THE RESEARCH REPORT

A NEWSLETTER BY INNOVEST Q3 | 2011

CHECK OUT OUR BLOG!

NEW CLIENTS

Innovest was recently hired to provide investment consulting services for:

Digital Retirement Solutions

South Metro Fire Rescue Authority

SM Energy

CONTENTS

THE RATING GAME: NOT ALL IT'S CRACKED UP TO BE

Gordon Tewell, CFA, CPC, Principal

USING RATING SYSTEMS FOR FUND ANALYSIS

Whether the investor is a 401(k) plan sponsor or an individual investor, once any investor selects the asset classes in which they intend to invest, all investors face the difficult issue of selecting managers in each asset class of their portfolios. A variety of methods have been used over time, but one method that seems to have captured the focus of many investors is that of the rating system.

Unfortunately, rating systems tend to be imperfect when it comes to predicting future performance. The basis of most rating systems is some combination of past performance, typically over 3-, 5- or 10- years and a measure of the funds' risk. The problem with using purely quantitative rating systems is that the information used for each manager is historical. If you have ever read a mutual fund's prospectus, you have encountered the disclaimer that past performance is not an indication of future performance. The Securities and Exchange Commission makes mutual funds put that disclaimer on a prospectus for a good reason—it is absolutely true.

RATING FUNDS ON PAST PERFORMANCE

Just because a mutual fund performed well in the past does not mean it will perform well in the future. In fact, it might mean the fund will under-perform the market over the next several years.

A good example of this is the performance of growth oriented mutual funds which focused on the information technology sector during the late 1990s. For many years, funds with an overweight exposure to technology stocks generally performed better than their broadly diversified peers. The ratings under various rating systems for many of these technology-focused mutual funds were high due to the explosive growth of the high-tech companies in which they invested during the high-tech boom. But as we all know, these stocks funds suffered significantly during the high-tech bust. This is a clear example of the problem with the rating systems. Savvy investors realize that they should not blindly invest in mutual funds just because they have been highly rated.

*It is not known whether the listed clients approve or disapprove of the services provided. The new clients on page one and above in the spotlight are listed here with their approval and permission.

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RATINGS FAIL OVER MARKET CYCLES

A 2009 study by Advisor Perspectives evaluated the predictive ability of the Morningstar rating system. The study measured the probability that a randomly selected higher-rated fund would outperform a randomly selected lower-rated fund. The study's organizers believed that this metric was the most meaningful way to assess the usefulness of the rating system. The firm evaluated incremental improvement that would obtain by, for example, trading up from a 4-star to a 5-star fund.

The study found that a one-star improvement across the five fund categories tested (US Equity Funds, International Funds, Balanced Funds, Taxable Bond Funds, Municipal Bond Funds) was 50.6%. Essentially, there was a fifty-fifty chance whether a higher rated fund would outperform a lower rated fund.

In response to the study, Russel Kinnel of Morningstar stated, "In short, the star rating is a backward-looking measure of past performance. What it is not is a forward-looking measure of fundamentals."

In 2010, C. Thomas Howard, a professor at the Reiman School of Finance, University of Denver, confirmed Advisor Perspectives' evaluation. Howard's study evaluated the predictive power of the Morningstar weighted historical returns using a sample of all active US equity mutual funds spanning the period from January 1980 through June 2008. He found that the fraction of the equity funds' subsequent one-year return volatility explained by these weighted historical returns was .002 (i.e. r-squared). This essentially zero correlation is right in line with Advisor Perspective's findings that star ratings are not predictive of future fund performance.

EVEN TOP-QUARTILE FUNDS LAG AT TIMES

An additional test of the predictive value of historical performance was conducted by Investment consulting firm DiMeo Schneider. Their analysis identified funds in various investment categories that had been in the top quartile over the past 10 years—funds that many investors would be drawn to. The study concluded that nearly 85% of those top-quartile funds (across all categories) delivered investment results below their respective benchmarks for at least one three-year period (12 consecutive quarters) during that same 10-year timeframe.

The *Morningstar Ratings Methodology* document states, "While the long-term overall star rating formula seems to give the most weight to the 10-year period, the most recent three year-period actually has the greatest impact because it is included in all three rating periods. Based on this, there should be a concern that funds which have performed well in the most recent 3-year period will have a higher rating and will lead investors to the conclusion that these funds will outperform going forward.

