THE RESEARCH REPORT

A NEWSLETTER BY INNOVEST FALL | 2012

NEW CLIENTS

Innovest was recently selected to provide investment consulting services for:

Platte River Power Authority

The Berry Company

Behavioral Healthcare, Inc.

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

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RETIREMENT PLAN FEES AND THEIR IMPACT ON PARTICIPANT OUTCOMES

Jerry Huggins, Vice President

There continues to be a dramatic shift in how most employees plan and save for their retirement. More and more employees are relying on defined contribution plans to be the largest or at least a significant source of their retirement income. This shift has caused many plan sponsors to reevaluate their plans and make significant changes to plan design and investment offerings that are more focused on helping participants become ready for retirement.

To reach the goal of retirement readiness, employees need to concentrate on a savings program that accumulates an account balance that is sufficient to meet their targeted income replacement during retirement. The variables in an effective savings program include early participation, adequate savings rate, realistic returns on investments, and plan fees. For employees this means that they need to start participating as soon as possible, save at an adequate rate, and allocate investments properly to provide institutional-like returns. For plan sponsors this means that they need to periodically review to ensure plan fees are reasonable.

With fees playing such an important role in the success of a participant's retirement savings efforts and more scrutiny being paid to them because of litigation and the new fee disclosure regulations enacted by the Department of Labor (DOL). The following information has been prepared to help plan fiduciaries better understand plan fees and the effect they may have on participant savings and reaching their retirement goals.

WHAT MAKES UP PLAN FEES?

To better understand how plan fees effect participant retirement savings you need to review what makes up the underlying cost structure and how fees are charged. Plan fees generally fall within three categories: Recordkeeping/Administration Fees, Investment Fees, and Individual Participant Fees.

- Recordkeeping/Administration Fees are the costs associated with the day-to-day operations and servicing of the plan. These operations and services include plan and participant daily valuation and accounting, portals to access information and initiate changes (voice-response systems, toll-free customer service and online), providing communication and education, compliance and custody/trust, and reporting. These fees are either paid by the plan sponsor or passed along to participants. A lot of the time these fees are covered by revenue sharing from investment fees that are being deducted from investment returns.
- Investment Fees are the investment management fees identified with each investment option made available in the plan. Investment expenses typically associated with investment managers include management fees, 12b-1 fees (mutual funds), and other fees. Management fees, also known as investment advisory fees, are the charges for managing the assets of the investment portfolio. Rule 12b-1 fees are charges used to pay for the marketing of the fund, and pay brokers and plan service providers for distributing (selling) the fund. Other fees are those charges related to the day-to-day operations and administration of the investment product, including recordkeeping, portals to investment and account information, and furnishing statements. Each of these fees are ongoing asset-based charges deducted from the investment performance and may be used in revenue-sharing to help cover plan recordkeeping/administration fees.
- Individual Participant Fees are the charges for services associated with the optional features offered in the plan. These optional features that can be initiated by participants can include loans, distributions, QDRO's, fund short-term redemption fees, investment advice and managed accounts, and the use of a self-directed brokerage account. These fees are charged directly to the account of the participant who chooses to utilize one of these plan features.

With an understanding of what makes up a plan's underlying cost structure, we can move on to what plan providers consider when determining fees and the range of fees that are currently being paid by plan sponsors.

Absent any custom communication campaigns or heavy onsite education, the initial consideration by providers has been the asset size of the plan. This was an important consideration since it helped plans absorb large start-up costs and provided record keepers with scale allowing them to drive down their unit costs. As asset-based investment-related fees became more common, plan asset size became less important and plan providers started paying more attention to the number of participants and the average participant account balance when determining the fees they charged.

Based upon our experience working with plan sponsors, participation in industry groups, and review of fee surveys and benchmarking studies we are comfortable providing a representative range of fees paid by defined contribution [401(k), 403(b), and 457] retirement plans. We have determined that plans with assets between $10 million and $100 million, fall within a range of fees (as a percentage of assets) between the highest fee of 1.70% and the lowest fee of 0.50%, with the average fee being 1.15%.

