the Research Report

2ND QUARTER 2007

REMAIN PATIENT WITH LARGE CAP GROWTH

By Peter Mustian, Senior Research Analyst

The euphoric feeling enjoyed by many equity investors over the last few years was recently shaken as the equity markets sharply corrected at the end of the month of February. Though not entirely unexpected, it was nevertheless a harsh reminder for many investors that markets tend to be cyclical and runs of any kind will not last forever. The equity markets had been on an exceptional run since last July and going back further, the S&P 500 had gone 949 days without more than a 2% decline. This is the longest such streak in more than a century. This recent pull back resulted from a variety of negative catalysts that came together including growing concerns of over inflated international markets, the ominous fate of sub-prime lenders, the continued release of economic data suggesting the US economy is slowing and former Fed Chairman Alan Greenspan stating that it was "possible" that the US economy could enter a recession in late 2007. Though not all economic data suggest such a dismal fate for the US equity markets in the near term, the majority of economic data and indicators do seem to suggest that the US economy is in fact slowing. According to Reuters, consensus earnings estimates for S&P 500 companies are expected to grow 6% during 2007 compared with 15% in 2006 and an average of 8.5% over the last 18 years. Our own internal research and analysis leads us to a similar conclusion and thereby the question facing many investors is how is it best to position their portfolio in a slowing economic environment.

continued on page 2

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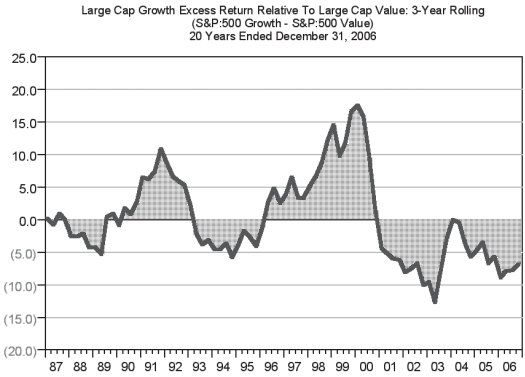
INNOVEST PORTFOLIO SOLUTIONS

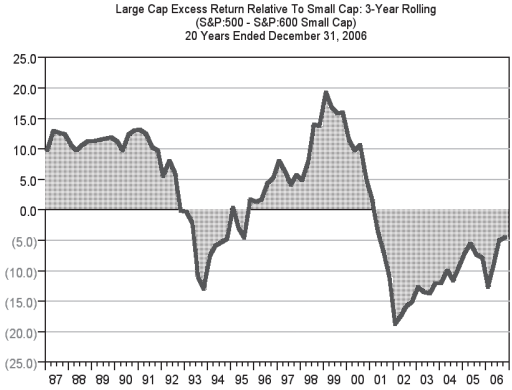
continued from page 2

"The farther back you can look, the farther forward you are likely to see." Applying this adage to the markets and the current economic environment we can see several noteworthy trends that lead us to believe preconditions are in place for a market rotation to favor quality large cap growth companies. These preconditions include the current slowing economic environment, a sustained period of underperformance, and historically attractive valuations. In a slowing economic environment large, high quality, companies that have consistent earnings growth should become increasingly attractive to investors as their relative valuations increase. In previous decelerating economic environments and profit growth cycles, shares of the highest quality companies have tended to outperform. This typically occurs because as the economy slows, larger companies are generally less susceptible to risk and downturns due to their more diversified income stream across various products and because they carry less debt. Also, as markets slow and volatility increases, investors typically become more risk adverse leading to a flight to large quality stocks that they view as safer options. Typically, small companies do better during economic recoveries as they are more leveraged and flexible to changes in the economic environment.

In addition to current economic environment, we believe there is significant market pressure for superior performance of large cap growth companies due to the significant period of recent underperformance. Though this might seem counter intuitive at first glance, keep in mind the cyclical nature of markets and the time proven market principle of reversion to the mean. Over the last seven years ending December 31, 2006, the S&P 500 Value index has returned 5.4% compared to the S&P 500 Growth Index that returned -3.1%. Large cap value stocks have outperformed large cap growth stocks for seven consecutive years and small cap value stocks have outperformed small cap growth stocks in six out of the last seven years. From a market cap perspective, small cap stocks have outperformed large cap stocks in six of the last seven years.

The charts to the right further illustrate value's dominance over growth and small cap over large cap the last seven years.



