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Variable Compensation

Profit-Sharing, Bonuses & Incentives

The second monetary component of the compensation package may be in the form of profit-sharing, bonuses or incentives. The criteria for earning these must also be clearly defined so it is transparent, and everyone understands. Although this part of the compensation may be a more significant part of the package for others, based on specific roles, we believe it's important everyone on the team has the ability to share in the upside of a successful advisory practice in some way.

PROFIT SHARING

Profit-Sharing is an important part of a compensation package[1]. Before we dig into it, it's important to understand it in the context of total compensation.

When it comes to profit-sharing with your team members, it:

- Demonstrates your willingness to share in the success of your practice
- Shows you value helping them achieve their personal financial goals
- Creates an awareness of profitability (versus production)
- Helps prioritize business activities that drive profitability
- Creates an awareness about expenses
- Encourages efficiency to minimize expenses
- Promotes committed support of your vision
- Helps attract and retain high quality individuals

Over the years we've observed a few common flaws related to profit-sharing. We want you to be aware of these flaws and provide you with solutions to overcome them.

First, profit-sharing is often calculated as a straight percentage of net or gross production, which does not necessarily reflect profitability. You have likely experienced volatile months in the past, where you were barely covering your expenses, and yet your team was still reaping a bonus. This profit-sharing model can breed a feeling of 'entitlement' and doesn't reflect profitability. It simply doesn't work.

Second, profit-sharing is often paid out on a monthly basis along with Base Salary. This tends to create a 'salary' mentally and your team will come to expect it – even when the bad months hit. In fact, most individuals will quickly adjust their standard of living to reflect the profit-sharing component when it is paid monthly. This means they will be susceptible to volatility and generally respond negatively to any downticks in their bonus – even when caused by factors beyond your control (i.e., think a fee-based practice in a down market).

[1] The amount generated by profit-sharing will vary depending on the role and the level of profitability within a practice.

Finally, profit-sharing has often been done on an arbitrary basis. This model may be easy to maintain when you have only one team member, but as your team grows so does the complexity of your profit-sharing. This can also result in confusion about how it actually works.

Like everything else in your practice, we recommend you establish a profit-sharing process that serves you over the long run. Refer to the Take Action section of this strategy for step-by-step instructions on how to achieve this. We also suggest you calculate and pay profit-sharing on a quarterly basis. This gives you a reasonable time frame to measure profitability and makes it more likely it will be viewed as the 'profit-sharing' it was intended to be. Finally, you need to clearly communicate this process to your team, so they understand it.

This profit-sharing model:

- Is based on a formula that reflects profitability
- Allows advisors to draw a monthly salary and/or return of Owners Equity
- Allocates profit based on the contribution of each individual
- Is calculated and paid quarterly

Step 1: Determine your Net Profit

Complete the Net Profit[2] equation for your practice.

Begin with:	Gross Production
Less:	Firm Payout
=	Net Production
Less:	Fixed & Variable Expenses[3]
Less:	Owner's Equity[4]
=	**NET PROFIT**

Step 2: Determine your Team Profit-Sharing Pool

Decide what percentage you want to allocate to the Team Profit-Sharing Pool.

Begin with:	**NET PROFIT**
Multiply by:	Team Percentage[5]
=	**TEAM PROFIT-SHARING POOL**

[2] Begin with current information, but also consider your projected income and expenses.
[3] This includes all expenses incurred to operate the business, including the Advisors draw or monthly salary.
[4] This may or may not be a component you choose to include in the formula.
[5] This percentage will vary from practice to practice.