A discussion of the current market environment might shed light on the risk of chasing recent outperformers. It is commonly believed that high quality stocks act as cushion during market downturns, thereby providing some downside protection. If this thesis is correct, then one would expect that in periods of declining risk, narrowing credit spreads, and flattening yield curves, the quality premium would tend to be negative, and managers who invest in the stocks of high quality companies would underperform.

This theory proved true during the recent market recovery. From January 1, 2009 to March 31, 2011, those stocks with higher variability in growth and stability of earning and dividends have dramatically outperformed the stocks of higher quality companies.

The ratings for many low-quality, high-beta focused mutual funds have increased dramatically based on their short-term outperformance during this timeframe. But as markets refocus on the quality of earnings, we would expect these managers to underperform, disappointing investors who have relied on their recently improved ratings.

CONCLUSION

We concur with the research presented above that ratings are not an effective forward-looking measure. This is not to say that rating systems have no value. Past performance can be one indication of a well-managed fund. In addition, a rating system can be used as a first filter when developing an overall investment strategy. For example, the rating system could be used as an introduction to prospective funds - but not the deciding factor or the only factor to use when

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researching and selecting a mutual fund.

Ratings and past performance must be combined with other information. The correct approach to fund selection relegates historical performance to a secondary consideration. The primary focus in manager choice should be qualitative, including a thorough analysis of the product's management, investment philosophy and process.

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DRIVING SUCCESSFUL PARTICIPANT RETIREMENT OUTCOMES

Jerry Huggins CFP, MBA

The dream of a secure retirement seems to be fading away for millions of workers as they increasingly face the tremendous challenge to accumulate enough savings for an adequate retirement. Americans' confidence in their ability to attain a secure retirement has reached a new low, according to the 2011 Retirement Confidence Survey produced by the Employee Benefit Research Institute (EBRI).

The 2011 EBRI survey indicated that the percentage of workers with "no confidence" in having enough money for a comfortable retirement reached 27 percent, the highest level measured in the 21 years of the survey. At the same time, the percentage of "very confident" workers declined to the previous low of 13% measured after the market declines in 2008 and early 2009. What is more surprising than the loss of confidence is that these workers are not making any adjustments to their savings and spending to get themselves back on track. Instead, they are modifying their expectations about how they will transition from work to retirement, by retiring later and working during retirement.

Unfortunately, as more workers lose confidence and become more complacent about taking responsibility for their retirement savings, defined contribution plans are being blamed for failing to provide an adequate retirement. We do not believe that defined contribution plans are the problem. Nonetheless, plan sponsors can do much to ensure retirement is a pleasant destination for their employees. Plan sponsors need to begin focusing on providing employees a better retirement planning experience. Effective sponsors move beyond offering only a competitive employee benefit and towards providing their employees with a secure retirement. The following are some relevant strategies that can help defined contribution retirement plans jump-start employee confidence and drive successful participant outcomes.

SHOW ROOM FLOOR

As a steward for your employees, it is crucial that you are committed to ensure everyone is participating and working towards the goal of a secure retirement. The ideal plans we see are those in which employers take an active role in improving the behaviors and practices of their workers. It is not enough just to make it possible for employees to save. The plan needs to be easy for them to participate in, understand, set goals and manage. Employers need to be involved in making the plan visible and promoting the retirement program's incorporation of the most current and effective best practices. Fiduciary oversight entails constant review of the plan's design, recordkeeping and administration, education and counseling, investments, and cost controls. It is crucial that each of these factors be prudently managed to encourage active involvement and to meet employees' needs.

Effective employers embrace the task of positioning and promoting their retirement plan on an ongoing basis. Employers need to continually reinforce to employees how vital the benefits of the retirement plan are to their future lifestyle and how the unique features of their

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plan have been designed to help them achieve a secure retirement. Employees want to be involved in something important and special. The more important you make the retirement plan, and the more you communicate the plan's special features and benefits, the greater attention and involvement you will get from employees.

CRUISE CONTROL

Employers have become increasingly concerned about those employees not participating in the plan, as well as those participants who may not be contributing sufficiently and diversifying their investments. Despite increased recognition of the value of defined contribution plans, employees continue to remain disinterested in spending the time to enroll and manage their retirement accounts. Employers are starting to respond to employee complacency by adding auto-features to their plans to drive what is in employees' best interest. To get employees ready for retirement, employers are utilizing these auto-features to automatically enroll employees, annually increase their contributions, provide investments that automatically allocate assets over time, and make available withdrawal programs to automatically distribute income in retirement.