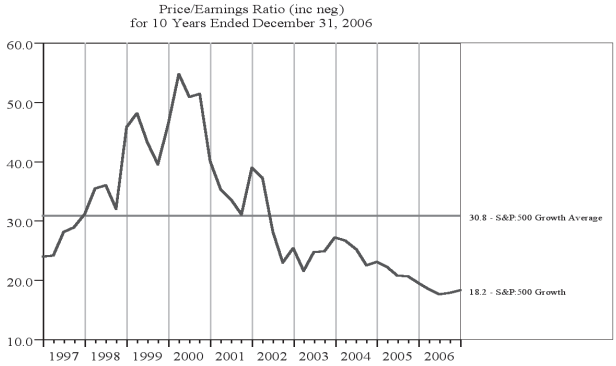


These charts also provide strong evidence of the cyclical nature of markets. However, it is important to note that the exact point in which a market cycle reverses is nearly impossible to predict and there are numerous dangers associated with trying to time the market.

The noticeable underperformance and negative investor sentiment towards large cap growth companies has led to attractive valuations, particularly when compared to value companies which have enjoyed a strong run. Simply put, large growth companies appear to be trading at very attractive prices. A recent report from Davis Hamilton Jackson, a growth manager, suggest that on a 2007 P/E to expected growth basis, or PEG ratio basis, the Russell 1000 Value Index appears to be 70% more expensive than the Russell 1000 Growth Index.

As of 12/31/06	*Calendar P/E 2007*	*Consensus EPS Growth 07 vs 06*	*P/E to Growth*
Russell 1000 Growth	18.9	17.2	1.1
Russell 1000 Value	14.4	8.2	1.8

Additionally, earnings growth estimates for traditional value companies and sectors such as materials and energy are well below last year, while earning growth estimates for traditional growth sectors such as technology and consumer discretionary are being projected much higher compared to last year. Many portfolio managers we have spoken with confirmed this by mentioning that their screens are identifying an increasing number of large growth companies with positive earnings estimate revisions. Finally, the chart below further reflects the relative attractiveness of large cap growth stocks; the P/E ratio of the S&P 500 Growth Index is at a 10 year low and well below its 10 year average.



We believe the preconditions are in place for a market rotation to favor quality large cap growth stocks, and we are therefore advising investors to remain patient with their large cap growth managers and this portion of their portfolio. In the late 90's, value stocks were often overlooked as people chased the top performing growth names. However, the reversal quickly came in the spring of 2000 as many of the high flying technology stocks corrected and value stocks began its seven year period of dominance. The lesson in all of this is market cycles have and will continue to be apart of the economic landscape and therefore the best position for ones portfolio is to remain balanced and well diversified. •

A SOLID 2006 WITH AN EYE TO THE FUTURE

By Richard Todd, Managing Principal

Our promise to clients is that as Innovest grows, they will directly benefit from that growth. We are very focused on delivering specific benefits to our clients as a result of our success.

2006 was a very good year for Innovest as we grew at a 15 % clip. We have had revenue growth for ten consecutive years.

We launched Insight Employee Benefits Communication and brought **Rick Rodgers** in as Managing Director. At his prior firm, Rick had performed employee communication and training for a number of our clients and we felt his expertise and experience could enhance our solutions in those areas. Rick has won national awards for his approach to benefits training and his communication materials. We are excited to have Rick join our family. He has already added value to clients, helping to bridge the gap between the consultant, the vendors, and participants. His design and delivery of education to trustees and plan participants has received excellent reviews from our clients.

continued on page 5

AROUND THE FIRM 2ND QUARTER 2007

ARTICLES

Rich Todd's articles, *Recent 401(k) Legal Cases are only the Beginning, Why Institutional Investors Out Perform Individuals,* and *International Managers' Strategies Can Vary A Lot* were published in his column in the Denver Business Journal.

All of these articles can be viewed on our website: www.Innovestinc.com.

EVENTS ATTENDED

Anton Collins Mitchell and Innovest co-hosted a breakfast seminar for their 401(k) clients on February 15th. Ed Frado from ACM and Rick Rodgers from Innovest peeled back some of the layers of the Pension Protection Act of 2006. Copies of the presentations can be found on www.innovestinc.com.

The 7th annual Rocky Mountain Endowment and Foundation Conference was held at Cherry Hills Country Club on March 29th. This annual conference, organized and executed by Innovest, is sponsored by the University of Northern Colorado Foundation. Conference speakers/supporters this year were Ann Hinkins and Paul Egan from EKS&H, Christopher Beall from Faegre & Benson, John Riddle from BRC Investments, and Rick Rodgers from Innovest's InSight EBC Division. Don Trone from the Center for Fiduciary Studies was the keynote speaker and this year's guest speaker was John Harpole, Co-chair of the Seeds of Hope Foundation.

