THE RESEARCH REPORT

AN INNOVEST NEWSLETTER Q2 | 2009

NEW CLIENTS

Innovest was recently hired to provide investment consulting services for:

Adams County

Arapahoe County

Jefferson Center for Mental Health

North Colorado Medical Center

Swisslog Translogic

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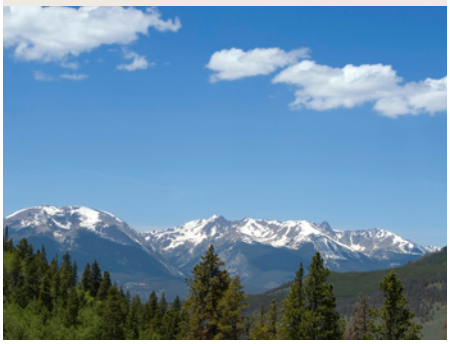

IS DIVERSIFICATION DEAD?

Scott Middleton, CFA, CIMA®

In March of this year, 264 investment professionals were asked to judge whether this statement is true or false: "Diversification failed investors in the current financial crisis." The question appeared to be controversial: 50% answered "true," and 50% "false."

Had this same question been addressed to individual investors or investment committees, a strong majority probably would have answered "true" – and with great intensity. Not only were stocks down severely in 2008, but investors felt that there was no available shelter in the worst financial storm since the 1930s.

Since diversification is considered a cornerstone of modern portfolio management, it is only reasonable to evaluate whether or not it stands up to severe tests like 2008. Such an analysis needs to take into account that diversification takes several distinct forms, each of which need to be examined separately. The goal of this review is to help investors improve their portfolios' design and long-term performance in order to meet their objectives.

DIVERSIFICATION AMONG INDIVIDUAL SECURITIES

When nearly all U.S. stocks declined in 2008, owning a large number of stocks did not come even close to offsetting losses. However, that did not mean that diversification among individual stocks did not provide meaningful advantages.

According to investment research firm Morningstar, only one domestic stock fund (excluding leveraged offerings) out of 15,272 lost more than 75% last year. In contrast, 2,886 of the 10,691 stocks in Morningstar's database of U.S. stocks (27% of the companies) declined in value by more than 75%.

Within the broad asset classes of stocks, bonds, and alternatives, diversification among individual securities always has been, and always will be, essential. Diversification among individual securities alone, however, does not offer protection from losses.

AMONG DIFFERENT STYLES

Sub-components of asset classes, such as growth and value, did not provide much performance differential in 2008. Among large

cap U.S. stocks, style returns were fairly close to one another:

S&P 500	-37.0%
S&P 500 Growth	-34.9%
S&P 500 Value	-39.2%

However, in the three-year period of 2000-2002, there were notable differences in the performance of large growth and large value stocks (returns are cumulative for the three calendar years and are not annualized):

S&P 500	-37.6%
S&P 500 Growth	-48.1%
S&P 500 Value	-25.9%

Stock market history demonstrates that it would be unreasonable for investors to expect one style to be up significantly when the other style has severe losses. In addition, since there are no guarantees that one style will consistently outperform the other in either up or down markets, it is prudent for equity investors to be diversified among both value and growth styles.

AMONG DIFFERENT CAPITALIZATIONS

Diversification among U.S. stocks of different capitalizations also offered little benefit in 2008:

Large Cap U.S. Stocks	-37.0%
Mid Cap U.S. Stocks	-36.2%
Small Cap U.S. Stocks	-31.1%

Just like with value and growth stocks, 2008 reminded investors that they should not rely on small or mid cap stocks to be up dramatically when large cap stocks are down, and vice versa. Mid and small stocks should be owned primarily for their potential of long-term appreciation. In the seven years ending 12/31/08, small cap stocks outperformed U.S. large caps by an average of 4.6% per year.

Since small cap stocks tend to be more sensitive to the economy than large stocks, they have the tendency—but not the guarantee—to perform better than large stocks after economic recessions:

Stock Performance After Recessions (1945-2007)

	After One Year	After Three Years (Cumulative)
Large Cap Stocks	+19.1%	+47.7%
Small Cap Stocks	+33.7%	+74.0%

Since the cycles of the economy and the beginning and ending periods of small cap outperformance cannot be predicted with consistent accuracy, the best long-term approach is for investors to diversify broadly among large, medium and small stocks.