Auto enrollment has become a very successful plan feature that has positively changed participation in defined contribution plans. Implementing an auto enrollment feature in a plan is an excellent way for employers to enroll new and existing employees in the plan and save for their retirement. When adopting this feature it is important to ensure that the initial default contribution rate is set at an adequate level (6%) and also includes annual automatic contribution increases to help these participants move to a higher savings rate. It is believed that most participants will need a total savings rate (employee and employer contributions) in the range of 12% to 15%, to reach a sufficient savings amount.

Having employees participate and save at an appropriate rate is only part of the retirement plan equation. Equally important are the investment choices in the plan and the strategic role these investments play in a participant's success. Since most employees are not sophisticated investors and have no desire to construct, reassess, and rebalance the investment portfolios, employers have been simplifying investing for participants by including auto-investment alternatives. Investments of this type include retirement target-date funds, risk-based model portfolios, and managed accounts. For the majority of participants, these investment alternatives make investing easier, and provide them with a single investment option that gives them broader diversification and more consistent investment performance.

In January of 2011 the first Baby Boomers turned 65 years old, and millions of them are preparing to retire. Unfortunately, many Boomers are worried about withdrawing too much money during retirement and outliving their retirement savings. To help participants manage their retirement savings withdrawal rate in a "safe" or "sustainable" way, employers are now including automatic withdrawal features into their plans. These auto-withdrawal features include systematic withdrawal plans, lifetime income options, and guaranteed minimum withdrawal benefits (GMWB). They are designed to benefit participants with a convenient solution to receiving retirement income without having to worry about the premature depletion of their retirement savings.

PERSONAL ROAD MAP

A recent survey conducted for the American Institute of Certified Public Accountants (AICPA) demonstrated American workers' growing concerns about affording retirement. For the second year in a row, the workers surveyed ranked retirement as their most important financial concern. The survey also reported that more than half of working adults (55%) do not know how much they need to save to retire comfortably.

To help reduce these concerns, employers cannot merely continue to tell employees that they need to save. Rather, the most effective employers provide employees with real numbers on how much they need to save. In plans where employers have provided employees with retirement savings goals, employees are more engaged in actively planning for their retirement, have higher savings rates, are more attentive to their investment allocations and returns, and put

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more time into monitoring the progress of the retirement accounts. Recent studies demonstrate that workers who have identified a retirement saving goal are much more confident that they are on track to achieving a secure retirement.

The employer, assisted by the current plan provider or an outside advisor, can furnish employees with both an income replacement ratio and a savings goal. The income replacement ratio is the traditional metric that identifies how much of an individual's current salary will need to be replaced in retirement. Once the income replacement ratio has been determined it can be translated into a personal savings goal by using any number of retirement savings tools available through plan providers or outside advisors.

Below is a chart taken from AON Consulting's 2008 Replacement Ratio Study, showing income replacement ratios for different income levels.

Estimated income replacement ratios by income level

Pre-retirement Income ($000)	Replacement ratios		
	Social Security %	Private and employer sources (%)	Total (%)
20	69	25	94
30	59	31	90
40	54	31	85
50	51	30	81
60	46	32	78
70	42	35	77
80	39	38	77
90	36	42	78

Once an employee has set a personal retirement goal, it is equally important to make sure that they receive ongoing assessments of how they are doing relative to their goal. The retirement plan provider or outside advisor needs to update participants at least annually on whether they are still on target to reach their personal goal. If the participant is no longer on target to reach their goal, the program that is monitoring participants retirement readiness should automatically provide alternatives that will get them back on track to reach their goal.

SUNDAY DRIVE

Employers need to help ensure that employees are ready for retirement by taking the time to understand the needs of their workforce and implement plan designs that remove the many road blocks preventing their employees from a successful retirement outcome. Employers need to concentrate on getting all employees into the plan, encouraging saving at an adequate rate, investing properly, and measuring their success against their savings goals. Ultimately, it is not good enough just to offer a retirement plan to employees. The most effective plan sponsors offer a full service solution. Not surprisingly, employees participating in healthy and effective plans are best equipped to reach their retirement destinations.