Brad Brewer attended the Healthcare Financial Management Association (HFMA) Annual Conference here in Denver.

In April, Steve Karsh made site visits to various hedge fund and fund of hedge fund managers in New York. In addition he attended the Morningstar/Ibbotson Asset Allocation Conference in Miami, FL.

Innovest hosted Callan's Investment Advisor Group's (IAG) Business Planning Roundtable. As the exclusive regional member of this organization, we shared best practices with firms from other parts of the U.S. like Innovest.

Jeremy Frank joined Innovest as a senior analyst. Jeremy was an analyst at a hedge fund consulting firm and has enhanced our expertise in hedge funds and quantitative investment strategies. Jeremy, who has a Masters of Science in Finance from Boston College, is a information technology expert and leads our efforts in developing our Innovest Portfolio Management System (IPMS). Jeremy has helped us move our database into the 22nd century! It is integrated with both our performance reporting database and our portfolio accounting software and it allows for a more robust tracking of manager related information.

The next generation of IPMS is to allow clients to access the database to view all Innovest research on their products and managers. In addition, each client would have access to their performance reports, investment policies and plans, asset allocation studies and portfolio accounting. We expect to work with clients and their other financial professionals to also include trust and plan documents, tax returns, employee and trustee education information, financial plans and financial statements. We are very excited about the possibilities IPMS offers our clients.

Karla Maris joined Innovest as our Office Manager. Karla makes sure our office runs smoothly and spoils our clients and staff. We are pleased to have Karla as a big part of the Innovest team!

New Clients

2006 was a successful year in new client development. Thank you to our clients and friends who sent us those referrals and acted as references. New clients included a number of families, public and corporate plans, a hospital, a couple of public plans, a multi-employer VEBA, and a non-qualified plan. We were also engaged in a number of new expert witness assignments. We have a diversified clientele and believe that this is a crucial element in keeping our advice cutting edge. We have a tremendous team of professionals at Innovest.

Client Survey*

Our 2006 client survey resulted in an overall rating of 4.6 percent on a 5.0 scale. This year, like last, our highest ranking was the experience and advice of our consultants. We were pleased with the results and will continue to formally survey clients for constructive feedback. Our survey has historically been the catalyst for firm initiatives such as intra quarter market information, manager reports, and performance report enhancements.

Published Research Articles and Presentations

Rich Todd continues to write his monthly column in the ***Denver Business Journal.*** In addition, Rich had a research piece published in the ***Journal of Investing.*** Both **Rick Rodgers** and **Wendy Dominguez** had their thoughts published in ***NAGDA's The Contributor*** and Wendy also had a paper published by ***CPA Journal.*** Cliff Stanton had a white paper published by ***Senior Consultant.***

continued on page 6

continued from page 5

Rick Rodgers spoke at the Colorado Government Finance Officers Association (CGFOA) annual conference, the Colorado Public Pension Coalition quarterly luncheon, the Colorado Municipal League Conference, the Colorado Public Human Resources Association, and the Colorado Public Pension Conference. Rick received a first place "Eddy Award" on behalf of one of our clients for excellence in participant communication.

Rich Todd also spoke at the CGFOA annual conference as well as the Rocky Mountain Foundation and Endowment Conference, Colorado Public Pension Conference and the Association of Small Foundations Advanced Trustee Leadership Seminar.

Brad Brewer spoke at the Colorado Public Pension Conference and the Colorado Municipal League Conference.

Innovest had a solid year and we look forward to a great 2007. Thank you for your tremendous support and confidence! •

*Innovest Portfolio Solutions LLC obtained these survey results from responses to a questionnaire that was sent to all representatives with investment responsibilities of 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 tolerance than other clients who did or did not respond to the survey or to perspective clients. The results reflected in the client survey are not a guarantee of future performance.

CASUAL READING CAN BE DANGEROUS TO YOUR PORTFOLIO

By Steven Karsh, Research Manager

When reading investment pieces from websites such as Microsoft Money.com, Fool.com, The Street.com, MarketWatch.com among others, it is important to fully understand what you are reading because "facts" can be misleading.