WHAT IS THE IMPACT OF FEES ON PARTICIPANT SAVINGS?

Plan sponsors know that a participants ending account balance will determine the amount of retirement income they will receive from the plan. While the contributions to their accounts and earnings on their investments will play a big role in their final account balances, fees paid by participants may substantially reduce the growth of their accounts. Using the information from the representative range of fees, Figure 1 shows the growth of a participant's account under each of the three fee scenarios.

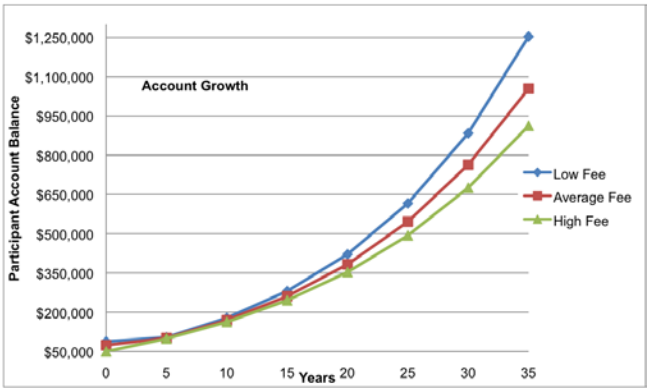

Figure 1: Participant account growth of a low, average and high fee plan.

All projections assume an initial participant account balance of $50,000; monthly contributions made to the plan of $500; average annual growth rate of 7% (before fees); fees are paid by participant; time period is 35 years.

A summary of the chart shows that the low cost plan would provide the participant with an ending balance of $1,253,271, while the average and high cost plans would provide a participant with ending balances of $1,053,932 and $912,196 respectively. The differences in accumulated assets comparing the low cost plan versus the average and high cost plans were $199,339 and $341,075, or nineteen (19%) and thirty-seven (37%) more in the low cost participants account over a thirty-five year period. These differences are meaningful and also translate over into the participant's retirement income. Based upon the accumulated values in the prior scenarios, a participant withdrawing at a five (5%) rate over a twenty-five year period would be able to withdraw $13,984 and $23,927 more a year in the low cost plan versus the average and high cost plans.

All things being equal, lower plan fees remove a significant hindrance on the growth of participant account balances, especially those participants with a long-term investment time horizon.

WHAT CAN PLAN SPONSORS DO?

First, plan sponsors should review and understand their plan's contracts, services, and cost structure (including expenses and revenues). Once they have a good understanding of the services being provided, they need to determine the cost of each service and how and who are paying these costs. In addition, the plan sponsor needs to be aware of the investments in the plan that are providing revenue-sharing and the level of revenue that is being generated to pay the recordkeeping/administration costs. And if the revenue-sharing being generated is in excess of reasonable plan costs, the plan sponsor needs to make arrangements to lower the revenue-sharing or capture it within the plan for the benefit of the plan and its participants.

Second, if the plan sponsor decides that prudence requires considerations beyond their current knowledge, hiring a consultant for help may prove to be valuable. Consultants bring a strong knowledge of the market and an outside perspective of provider service quality and costs. Consultants can help plan sponsors evaluate the reasonableness of their fees through comparisons with their other clients, recent service provider proposals they have received, and benchmarking surveys that they subscribe to. And if a plan sponsor wishes to gather more specific service and fees information regarding their plan, they can use a consultant to request and compile competitive responses from service providers through either a request for information (RFI) or a request for proposal (RFP).

IMPROVING INVESTMENT RESEARCH: QUALITATIVE DUE DILIGENCE IN MANAGER SELECTION

Brian Kinsella, MBA, Analyst

Without a doubt, investment performance is a major factor in selecting a fund manager. Good performance is an integral part of identifying high quality investment managers. Performance by itself, however, is not nearly the whole story; it may not even be the most important of the factors to consider when selecting a manager.

