

Private Bank



Executive reward and retention strategies in family offices

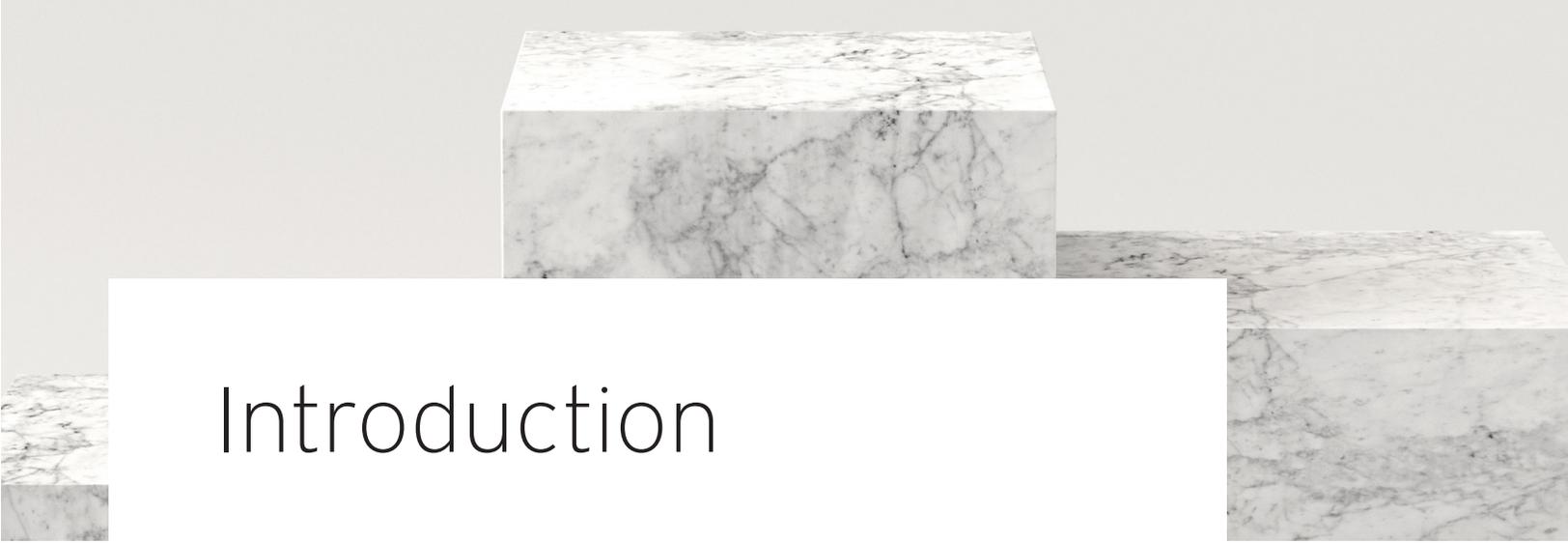
Citi Private Capital Group

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Author

Stephen Campbell
Chairman, Citi Private Capital Group

A decorative background featuring several rectangular blocks of white marble with grey veining, arranged in a staggered, overlapping fashion. The blocks are set against a plain, light grey background.

Introduction

The optimal outcome of any effective reward and retention strategy is one that achieves equilibrium between the parties.

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.

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

This lack of understanding has given rise to a classic inefficient market for human capital in the industry. As in financial markets, human capital assets - in this case, family office executives - can become arbitrarily over- or under-valued, as both families and executives struggle to establish appropriate pricing owing to insufficient information.

Ironically, the absence of suitable information, 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, not only to learn that the subject has never previously been broached, but also that the executive shares the same concerns.

A constructive approach to attracting, retaining, and motivating senior family office executives includes two key elements - process and structure.

Process

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 key behavioral factors?

Understand family values

Foremost amongst 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 each other's intent with respect to reward and retention.

It is therefore essential that executives understand the family's values and their feelings about compensation. Similarly, the family need to understand the executives' compensation needs and expectations.

Navigating these issues can be delicate. Consultants, search executives, and advisors can help by asking candid questions of all parties. It is important to look for 'tells', such as 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 level of outcome 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, though, circumstances and attitudes may change, so repeating this process may be necessary over time.

It is therefore essential that executives understand the family's values and their feelings about compensation.