Source; AON Consulting's 2008 Replacement Ratio Study. This graph illustrates three significant points about the replacement ratio calculations

2. Total Replacement Ratios that are required to maintain a person's pre-retirement standard of living are highest for the very lowest paid employees. This is primarily for two reasons. First, before they retire, lower paid employees save the least and pay the least in taxes as a percentage of their income. Thus, they spend a higher percentage of their income and need higher Replacement Ratios to maintain that level of expenditures. Second, age- and work-related expenditures do not decrease by as much, as a percentage of income, for the lower paid employees. This also means they need more income after retirement (as a percent of their pre-retirement income) than the higher paid employees.

3. After reaching an income level of $60,000, the total required Replacement Ratios remain fairly constant at 77 percent – 78 percent. This is primarily because post-retirement taxes increase as income levels increase. Post-retirement taxes increase from 0.1 percent of post-retirement income for a $60,000 person to 6.7 percent for a $90,000 person. To pay the additional taxes, higher paid employees need more retirement income.

CLIENT SPOTLIGHT

SOUTH DAKOTA SCHOOL OF MINES AND TECHNOLOGY FOUNDATION*

The SDSM&T Foundation is the official gift-receiving entity for the South Dakota School of Mines and Technology in Rapid City. The Foundation serves the University by seeking resources necessary to provide students with exceptional intellectual, professional and personal development opportunities.

Recently the foundation created the *Building the Dream* campaign which is dedicated to achieve funding for scholarships, faculty, student experience and capital improvement efforts for the University.

The South Dakota School of Mines and Technology is dedicated to being a leader in 21st Century education that reflects a belief in the role of engineers and scientists as crucial to the advancement of society. Its vision is to be recognized as a premier technological university in the United States. Its mission is to provide a well-rounded education that prepares students for leadership roles in engineering and science; to advance the state of knowledge and application of this knowledge through research and scholarship; and to benefit the state, region, and nation through collaborative efforts in education and economic development. The University currently has 2,354 students.

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AROUND THE FIRM

WELCOME

As Innovest continues to grow, we have committed to our clients that we will add talented, dedicated people to our team to maintain the highest level of customer service to which they've become accustomed. We are very excited to welcome a new member to the Innovest family. Gina Champ joined Innovest in August.

Gina is an Analyst at Innovest. Her primary responsibility is to provide support to both business development and marketing efforts at Innovest for their retirement plan, foundation and endowment, and wealth management practices. She has over 10 years of investment experience and joins the Innovest team via Invesco and Oppenheimer where she was responsible for client relations and training.

RECOGNITION

Both Rich Todd and Jerry Huggins are very proud of their daughters. In August, Rich's daughter, Alex, headed off to Purdue University on a swimming scholarship. Congratulations Alex on this accomplishment! Jerry's daughter Lauren, who committed to the University of Colorado for 2012, was recognized by ESPN for her basketball talent!

Martin Walsh's article on Municipal Bonds was published by *RIA Biz*. The article provided insight on the relative safety and tax effectiveness of these investments.

RECENT EVENTS

On June 5, 2011, members of the Innovest team participated in the 6th Annual Steps-n-Strides 5k Run/Walk to benefit the Kyle O'Connell Foundation. The Kyle O'Connell Foundation (proposed by Eileen Pohs, Analyst Assistant) makes efforts to create awareness and raise funds to support pediatric brain tumor research, as well as assisting families impacted by the many struggles associated with pediatric brain tumors.

Donna Patch and Jerry Huggins attended the Colorado County Treasurers Association Summer Conference held on June 20-24 in Gilpin County. The conference offered a series of educational sessions for County Treasurers, Public Trustees and Associate Members. Innovest was also a co-sponsor of the event.

On June 21, Innovest hosted "Fiduciary Education for Defined Contribution Trustees." The fiduciary training and continuing education program was customized for retirement plan trustees and provided the background for trustees, if they choose, to obtain and maintain the Registered Fiduciary, RF designation.

The Innovest Team celebrated the Rogers Casey Conversion with a BBQ at Bible Park.

On July 18 at Sports Authority Field, Innovest hosted a Capital Markets Update, "Avoid the Pitfalls that Come from Extreme Markets." The lunch held in a suite at Sports Authority Field at Mile High, was presented by Marvin Flewellen, Senior Portfolio Manager, Invesco AIM Financial Management Group.

In July Innovest members participated in a Platte River clean-up project with SPREE (South Platte River Environmental Education), an effort organized by Greenway to educate children of environmental preservation.

