the Research Report

4TH QUARTER 2007

TRUSTEE DECISIONS VARY IMMENSELY BETWEEN DEFINED BENEFIT & DEFINED CONTRIBUTION PLANS

By Richard Todd, Managing Principal

Employees, plan sponsors and trustees should understand the differences in managing the assets of defined contribution investors and defined benefit plans. Especially in the governmental area, there is often a cross section of trustees that serve these two distinctly different retirement plans. In the defined benefit arena, plan trustees are responsible for asset allocation, investment selection and monitoring. With defined contribution plans, trustees are typically responsible for selecting a menu of options from which participants are asked to choose and monitoring. Ultimately, those participants allocate their own investments.

Time Frame

Time Frame is one of the most important factors for any investor. Defined benefit plan portfolios are usually designed based on the life of an average member of the plan. This can be a benefit to an older participant but can be a detriment to a younger member as the portfolio is typically too conservative for a young investor (more money in bonds).

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Performance Powered by People

INNOVEST PORTFOLIO SOLUTIONS

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The younger defined contribution investor has a very long time frame and can benefit from taking a more aggressive portfolio stance than a typical defined benefit plan (more money in stocks). Generally, the portfolio of a younger investor and consistent saver should be able to grow a portfolio to generate income that can far outdistance a defined benefit payment at retirement.

Contribution Timing

Defined contribution allocations are much greater as a percentage of salary for younger participants than for older participants with a defined benefit plan. Defined contribution plans are based on a percentage of salary while defined benefit allocations are salary and age based. Again, this is a formula for younger participants in a defined contribution plan to be much more aggressive in early years than a typical defined benefit plan allocation. However, in later years, defined contribution participants should allocate assets more conservatively as they approach taking income from those assets and grow closer to life expectancy. The impact of a significantly down stock market to a person living off their assets can be extremely detrimental to the DC retiree – it impacts their nest egg and consequently income distributions. A conservative stance by a DC retiree is usually warranted unless there are additional assets or they have income from other sources. In a defined benefit plan, employer contributions to the plan continue as the retired receive a defined benefit, while with a DC participant, those contributions cease.

Life Expectancy

For a defined benefit plan with many participants, actuaries can be fairly accurate in determining average life expectancy of the average participant. Planning and investment policy is therefore easier for the trustees and investment committee of a defined benefit plan. For a participant in a defined contribution plan, predicting life expectancy is much less accurate and therefore planning is more difficult. The variability of one person's life expectancy is much larger than a large pool in a D.B. plan. Target date portfolios, based on retirement date which is more predictable, are becoming more popular for plan sponsors and participants for good reason.

Investment Opportunities

In a typical defined contribution plan, the investments must be liquid and valued on a daily basis. Most plan sponsors and record keepers offer daily valuation and therefore DC plans offer mutual funds, commingled funds, or for large plans, separate account portfolios that are unitized to provide daily valuation.

In a defined benefit plan, the assets do not need instant liquidity and trustees may have the flexibility of selecting and monitoring private equity funds, hedge funds, real estate and natural resource products --– all of which may be appropriate and complementary investment options.

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Employee Communication

Defined contribution plans ultimately place the onus on participants to select investments from a menu chosen by the plan sponsor and allocate them properly. Therefore participant communication is a crucial element of success for a defined contribution plan. Participants should be given the ability to do cash flow and retirement planning, and should be educated on the basic tenets of investing, and capital markets theory, and detail on the investment options. For those participants not interested or educated in investing, they should be offered target date or model portfolios.

Don't underestimate the needs for communication for defined benefit participants, as well. Plan sponsors have found that defined benefits can be complicated and participants appreciate them more if they understand them.

Although there is often overlap between trustees on defined benefit and defined contribution plans, trustee decisions need to take into account the dramatic differences in the plans. Regardless of the plan, trustees are responsible for asset allocation, prudent investment selection and ongoing monitoring and evaluation. •

INNOVEST: STRIVING TO BE ONE OF THE BEST PLACES TO WORK IN DENVER

By Donna Patch, Principal

The Denver Business Journal accepts nominations for awards for outstanding individuals and companies throughout the year. Individuals can be recognized in many categories: "Outstanding Women in Business," "CFO of the Year," and "Forty under 40." Companies are recognized only in one category: "One of the Best Places to Work in Denver." It was a nice surprise when we learned we were nominated by one of our employees and what we learned about ourselves was invaluable.

Once nominated, the DBJ provided all Innovest employees with a survey. There were various categories for which each of us rated Innovest on a scale of 1-6, with 6 as the highest score. We're proud to say we averaged 5.44 overall.

- **Team Effectiveness –** When we describe ourselves in the business community we say that we use a team approach in consulting to our clients. Our employees validated this with 92% in agreement. *(Average score: 5.4)*

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AROUND THE FIRM 4TH QUARTER 2007

WELCOME

Garry Beaulieu – Garry has joined Innovest as a Principal. With over 20 years of experience in investment management, Garry focuses on customized investment solutions and complex financial and estate planning issues for high net worth individuals and families. He was vice president and wealth strategist for Northern Trust and a founding member of the Denver Office of Mellon Wealth Management. Garry is very active in the community and is currently President of the Rocky Mountain Estate Planning Council. Additionally he is a trustee and head of development for creative Adoptions.