Define outcomes

A solid reward and retention strategy must be based upon a clear understanding of expected 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 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 often overlook other ways in which their family office executives can be rewarded. Families could reward executives by utilizing their resources and networks to offer their executives opportunities that they might not otherwise have.

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 arranged a publisher for her. Other examples abound of families providing access to their vacation homes, facilitating membership of corporate and non-profit boards, providing access to a family-owned aircraft, or making an annual charitable donation allowance as a way to enrich the relationship further, as well as 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 on the one hand and the needs and motivations of the family office executives on the other. Skewing the arrangement too far in favor of one party over the other invariably results in dissatisfaction, mistrust, and an ultimately poor ending to the relationship. The aim, therefore, should be an outcome in which both parties gain ground, 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.

Best practice would therefore be for families and executives to discuss a wide range of outcomes and their implications.

Structure

Having established the basis of a reward and retention strategy, it is important to examine the structural elements that are often employed. While these represent commonly used tools, one benefit of family control over their office is the flexibility to customize or craft virtually any solution that makes sense.

Base compensation

Salary amounts vary greatly by geography, active assets under management, and the executive's experience. About three quarters of family office Chief Executive Officer (CEO) and CIO salaries are in the range of \$250,000 to \$500,000 a year^{1,2} while chief financial officer, general counsel, and chief operating officer compensation is often around 50% of these levels. It is not uncommon for the CIO to be paid the same as or more than the CEO owing to the role's specialized responsibilities. Annual salary adjustments in January are typical in about half of family offices.

Base salaries reflect two primary factors: comparable amounts paid by similarly-located family offices and executives' salary history.

Although difficult, obtaining salary comparatives is not impossible. 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. As to past compensation, it is not uncommon for executives to take a reduction in salary - but not in total compensation - in order to work in a family office setting that requires less commercial stress and travel. That said, families should expect to pay for quality executives in today's increasingly competitive environment.

\$250,000 - \$500,000

The salary range for 75% of family office CEOs and CIOs^{1,2}

Executive bonus

Bonuses have become increasingly popular as a way to reward and retain top family office executive talent. A 2017 survey by Fidelity Investments³ found that 70% of C-level executives are eligible for some form of bonus. Bonuses are typically between 50% and 150% of base compensation and come in two basic forms: discretionary and objective-driven.

As its 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.

To the extent that most 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 bonuses and calling attention to shortfalls in performance.

Objective-driven bonus structures provide an opportunity to tailor bonuses 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 families and executives to determine what is important in the coming 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.

¹ Largely for offices with active assets of \$400 million to \$1 billion in size

² Citi Private Bank Global Family Office, November 2017

³ Fidelity Investments, 'Insights on Family Office Compensation', 2017

Carried interest

Popular in the fund management business, carried interest is a reward and retention arrangement that pays executives a specific percentage of net gain in 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%.

Carried interest 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 this 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 payment. 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 in to

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' 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 likely to be 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 - typically 10% to 20% - are achieved.

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.

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 real estate, private equity, and venture capital are most appropriate for this structure. There must be a direct connection 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 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.
- It is desirable to start off slowly, creating a synthetic tracking pool and giving eligible employees 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.

2/3

the number of family office heads that have a co-investment agreement with the family they serve⁵

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. In a 2017 survey of global family office heads carried out by Citi Private Bank⁴, two-thirds indicated they had a co-investment agreement with the family.

Some families compel 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 \$50,000 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, follow-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 issues of shares in a venture are priced at less than what they originally paid.

^{4,5} Citi Private Bank, Global Family Office Survey, 2017

The principal advantage of long-term compensation strategies is that they can fulfill multiple needs for both families and executives

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.

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 annually or accumulate over a multi-year period based upon portfolio or investment company performance.

The principal advantage of long-term compensation strategies is that they can fulfill multiple needs for both families and executives. They 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. In the same Citi Private Bank family office executive survey mentioned earlier, 53% of executive respondents reported having a long-term incentive program in place.⁶

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. Set annual reviews including candid 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.

⁶ Citi Private Bank, Global Family Office Survey, 2017

Stephen Campbell is Chairman of Citi Private Capital Group where he advises families of significant wealth on family office and investment management best practice.

Previously, he was CIO of a Seattle-based family office, and has held senior investment and technology roles with Fidelity Investments in Europe and the United States. Stephen was Founder and CEO of two financial technology companies, and has led investments in numerous early-stage companies.

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