Many investment consultants and advisors have a strict screening process before selecting a manager for a research watch list, or before placing a manager on their investment platform. Often, good performance is the only criterion in a firm's research process. If the numbers are great, invest; if the numbers are bad, do not invest. Unfortunately, it is not that simple. Backward looking research that only focuses on performance can actually limit

success over the long term.

Innovest's approach to research goes well beyond the investment performance numbers of a manager. A multi-faceted, qualitative assessment of the investment universe is important in finding quality managers. Particularly in these times of high market volatility and uncertainty, one has to look at the underlying reasoning behind performance. How are those performance numbers (good or bad) reached? And even more importantly, are the results consistent and replicable?

A good manager will typically have honest, straightforward answers that dictate their process and philosophy for their fund. In 2009, as the stock market rebounded from record lows in 2008, a number of managers had all-time high returns for the year (and they are not hesitant to market these returns). But performance is a relative measure, and when compared to the benchmark S&P 500 index, which returned close to 27%, that performance may not look as superior. Was good performance based on a strict, repeatable, and explainable strategy that was properly positioned for the market run-up? Or were lucky bets and risky plays the drivers of high returns? What did 2010 look like, or 2002? There are simply too many qualitative factors to consider, which gives a "just numbers" approach to investment selection not enough credibility.

The Innovest research team meets with many hundreds of managers each year as part of our ongoing, intensive research process that favors a qualitative due diligence approach. This research approach is exhaustive and entails learning more about the investment manager's team and process. Notably, Innovest applies a forward looking analysis to managers: not a rear view mirror analysis.

A prime example of the potential pitfalls in making performance-based investment decisions came in 2008. A manager that we researched experienced unusually high positive returns for a number of years leading up to 2008. The team was solid, yet the fund was highly concentrated. The fund's philosophy and process seemed flawed and

NON-PROFIT CLIENT SPOTLIGHT

PLATTE RIVER WHOOPING CRANE TRUST

The Crane Trust is a non-profit organization dedicated to the protection and maintenance of critical habitat for the whooping crane, as well as sandhill cranes and other migratory birds, along the Big Bend Region of the Platte River Valley near Grand Island, Nebraska. Only two species of cranes are found in North America—the Sandhill Crane, the most abundant crane species in the world—and the Whooping Crane, the rarest.

The Crane Trust acquires land and water rights, manages, protects and restores habitat, and conducts research related to migratory birds and their habitat needs. The trust currently owns and manages more than 10,000 acres, ensuring habitats remain for the migratory birds.

December marks the 34th anniversary of the Platte River Whooping Crane Maintenance Trust. The organization and its supporters have much to celebrate, including the successful restoration of migratory bird habitat in central Nebraska and steady gains in the whooping crane population since the organization's creation in 1978.

In 2012, the Crane Trust acquired the Nebraska Nature & Visitor Center to help fulfill its mission by providing a more active resource for community outreach and education. In 2012, a new discovery trail is being developed by the Trust. Prairie hikers on Crane Trust land will soon be able to stop at learning stations along the discovery trail.

The stations will offer the opportunity for visitors to learn about wildlife, other natural resources, and scientific research of the Crane Trust. The stations are designed to provide a hands-on experience, and may even include technology that will provide visitors with access to maps, global positioning system data, and video. The goal of the first year is to create 10 to 15 stations along the trail, one of which is a herd of six bison. In total, 24 stations are planned. Once completed, visitors will be able to spend the entire day on the prairie and interact with nature in an entirely new way.

Innovest is proud to provide investment consulting services to The Crane Trust.

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not in line with prudent risk control. They took unnecessary risks by overweighting in certain sectors, particularly financials. We felt the fund was not diversified enough and had set itself up for disaster if any major market event occurred. Accordingly, we chose not to recommend the fund for clients. When the Great Recession began in 2008, this particular fund was down massively due to the portfolio's concentrated risk. It became one of the worst performing funds in the sector, wiping out the outsized returns it had achieved in previous years. Sadly, this is an all-too-common story in the investment world.