The Greenway Foundation (proposed by Pam Cruz, Accounting Manager) is another way Innovest employees have chosen to give back to the community. The Mission of the Greenway Foundation is to advance the South Platte River and the surrounding tributaries as a unique environmental, recreational, cultural, scientific and historical amenity that uniquely links Denver's past and its future.

Donna Patch and Gordon Tewell attended the Western Pension Benefits Conference in Las Vegas in July. The conference brought together professionals with expertise in the dynamic field of employee benefits to educate, provided information, and fostered sound principles of benefit plan governance within the industry. Gordon was one of the conference speakers, providing guidance on the selection of investment advisors and retirement plan providers.

The three day annual Colorado Public Plan Coalition Conference was August 17-19th at Cheyenne Mountain Resort in Colorado Springs. Donna Patch has been a co-chair of the CPPC Board for the last five years. The multi-day format allowed for general sessions and workshop programs to explore topics in detail. The conference also provided the members with opportunities for formal and informal networking.

Wendy Dominguez was a panelist at the National Conference of the Catholic Association of Latino Leaders on August 13. The panelists discussed preserving their faith in both their public and personal lives.

The twelfth annual Colorado CEO Forum will be held September 27th at the Denver Center for the Performing Arts. This year's topic is Economic Recovery: The Future is Your Decision.

In October, Innovest will support the Denver Rescue Mission (proposed by Caitlin Markel, Analyst) by providing food to those in need. The Denver Rescue Mission is changing lives by meeting people at their physical and spiritual points of need, with the goal of returning them to society as productive, self-sufficient citizens.

For more information about Innovest's past and present charitable donation projects, visit our Community Involvement page on the Innovest website.

Remember to check out Innovest's Blog at http://www.innovestinc.com/blog/. Our blog, which is continually updated with articles and commentaries from our must trusted sources, also features Innovest's insights on the markets.

EMPLOYEE SPOTLIGHT

PAMELA J CRUZ
Accounting Manager HR

Pam (left in photo) is responsible for overseeing all financial accounting functions at Innovest including production and analysis of financial statements, accounts receivable, accounts payable and all payroll functions. In addition, she is responsible for Human Resources, which includes keeping abreast of the changing state and federal labor laws, new hire/termination processing, and coordinating employee insurance issues and disability claims. She also reports to principals and employees regarding compensation reviews and vacation usage.

She joined Innovest in 2007 with several years experience in bookkeeping and office management, having worked for a CPA and a money management firm.

Pam is involved in an ENDOW (Educating on the Nature and Dignity of Women) study group and is active in her community and church. She volunteers at Grant Ranch School in southwest Denver and served on the board for Southwest Denver Soccer for two years, including coaching developmental soccer. She is the mother of two children and is married to a sergeant in the Denver Police Department.

WHERE IS YOUR HOMETOWN?

Denver, Colorado.

WHAT DO YOU LIKE BEST ABOUT WORKING AT INNOVEST?

There are several things I like about working at Innovest. It is impossible to pick just one. Innovest has given me the opportunity to work with flexibility for a great company. Innovest is constantly striving to improve their service to their clients as well as to the community.

Innovest believes it is important to give back, and that is evident through their many charitable contributions. The staff at Innovest makes all the difference—daily I witness the dedication of the team to support each other and make work enjoyable.

HOW DO YOU GIVE BACK TO THE COMMUNITY?

I volunteer at my church, St. Rose of Lima, and I am a member of Innovest's Charitable Donation Committee. In 2011 I coordinated a volunteer project with The Greenway Foundation's South Platte River Environmental Education (SPREE) where 15 Innovest employees and family members picked up trash on the banks of Cherry Creek. I donate annually to several charities, including; Heifer International and Susan G. Koman for the Cure. I also volunteer at Grant Ranch Elementary School for different functions throughout the year.

WHAT ARE YOUR HOBBIES AND INTERESTS?

Aside from supporting my kid's sporting activities, I enjoy golfing when I get the opportunity. I also enjoy a good crossword or Sudoku puzzle.

TELL US ABOUT YOUR FAMILY.

I have two children, Russell, 12 1/2, and Taylor, 11. Russell plays football, basketball, baseball and the saxophone. Taylor plays volleyball, basketball, gymnastics and the flute. My husband of 16 years, Keith, is a sergeant with the Denver Police Department, and coaches my son's baseball team. I am the youngest of eight children, and my parents still live in my childhood home. All of my siblings live in the Denver area.

EDITOR

GINA CHAMP

INNOVEST PRINCIPALS

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