AMONG DIFFERENT GEOGRAPHIES

Following many years of outperformance, equities outside the U.S. significantly underperformed U.S. stocks in 2008:

Large Cap U.S. Stocks	-37.0%
International Stocks (Developed Markets)	-43.4%
Emerging Markets Stocks	-53.3%

Calendar years 2000 to 2002 were another time period when international stocks did not add value to a U.S.-only equity portfolio (returns are cumulative for the three calendar years and are not annualized):

Large Cap U.S. Stocks	-37.6%
International Stocks (Developed Markets)	-43.3%

From 1976 to 2008, a total of 33 calendar years, large cap U.S. stocks had negative total returns in seven of those years (21.2% of the time periods). During those seven negative calendar years for U.S. stocks, international equities of the developed world rose only one time.

Since the U.S. comprises less than half of the world's GDP and its equity values, long-term U.S. investors should benefit from having a portion of their equity exposure outside of North America. The main reason to own international stocks is for their long-term growth, not for protection when the U.S. stock market is suffering losses. In the seven years ending 12/31/08, international stocks outperformed U.S. equities by an average of 4.9% per year.

AMONG DIFFERENT ASSET CLASSES

The two largest asset classes are commonly defined as stocks and bonds. Their 2008 returns were dramatically dissimilar:

Large Cap U.S. Stocks	-37.0%
Investment-Grade U.S. Bonds	+5.2%

In the seven negative years for U.S. stocks between 1976 and 2008, investment-grade

U.S. bonds had positive returns in every one of those years. This historical relationship should not be considered a future guarantee, however. Considering bonds' low nominal interest rates and their vulnerability to the fear of rising inflation, it is possible for both U.S. stocks and bonds to decline concurrently in future years.

The returns of other assets, often classified as "alternatives," were far from positive in 2008:

Hedge Funds	-20.4%
Commodities	-35.6%

While hedge funds declined in value much less than equities, the hope that they would be up in a bear market vanished in the credit and deleveraging crisis. In the last severe bear market of 2000-2002, both hedge funds and commodities performed notably better than stocks (returns are cumulative for the three calendar years and are not annualized):

S&P 500	-37.6%
Hedge Funds	+9.6%
Commodities	+33.6%

Commodities were also up significantly (+41.6%) in the one-year period ending June 30, 2008. Investors who rebalanced their portfolios in mid-2008 (including taking some profits in their commodity positions) benefitted more from their diversification than those investors who did not rebalance.

Part of what made 2008 so painful for many investors is that outside of cash (T-bills were up 2.1%) and high quality bonds (up 5.2%), losses in most other asset classes were so severe—down 20% to 53%. In times of financial crises, risky assets tend to decline in tandem. In other words, their correlations often increase in down markets, damaging the benefits of their diversification.

Although diversification did not help as much as investors would have liked in 2008, it did not die a premature death. In particular, meaningful allocations to high-quality bonds enhanced 2008's returns. Over long periods of time, most asset classes do not move in tandem and asset class diversification offers the potential for smoother portfolio returns.

STEPS TO TAKE NOW

These proven steps should help investors build stronger long-term portfolios:

- Know your downside risk tolerance. Review worst-case scenarios for your portfolio, and don't let good markets lull you into taking on more risk than is prudent for your situation.
- Pay close attention to when you may need to make major distributions from your portfolio. Do not take risks with those monies needed in the near-term.
- Select asset classes for your portfolio with reasonable, forward-looking, long-term expectations of what each asset class should return. Understand the risks and long-term correlations between asset classes.
- Consider the historical advantages of adding to your portfolio high-quality bonds (and other conservative investments) to lessen volatility and to reduce portfolio losses.
- Among equities, invest in different styles (growth and value), capitalizations and geographies for long-term enhanced returns, not for protection in crises.
- When investing a portion of your portfolio in alternative investments, realize that they may be inconsistent in adding downside protection.
- Always diversify among individual securities in each asset class. Lack of diversification among individual securities adds unnecessary risk.
- Be patient in the midst of market volatility and disappointing returns. Don't let emotions manipulate your investment decisions.
- Rebalance your portfolio periodically. Taking profits in up markets can be difficult because it is easy to get caught up in the excitement of making money and taking on more risk. Alternatively, it takes stamina to buy low when fear and panic are prevalent. Rebalancing is a proven buy-low, sell-high strategy for all long-term investors.

Scott is Principal and Senior Investment Consultant at Innovest.