Thorough qualitative research is a central part of Innovest's investment research and a differentiator for the firm. Backward-looking performance analysis is just not enough to understand the truly high quality investment managers in the broad investment universe. Study after study confirms that institutional investors outperform retail investors. One of the reasons: retail investors chase returns without performing the proper due diligence on managers. The Innovest research process emphasizes qualitative due diligence over flashy performance. This is a philosophy that will serve our clients well over the long term.

2012 CLIENT SURVEY RESULTS

Wendy Dominguez, Principal and Co-Founder

Thank you to all our clients who completed our 2012 Client Survey. As we kick off our 16th year in business, striving to deliver exceptional service and results to our clients is, and has always been, our highest priority. In the midst of heightened market volatility and investor uneasiness, we received one of our highest scores in the history of our surveys. With an overall response rate of 34%, the level of overall satisfaction with our services was 4.7 (1=poor, 2=fair, 3=average, 4=good, 5=excellent). Over 98% of our clients who responded to the survey provided ratings of excellent or very good in all categories.

The highest score was for the treatment our clients received from our entire team, in which we scored a 4.9—our highest score ever! Innovest is focused on the service we provide to our clients, and we are very proud that our team earned the highest marks in this area.

Overall, we are pleased with the scores we received, but we are always looking at ways we can improve. While the investment markets will always be uncertain, it is our goal that the service and results our clients receive will remain unparalleled.

*Innovest Portfolio Solutions LLC obtained these survey results from responses to a questionnaire sent to all clients. Results of the client survey may not be representative of the experience of all clients. Clients who responded to the survey may have different investment objectives and risk tolerances than other clients, who did or did not respond to the survey. The results reflected in the client survey are not a guarantee of future performance.

AROUND THE FIRM

RECENT EVENTS

Olympic fever swept the world for just over two weeks in August, and Innovest was no exception! Innovest is proud to know our own Olympic Gold Medalist—Taylor Ritzel. Taylor, a member of the U.S. Women's Rowing Team, achieved an incredible gold-medal victory in the Women's Eight. Taylor's younger sister, McLane, was a summer intern with Innovest this year. We are proud of Taylor's achievement and the achievements of all the athletes who participated in the games!

Gold Medalist Taylor Ritzel with her sister, McLane, and the Innovest Team

Innovest President Wendy Dominguez has been nominated for the Denver Business Journal's *2012 Outstanding Women in Business*

Award. The award recognizes Denver's most influential women who have made significant contributions not only in the world of business, but also in their commitment to their communities and their lifetime achievements. In August, an event celebrating these exceptional women was held in Cherry Creek.

Also in August, Alex Todd, daughter of Rich Todd and member of the Purdue University women's swimming team, was honored by Purdue Intercollegiate Athletics with the *Durham Brothers Leadership Award*. This award recognizes underclassmen athletes who have exhibited outstanding leadership both on and off the field evidenced by a positive attitude, a strong work ethic, and an overall commitment to excellence. Alex was one of only ten Purdue athletes to receive the award. Congratulations, Alex!

September 12-14, Innovest sponsored the Colorado Public Plan Coalition's (CPPC) Annual Conference. Richard Todd presented "Effective Management of Portfolio Volatility in Uncertain Markets" at the conference this year. CPPC provides education and networking opportunities for administrators of Colorado public plans and facilitates a forum for exchange of information and advancement of sound practices.

Also in September, the Innovest team and its families volunteered at the Ronald McDonald House Charities of Denver, which celebrates its 33rd year of providing families with a home away from home while their children are treated at metro-area hospitals. The team of Innovest volunteers found it rewarding to contribute to helping the families who rely on the Ronald McDonald House for its support in their times of need.

Innovest is pleased once again to have sponsored the 13th Annual CEO forum on September 25. Nearly 500 of the Rocky Mountain Region's CEOs attended the event. Richard Todd spoke at the event providing a history of Innovest. The event's keynote speaker, Herb Meyer, presented "What in the World is Going On? A Global Intelligence Briefing for CEOs." Mr. Meyer is host and producer of *The Siege of Western Civilization*, an international best-selling DVD outlining the threats to our security, our economy, and our culture.

