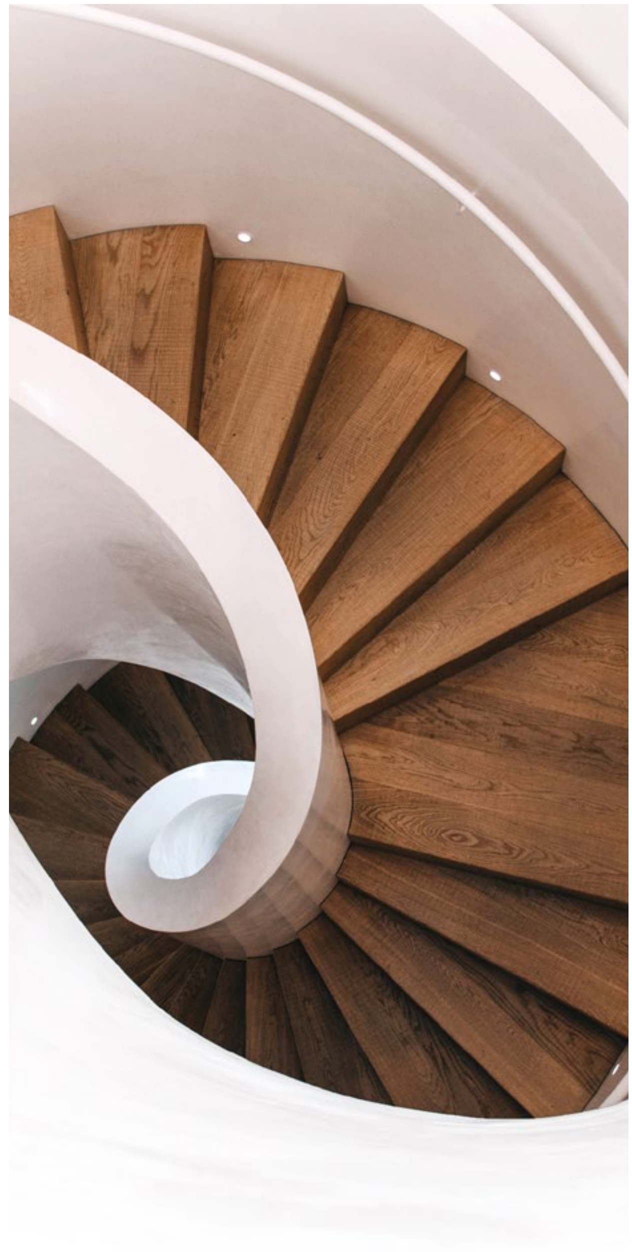
*Compensation Trends: U.S. and Europe, Family Office and Family Investment Firms. Prepared by Botoff Consulting for Citi Private Bank. November 2023.
** For guidance only. Based on our review of clients' operating budgets and survey data available.

LONG-TERM COMPENSATION

Long-term compensation plans in family offices typically consist of deferred cash or stock payouts that vest over a period of time–often three to five years. The vesting element provides a retention incentive, as well as a reward for meeting objectives. Stock may take the form of real or synthetic equity in the family investment vehicle or shares in underlying companies held by the family. The amounts awarded may be determined based on annual internal rate of return or accumulate over a multi-year period based upon portfolio or investment company performance and the term of the investment–in some cases over 10 years.

The principal advantage of long-term compensation strategies is that they can fulfill multiple needs for both families and executives. These reward performance, can be goal/objective-oriented, incentivize executive behavior and promote long-term retention.

Families could consider agreeing to pay executives a one-off lump sum payment at the end of five or ten years of service to encourage the executive to stay for that whole period. Nearly 60% of family offices report having a long-term/deferred incentive compensation program in place.*



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CONSIDERATIONS FOR EXECUTIVES

While the outward appeal of working for an affluent family may be a strong motivation, as with any role, there are positives and negatives. In assessing the opportunity to work for a family, it is essential to understand the "operating system" that governs the communication, decision making and conduct of the family office or private investment company. Simply sizing up the financial package is not sufficient to make a sound decision for you or the family.

The three areas to consider are the behavioral characteristics of the principal(s), the governance structure, and the number and scope of family shareholders.

An examination of the behavioral characteristics of the principal(s) should include an understanding of the investment bias and risk tolerance of the principal. For example, does she or he express extreme regret at financial losses, or engage in group thinking when considering investment ideas? Judiciously speaking with those who work closely with the principal will add insight, as well as addressing the question of risk tolerance and bias head on in discussions with the family.

Governance structure pertains to the methods by which key decisions will be made in such areas as investing, tax, estate planning, budgeting and family office operations. Probing as to how past decisions, both positive and negative, have been made by the principals and family provides insight into the real vs purported practices. If a family board or trustees exercise control positions, it is important to understand past decision dynamics, along with the backgrounds of key members.

Finally, the number of family stakeholders can be a determinant of family office complexity. Multiple family branches, multiple generations and large numbers of family members need not alone be a challenge if there is evidence of family cohesion, strong values and a shared view of the role and mission of the family office and executive. Indeed, many executives prefer to work with large families over a single principal. Similarly, a single principal, if aligned with the executive in terms of role, expectations, communication and decision making, can be an ideal setting.

Candidates and family members are each encouraged to candidly assess "fit" as a key element in attracting, retaining and motivating talented executives for the long term.

A UNIQUE ROLE AND POSITION

Having managed family offices ourselves and working closely with some of the top family office executives across the world, we truly believe that the opportunity to shape the legacy for future generations is a unique reward and worthwhile pursuit with few parallels. The opportunity to set up world-class foundations, invest in cutting-edge technology, set up a sustainable investing model or simply align the family's values and investments for the next generation are all opportunities that cannot be easily found elsewhere. Seasoned executives often note that generally a fair compensation basis follows a demonstrated capability and integrity to the values that matter most to the family.

Conclusion

Effective reward and retention strategies combine good process and pragmatic compensation structures that make sense for both families and executives. Families should resist the temptation to implement strategies without first engaging in the communication and analysis necessary to find a balance between family values and executives' needs and desires. Once agreement is reached, both parties should seek tax and legal advice and formalize the agreement. Setting annual reviews including honest conversations are essential to ensuring effective ongoing communication and understanding.

The very best reward and retention solutions are those that achieve equilibrium and which anticipate how things might go awry.

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We offer clients comprehensive private banking and family office advisory services, institutional access to global opportunities and connections to a community of like-minded peers.

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