AVOIDING INVESTMENT MISTAKES: THE IMPORTANCE OF A THOROUGH DUE DILIGENCE PROCESS

Peter Mustian, Senior Research Analyst

The tumultuous market environment since the fall of 2007 has subjected many investors to the harsh realities of what can occur when proper and thorough due diligence is not consistently applied in constructing a portfolio. Many investors, and even financial professionals, became victims of the idea that past performance is predictive of future performance and the tendency to extrapolate the recent past into the future. Further, many investors surrendered to the powerful propensity of following recent trends instead of relying on a consistent framework for evaluation and decision-making.

Innovest believes a due diligence process must be predicated on not only finding superior investment products, but also attempting to avoid grave mistakes. To illustrate the implications of this, Innovest recently studied the subsequent results of several investment strategies that were presented to our research group and, at the time, failed to meet our standards.

A few years ago, a mutual fund was introduced to the research group at Innovest as a safe alternative to a money market account, but with an enhanced yield. The fund was designed to preserve capital while generating income, yet with relatively low risk. Its historical performance was strong relative to its peers and it had a five-star overall rating from Morningstar. However, upon further review (and contrary to representations), the fund had invested more than 50% of its assets in mortgage-backed securities and utilized various risky derivative instruments. We rejected the fund. Later, in the second half of 2008, the credit crisis ensued, and many of the derivatives became illiquid, leading to significant write-downs. Further, because of the fund's concentration in risky mortgages, it ended 2008 down 35% and in the 99th percentile of its peer group.

We reviewed another fund in early 2008 that, at the time, had a very strong cumulative performance record. However, the fund company would not provide us details regarding the inner workings of their pure quantitative model. Without understanding how and why their performance was so strong, we could not move forward with recommending the product to our clients. Subsequent to our rejection, the fund ended 2008 down 55% and in the 98th percentile of its peer group. Based on this performance, we believe their model fails to maintain adequate risk controls and does not offer investors sufficient downside protection.

Another manager we followed had been hired to manage an All-Cap portfolio with a value tilt. However, over time, this manager became heavily invested in financial stocks, allocating approximately 75% of its portfolio to that sector. Furthermore, they ran a concentrated portfolio of only 25 to 30 securities. We felt that the portfolio was not nearly diversified enough for our clients to meet their mandate and terminated the manager in mid-2006. We didn't know the credit crisis would be coming, but we did know we weren't comfortable with the sector concentration the manager had built. In the later half of 2007 and throughout 2008 performance for the strategy was terrible on both a relative and absolute basis as many financial companies were devastated by the economic downturn and credit crisis.

Each of these examples highlights the need for due diligence to go beyond simply projecting the past into the future. Our approach to due diligence and research recognizes this necessity. We believe that past performance is only useful as an initial tool for screening funds that may be worthy of further research. Rather, we are intensely focused on understanding why and how a fund has performed well, if the portfolio management team has an investment edge (i.e., do we think the past performance was due to luck or skill), and whether we believe the edge is sustainable. Another important aspect of our process is the understanding that many managers will not meet our criteria. Thorough due diligence requires a disciplined and exhaustive effort. We meet with over 250 investment managers each year and believe that maintaining very high standards in our process reduces our mistakes. We will routinely pass on a fund if the manager's process lacks the transparency necessary for our review or if our conviction level is not extremely high. There are no guarantees that this process with always lead to success. However, we contend that our hard work and adherence to a thorough process will continue to add value over time for our clients.

CLIENT SPOTLIGHT

MAKING A DIFFERENCE: PIKES PEAK UNITED WAY

Pikes Peak United Way

Founded in 1922, Pikes Peak United Way is a community-based, autonomous member organization of United Way of America. Pikes Peak United Way is a locally-governed, independent organization dedicated to addressing the underlying causes of problems and creating lasting change throughout El Paso and Teller counties.

Pikes Peak United Way's annual campaign raises in excess of $5 million. Community volunteers allocate these funds to 42 partner agencies and community programs.

Like every nonprofit organization, Pikes Peak United Way has administrative and fundraising costs. However, unlike most nonprofits, these costs are underwritten through its Cornerstone Program, a program started in conjunction with the El Pomar Foundation. This means that 100 percent of the donations received by Pikes Peak United Way goes directly back into the community to help those in need.