Pamela Cruz – Pam 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. She recently joined Innovest with several years experience in bookkeeping and office management, working for a CPA Office and a money management firm.

Julie Kennedy – Julie is responsible for preparing quarterly performance reports, account rebalancing, opening new client accounts and preparing search books. She supports both the operations and research teams. Julie has over 20 years experience in accounting, taxes and customer service. Her experience includes office management, preparing tax reports and assisting clients.

EVENTS

The women of Innovest, Sherman and Howard, Anton Collins and Mitchell, and Milliman hosted the first annual Women's Networking Luncheon, "Girls Just Wanna Have…Lunch" on September 28th at Via Trattoria. Jan Hargrave, a renowned body language expert, presented her tips to the 65 women who attended.

Rick Rogers presented "Help Me Save, Help Me Spend" at the Western Pension and Benefits Conference Education Seminar on November 7th.

Wendy Dominguez attended a Fiduciary Seminar presented by Holme Roberts Owen. She also chaired the Endow Catholic Professional Women's Networking Luncheon on December 13th which was attended by 130 women and the Denver Post!

Steve Karsh went to the OPAL Alternative Investments Conference in Laguna Niguel, CA from Dec 2nd-4th. In addition he attended two CFA Luncheons: "'Fear' Not Overwhelming 'Greed' Is Driving Investment Decisions" Presented by RBS Greenwich Capital at the Denver Country Club on Nov 19 and "Sub-Prime Hangover Still Lingers" Presented by Goldman Sachs at the University Club on Dec 6th.

ARTICLES

Rich Todd was interviewed for the September 8th Rocky Mountain News article, *Coming up for Air.* The Denver Business Journal ran Rich Todd's monthly column (the first Thursday of the month) with, *Overconfidence in Self can be an Investor's Worst Enemy, A Quick Synopsis of the Unraveling of the Credit Markets, and Hedge-fund Problems Highlight the Need for Diversification.* Articles can be found on our website, www.innovestinc.com.

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- **Retention Risk –** Turnover is a concern for small firms like Innovest who believe that the whole equals the sum of the parts. When an employee leaves there can be a ripple effect which must not be felt by our clients. 89% responded that they were not a retention risk to Innovest. *(Average score: 5.4)*
- **Alignment with Goals –** We strive to be very forward looking in both our investment strategies as well as our business goals. 92% of us believed we were on task to properly to meet these goals. *(Average score: 5.4)*
- **Trust with Coworkers –** As a firm of only 19 employees, we need to be a cohesive group to effectively meet our clients needs. Trusting one another is paramount and 94% of us felt we had this level of trust with each other. *(Average score: 5.6)*
- **Individual Contribution –** As important as team work is for Innovest and our clients, the value of how we contribute individually must be acknowledged. 91% believed we were recognized for our contributions. *(Average score: 5.4)*
- **Manager Effectiveness –** Innovest has a relatively flat organizational structure with managers for functional areas: consulting, research, marketing, and operations. 80% of us believed that our managers were effective. *(Average score: 5.2)*
- **Trust in Senior Leaders –** The Senior Leaders at Innovest utilize a hands on leadership approach. We have close working relationships with them and it was great to see that 98% of us completely trust them. *(Average score: 5.7)*
- **Feeling Valued –** This is one of those areas where companies sometimes struggle. Staying focused on business goals in today's competitive market can remove the attention paid to individuals trying to reach those goals. 84% of our employees felt individually valued. *(Average score: 5.4)*
- **Satisfaction with Current Role –** Like most firms, Innovest has employees with a wide range of ages and experience. Our employees strive for more challenges and opportunities to which management has a challenge of responding. 88% of us are satisfied with our current role and appreciate the attention to this need by our managers. *(Average score: 5.4)*
- **People Practices –** This category encompassed the human resources issue of how people are treated and treat one another. 94% responded favorably *(Average score: 5.3)*

We are on a mission to be the best firm we can possibly be. As our mantra states: "Performance Powered by People," we must provide an exceptional place to work for exceptional people to want to be part of our team. We didn't take these results and just write about them; in fact their improvement has become part of our 2008 leadership goals. •

WHY CORRELATION MATTERS: IMPLEMENTING COMMODITIES IN A DIVERSIFIED PORTFOLIO

By Steven Karsh, Director of Research

Over the past couple of years Innovest has recommended clients implement commodities into their existing portfolios as they provide great diversification from other asset classes, most notably, domestic equities. As the table below indicates, commodities, as represented by the Dow Jones-AIG Commodity Total Return Index, has a relatively low correlation to domestic equities, as represented by S&P 500 Total Return Index and to domestic fixed income, as represented by the Lehman Brothers Aggregate Index.