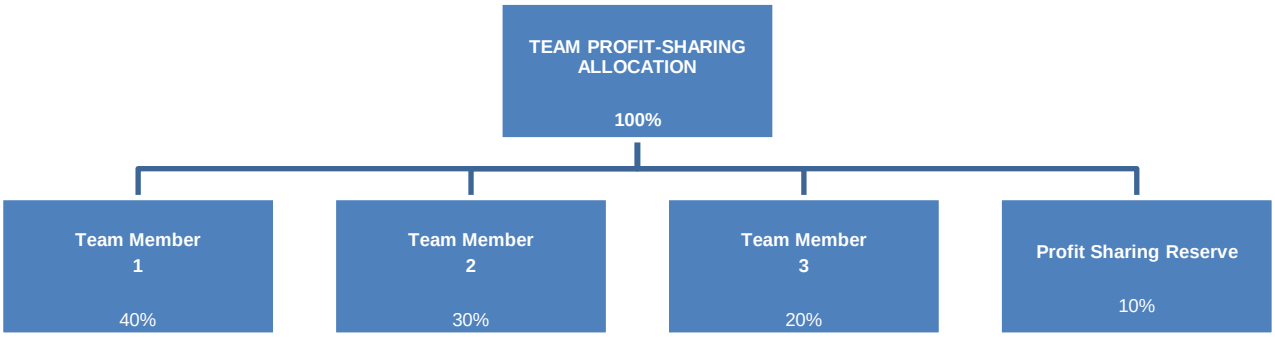
For example, 75% of Net Profit may be allocated back to you, the Advisor, and 25% made available for team distribution.

Choose a percentage that puts this number in a range you are comfortable with.

Step 3: Determine the Individual Profit-Sharing Allocations

Assign each team member their 'share' of the Team Profit-Sharing Pool. Individual allocations should be based on contributions to the team (role, responsibilities, education, tenure, attitude, and performance).

Individual Profit-Sharing Allocation - *Example*



We recommend you leave a 'reserve' in the Team Profit-Sharing Allocation to allow for:

- Special team acknowledgements (concerts, dinner, and other team events)
- Special individual acknowledgements (flowers, gift certificates, etc.)
- Providing team perks (parking, gym memberships, etc.)
- Paying out an extraordinary year-end or holiday bonus

Each year the 'reserve' should be spent in full on the team.

Step 4: Final Review & Adjustments

Adjust variables and assumptions in Steps 1 through 3, if required, to achieve your desired outcome. The profit-sharing process must make sense for your practice while also providing motivation to your team.

If you have a profit-sharing process that allows individuals to financially achieve when the practice does, it becomes the driving force behind future compensation growth. Having a stake in the upside helps attract and keep the right kinds of individuals.

BONUSES

Offering bonuses is another way of rewarding your team and some may choose to use this approach instead of the profit-sharing. The premise here is your team is rewarded if the overall advisory practice is in a position of awarding a bonus and the individual is deserving of it.

Depending on the specific role, bonuses may be paid monthly, quarterly, semi-annually, or even annually. For administrative positions, it is recommended that the bonus is not paid monthly as it is often embedded into their cost of living and doesn't provide a margin of safety in the event of sudden changes in bonus level.

What is important for your team is to KNOW the schedule of bonuses being paid and the criteria for which they are earned. Some teams have a simple calculation as a percentage of gross or net sales, while others look at reaching specific targets related to AUM and/or Production. Some have a combination where there is a percentage paid and then at the end of the year an extra bonus is received if these other goals are achieved.

Some teams also initiate bonuses for a variety of business circumstances the team handles extraordinarily well or completing big initiatives. This may involve helping the advisor change firms or a significant re-papering and restructuring of portfolio management for clients – both of which involve a lot of extra time and effort. You will know when something extraordinary is happening and your team is really stepping up – and when that happens, you have an opportunity to do something unexpected and show them how much you appreciate them. This could be in the form of a monetary bonus or something else, like a team dinner celebration, weekend get-away package or Gift Certificate to their favorite store or service provider.

At the end of the day, the bonus should be interpreted and received for what it is intended – a gift and recognition for great work.

INCENTIVES

Some advisory teams and firms have incentives related to specific initiatives that are also paid. Many teams, however, do not incorporate extra incentives and don't need to because of the effectiveness of their total compensation package.

An example of this is firm-driven initiatives or campaigns related to sales. Another example is advisory teams who provide incentives for new client assets brought into the advisory practice, which is often paid as a percentage of the new assets or a flat-rate fee.