During the Reagan Administration, Meyer served as Special Assistant to the Director of Central Intelligence and Vice Chairman of the CIA's National Intelligence Council. He is widely credited with being the first senior U.S. government official to forecast the collapse of the Soviet Union – a forecast for which he later was awarded the U.S. National Intelligence Distinguished Service Medal, which is the Intelligence Community's highest honor.

On November 14, Innovest will partner with EKS&H to host the inaugural Rocky Mountain Retirement Plan Conference. The all-day event at the Denver Athletic Club will provide an opportunity for plan sponsors to learn about current topics of interest in plan compliance, audit, investment trends, fiduciary obligations, and participant education. CE credit will be available for the conference attendees. Speakers at the event will include Innovest's Gordon Tewell, Bill Fender, Wendy Dominguez and Scott Middleton, as well as speakers from EKS&H, Sherman & Howard, Denver Compensation and Benefits, and InSight Employee Benefit Communications. For more information about this event, please contact Gina Champ at 303-694-1900 ext. 322, or gchamp@innovestinc.com.

EMPLOYEE SPOTLIGHT

JERRY HUGGINS, CFP, MBA, VICE PRESIDENT

Jerry is a Vice President with Innovest Portfolio Solutions, LLC and is responsible for client consulting relationships and new business development focused on the retirement plan sector. He has over 27 years of experience as an advisor in qualified/non-qualified retirement plan and investment management services.

Prior to joining Innovest, Jerry was a Vice President for ICMA-RC and Fidelity Investments, where his responsibilities included advising employers on their retirement plans over a 21-state region. He worked closely with retirement plan sponsors and their trustees to design solutions to meet their specific goals and objectives.

Jerry brings to Innovest's public plan retirement clients his depth of experience in providing services to and directly managing a variety of retirement

plans, as well as his in-depth understanding of IRS and DOL rules and regulations. Jerry's additional responsibilities at Innovest include retirement plan benchmarking and vendor search analysis, which provide fiduciary oversight and significant cost saving opportunities for Innovest's clients.

Jerry received his MBA in Finance from the University of Colorado at Denver and a B.S. in Finance from the University of Montana. He has held the Certified Financial Planner CFP® designation, through the Certified Financial Planners Board of Standards, Inc, for over 22 years.

WHERE IS YOUR HOMETOWN?

I grew up and went to school in Missoula, Montana—Big Sky Country.

WHAT DO YOU LIKE BEST ABOUT WORKING AT INNOVEST?

In my time at working at Innovest I have come to most appreciate the collegial environment that has been fostered within the firm. Innovest is a very dynamic firm that encourages everyone to share ideas and work together on improvements that benefit our clients. I enjoy this empowerment and client focus—it makes working here both challenging and satisfying.

HOW DO YOU GIVE BACK TO THE COMMUNITY?

My wife and I support various charities in the Denver Metro area, including *Colorado I Have a Dream*, *Women's Bean Project* and the *Urban Peak*. Every year, through The Denver Urban Renewal Authority, our family also helps to rehabilitate a Denver home in need of repair work and painting.

WHAT ARE YOUR HOBBIES AND INTERESTS?

I enjoy being around family and friends, and socializing at high school and college sporting events. For exercise, I enjoy going to the gym and lifting weights and golfing, but I am more passionate about both snow and water skiing. Fly fishing has been part of my life for as long as I can remember. More recently, I am learning to shoot skeet and sporting clays.

TELL US ABOUT YOUR FAMILY.

My wife, Tracy, and I just celebrated our 27-year wedding anniversary. She is an exceptional woman—successfully juggling family and a demanding work schedule as the Executive Director of the Denver Urban Renewal Authority. We have three beautiful daughters Erin, Megan and Lauren. Erin, our oldest, just graduated from Colorado School of Mines with a degree in Mechanical Engineering and is working for Schlumberger in North Dakota. Our other two daughters both attend the University of Colorado. Megan just started her junior year studying Psychology, and Lauren, the youngest, is entering her freshman year and will be playing basketball as a member of the CU Women's team.

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