CORRELATION BETWEEN COMMODITIES & DOMESTIC EQUITIES AND FIXED INCOME

	1 Yr	2 Yr	3 Yr	5 Yr	7 Yr	10 Yr	15 Yr	Since 2-91
S&P 500 TR	0.19	0.15	0.06	-0.01	0.07	0.09	0.10	0.09
LB Aggregate	0.49	0.19	-0.06	0.09	-0.01	0.04	0.03	0.01

The reason this is important is because when one part of the portfolio is declining in value, it is up to the other parts to pick up the slack. It is interesting to note that correlation between equities and commodities has increased over the past two years; however, it remains extremely low.

Below is a table that shows returns for both the S&P 500 and the Dow Jones-AIG Commodity Index for the 10 largest single monthly losses in the S&P 500 since 1991.

PERFORMANCE DURING LARGEST 1 MONTH DECLINES IN THE S&P 500

Date	S&P 500	DJ-AIG	Difference
Aug-98	-14.46%	-6.34%	8.12%
Sep-02	-10.87%	3.77%	14.64%
Feb-01	-9.12%	-0.42%	8.70%
Sep-01	-8.07%	-6.75%	1.32%
Nov-00	-7.88%	8.04%	15.92%
Jul-02	-7.79%	-0.54%	7.25%
Jun-02	-7.12%	1.94%	9.06%
Mar-01	-6.34%	-4.26%	2.08%
Aug-01	-6.26%	-0.04%	6.22%
Apr-02	-6.06%	0.00%	6.06%

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NEW CLIENTS JOIN INNOVEST

Innovest was hired to perform a vendor and investment review for **Arapahoe County's** $30 million 457 retirement plan. This is our second project for Arapahoe County, the first of which was a vendor consolidation project saving Arapahoe County more than $100,000 per year.

The Colorado Intergovernmental Risk Sharing Agency (CIRSA) has hired Innovest to perform a retirement plan vendor search as well as employee communication and individual counseling for their 65 employees. CIRSA is a resource for public entities seeking effective means of managing their risk through a pooled solution for their Property/Casualty and Workers' Compensation coverage needs.

The Sidney E. Frank Foundation – Colorado Fund has hired Innovest to provide investment consulting services for their investment portfolio.

Although commodities did not produce positive returns in each of the months, they significantly outperformed in almost every month ranging from +1.32% on the low end to 15.92% on the high end.

The table below shows both returns and standard deviations for commodities and the S&P 500 over various time periods. Outperformance by one asset class or the other depends on the time period measured, but you will notice how the standard deviation, or measure of risk, is consistently higher for commodities.

RETURN AND STANDARD DEVIATION COMPARISON

	Returns		Standard Deviation	
	DJ-AIG	S&P 500	DJ-AIG	S&P 500
1 Year	16.97%	16.44%	12.37%	8.07%
2 Years	4.81%	13.58%	13.12%	7.09%
3 Years	9.52%	13.14%	14.16%	7.53%
5 Years	14.13%	15.45%	13.81%	9.08%
7 Years	10.81%	2.60%	13.73%	13.55%
10 Years	7.64%	6.57%	14.59%	14.70%

Intuitively, it wouldn't make sense to add a riskier asset class to a portfolio if you wanted higher returns and lower risk but because of the low correlation between equities and commodities, adding the latter actually increases both absolute and risk-adjusted performance. On page 8 is a table that shows how performance would be affected with the inclusion of commodities. Portfolio A is a traditional 65/35 equity and fixed income portfolio while Portfolio B includes a 10% allocation to commodities 60/30/10.

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PERFORMANCE COMPARISON OF PORTFOLIOS WITH AND WITHOUT COMMODITIES

		1 Yr	2 Yrs	3 Yrs	5 Yrs	7 Yrs	10 Yrs
Portfolio A	Return	11.34%	11.85%	9.90%	10.60%	4.38%	7.10%
	Std Dev	5.13%	4.67%	4.91%	5.96%	8.44%	9.34%
	Sharpe	1.17	1.38	0.96	0.91	-0.03	0.26
Portfolio B	Return	11.90%	11.88%	10.19%	11.29%	5.17%	7.37%
	Std Dev	5.19%	4.60%	4.81%	5.73%	8.03%	8.89%
	Sharpe	1.26	1.41	1.03	1.05	0.06	0.30

** Portfolios rebalanced quarterly.* *Note: All data is as of October 31, 2007*

So, adding an asset class that has a very low correlation to other asset classes in the portfolio, even if that new asset class has a higher risk profile, is beneficial to the overall portfolio. •

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INNOVEST BLOG

Please visit our blog through our website: www.innovestinc.com

This is designed for our clients and friends to read our thoughts on a variety of investment and fiduciary issues. We have links to websites, research, and other blogs that can be helpful navigating the world of investments and stewardship. Keep us informed of your thoughts.

WATCH FOR THESE UPCOMING EVENTS

- 8th Annual Rocky Mountain Endowment and Foundation Conference: March 13, 2008
- Pensionizing your DC Plan Breakfast Seminar: February 7, 2008

For up to date information about registering and locations, go to www.innovestinc.com or call Donna Patch 303.694.1900 ext 310

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