Recently I read an article on MarketWatch.com titled, "Lazy Portfolios Win Again, Beat the S&P 500" dated January 16th, 2007, in which the author bashes hedge funds calling them "one the dumbest investments in America" and then goes on to compare the performance of hedge funds to the S&P 500. He points out that "they make no sense for the vast majority of America's 95 million investors…hedging is for high rollers and institutions". Hedge funds ARE primarily for institutional investors, that is why there are certain requirements to invest in them. However, they are becoming more accessible for the "little guy" as many mutual fund companies are starting to roll out "hedge fund" type mutual funds with no special investor requirements and low minimum investments. Mr. Farrell also points out the "exorbitant" fees hedge funds charge. Yes, many hedge funds charge exorbitant fees but there are many out there that don't. In fact, some of the most successful and largest in the industry don't charge any management fee and charge only an incentive fee and still produce outsized returns after fees.

continued on page 7

NEW CLIENTS JOIN INNOVEST

We kicked off 2007 with the addition of four new clients. We have been hired to provide investment consulting services to two local companies: CableLabs, a non-profit research and development consortium dedicated to pursuing new cable telecommunications technology and National Cattlemen's Beef Association who works to increase profit opportunities for cattle and beef producers by enhancing the business climate and building consumer demand. From the public sector, The City of Aurora General Employees Retirement Plan and Wastewater Reclamation District have both contracted Innovest's consulting services.

Mr. Farrell goes on to say a "Lazy Portfolio", one that he describes as somewhat of a passive index strategy that many so-called gurus tout, outperformed the S&P 500 index in 2006 which is true but not a "true" measure of the "lazy portfolio's" relative performance. One example of a "Lazy Portfolio" he praises is run by money manager Ted Aronson and consists of a combination of various Vanguard Index Funds. (By the way, Mr. Aronson runs a long/short equity hedge fund!) If you take the allocation of those funds and compare it to their appropriate indices, it has underperformed each and every year for the last five years. Aronson's portfolio annualized 5 year return of 9.92% is below that of its corresponding benchmark of 10.35%. This is to be expected due to fund expenses which the indices don't have.

The idea is not to bash Ted Aronson as he is a very successful investor but Aronson's portfolio has overlap problems with 15% in the S&P 500, 5% in the Total Stock Market Index (which includes the S&P 500) and 10% in the Extended Market Index which is also included in the Total Stock Market Index. Furthermore, any portfolio that has had emerging markets over the last 5 years is going to outperform the S&P 500. If Mr. Aronson's portfolio is fully diversified across equity markets (both domestic and international) and fixed income markets, why would he compare it to the S&P 500 which only includes large cap domestic stocks? Despite the many flaws in Farrell's comparison, the one issue he fails to consider is risk-adjusted returns. Without comparing the Sharpe Ratio of the "Lazy Portfolio" to that of hedge funds, one can't make a valid comparison. If we are to assume most investors are risk-averse, then risk-adjusted performance must be measured to make a valid comparison

If one compares performance of Aronson's "Lazy Portfolio" over the past 5 years to that of the CSFB/Tremont Hedge Fund Index you will find out that although the annualized return of the former is slightly higher (9.92% vs. 8.91%) the standard deviation or risk of the two is quite different. The 'Lazy Portfolio's" standard deviation is 12.00%, almost four times as much as the CSFB/Tremont Hedge Fund Index (3.43%). This equates to a Sharpe ratio (2.35% risk-free rate) of 0.69 for the "Lazy Portfolio" and a Sharpe ratio of 1.83 for the CSFB/Tremont Hedge Fund index– NO COMPARISON! And don't forget, the CSFB/Tremont Hedge Fund index is NET OF FEES. To make this even more dramatic, look at the maximum drawdown the two investments have had over the past 5 years. The "Lazy Portfolio's" biggest drawdown was 22.59% compared to 2.18% for the CSFB/Tremont Hedge Fund index.

continued on page 8

continued from page 7

What Mr. Farrell fails to point out is that most hedge funds are designed to avoid market or beta risk, precisely what investing in the S&P 500 provides—market risk. In other words, it is comparing apples to oranges. I think most investors would be able to sleep better at night with a slightly lower return and a whole lot less risk. There is a reason people invest in hedge funds, to hedge out market risk!

This article is just one example of many that investors can read on the internet each and every day. Not all are as flawed as this one, but it would be wise to sit and think about what the author says and determine whether what he/she says not only makes sense, but whether or not their investment philosophy fits with yours. •

Note: The referenced article published on MarketWatch.com has since been edited with the opinion about hedge funds removed.

WATCH FOR THESE UPCOMING EVENTS:

CPPC EDUCATION LUNCHEON
Tuesday, June 5, 2007 11:30 a.m. – 1:00 p.m.

Chris Baker, Director Advice Products ICMA Retirement Corporation will give a presentation on Managed Accounts and Advice.

Douglas County Events Center
500 Fairgrounds Drive
Castle Rock, CO 80104

To register go to
www.coloppc.org/workshops.htm

You are invited to:

INNOVEST CLIENTS & FRIENDS PARTY
Tuesday, June 12 4:00-7:00 p.m.

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