Pikes Peak United Way believes that monitoring quality of life factors is critical to a community's successful future. There are hundreds of examples of desirable places to live that have become less desirable because of controllable issues that local leaders did not recognize and address. It is easier to create broad coalitions around basic community goals when all see and agree on the issues that matter most.

In 2006, Pikes Peak United Way invited more than 100 interested community leaders to join Vision Councils to address key community areas. These leaders were drawn from the private, public and nonprofit sectors. The councils provided the vision and guidance for the first annual Quality of Life Indicators for the Pikes Peak Region report, published in 2007.

The data, or indicators, contained in the report are quantitative measures of the quality of community life. The report makes a conscious effort to present only facts. While it shows trends, the report does not attempt to evaluate these trends as positive or negative. The goal of presenting this data is to help community members prioritize and make educated decisions about which areas deserve investment of time, talent and resources. The goal of this entire effort is positive action.

Pikes Peak United Way's experience has been that the best way to help the most people is to get to the heart of the community's most serious problems. While Pikes Peak United Way is helping those who need help now, they are also creating lasting change. This approach maximizes effectiveness, because it allows Pikes Peak United Way to improve lives not just in the short term, and not just on the surface, but in a lasting and meaningful way that benefits the entire community.

For more information on Pikes Peak United Way or the Quality of Life Indicators for the Pikes Peak Region report, please visit www.ppunitedway.org.

Innovest is proud to provide investment consulting services for Pikes Peak United Way!

AROUND THE FIRM

WELCOME BACK

Kyle Johnson returned to Innovest for his fifth summer internship. Kyle is a student at Florida State University majoring in Finance and Entrepreneurship.

RECOGNITION

Rich Todd and Brad Brewer were named by *5280 Magazine* and *ColoradoBiz Magazine* as 5-star wealth managers. The magazines polled 73,000 high net worth investors in Colorado and both were named two of the top 5% of advisors in Colorado!

In May, Brad Brewer, Principal/Consultant celebrated his 7-year anniversary with Innovest, and Donna Shearer, Portfolio Accounting Coordinator celebrated her 11th.

Shawna Sambrano was accepted for inclusion to the National Association of Professional Women.

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AROUND THE FIRM, FROM P5

EVENTS

Scott Middleton presented "Investment Opportunities Today" at the Rocky Mountain Non-Profit Conference held at Cherry Hills Country Club in March. Also in March, Scott gave a presentation on high yield bonds and bank loans at the Citywide Banks Managers Luncheon and at the May Luncheon, Scott gave an overview of the capital markets.

Rick Rodgers presented "Understanding and Navigating Volatile Markets" at the Colorado Public Plan Coalition (CPPC) Trustee Education Workshop in March. Also in March, Rick was invited by the National Association of Government Deferred Comp Administrators (NAGDCA) to speak to a group of college students at Southern Arkansas University. In May, Rick presented at a Defined Benefit Plan Fiduciary Education Luncheon sponsored by Sherman & Howard and Innovest.

Steve Karsh attended JP Morgan's 11th Annual Wealth Management Symposium in Chicago. Additionally, he was elected to the Hillel of Colorado Board of Directors.

Brad Brewer helped coordinate the Homestead Community Run, a fund raiser sponsored by Homestead Elementary School. Proceeds from the run benefit the Wiley, Parker, Morgan Fund and the Gabby Krause Foundation.

Bill Fender attended the Accredited Investment Fiduciary Analyst 2009 Conference in Phoenix, May 6-10.

Rich Todd presented "Hiring and Retaining Great Employees" at the *Barrons*' conference in Phoenix in May.

Shawna Sambrano was elected to the Volunteer Association of Denver Health Board of Directors in March. Shawna joined 400 volunteers from Denver Health and Comcast for "Comcast Cares Day" and donated her time to assist with the Newborns in Need program. In April, she became a Volunteer Ambassador for Colorado Human Resource Association (CHRA). Additionally in April, Shawna helped organize a fund raiser sponsored by the Young Philanthropist Project supporting Advocates for Children. The event raised over $5,000 and awareness for CASA programs in Metro Denver.

IN THE NEWS

Rich Todd's bi-monthly column in the *Denver Business Journal* included: "Madoff Fraud Shifts Focus to Concerns about Hedge Funds".

ARTICLES

Transitions magazine published Brad Brewer's article, "Fiduciary Liability: Increased Risk Fueled by the 2009 Meltdown!" in the March issue. Articles can be found on the Innovest website, www.innovestinc.com.

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