THE RESEARCH REPORT

A NEWSLETTER BY INNOVEST SPRING | 2013

NEW CLIENTS

Innovest was recently selected to provide investment consulting services for:

AAA Colorado, Inc.

Colorado Intergovernmental Risk Sharing Agency (CIRSA)

Western Union

Vail Resorts

*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.

CONTENTS

OUR 17TH YEAR IN BUSINESS

Rich Todd, CEO and Co-Founder

It seems like yesterday that Innovest opened its doors as a new firm with 25 clients. While we were confident of our business plan, our independence, and our unique approach, like any entrepreneur we were a little uneasy about "taking the plunge" without the big company safety net.

Reflecting on our history causes us to be grateful. Thank you to Wendy for helping to envision a better investment consulting model and to take the risk of starting a small business with me. Thank you very much to great clients, friends, outstanding partners and employees who have given us a wonderful 17-year experience. While the risks are different today, we do not take for granted our successes and constantly strive to make Innovest a better company each year—for our clients, partners and employees.

2012 was a record year for Innovest, our 16th in the last 17 years. We grew nearly 14%, landing 22 new clients and losing one. We have 200 clients at Innovest, and our historical client retention rate is 97%. Growth is important to us, as it helps create opportunities for our team and allows us to continue to bring in new high quality professionals. We are dedicated to a 7-to-1 client-to-employee ratio, and in 2012 we added two professionals to our 28-member team. We just signed a new seven-year office lease that created capacity for another 10 employees.

We work as a team at Innovest and measure the happiness of our employees, believing success comes more easily to those that are happy. We also conducted 360° reviews, asking our team to confidentially evaluate each other. One broken cog in a wheel can disrupt a whole machine, and when Innovest is humming we are very productive. Quantum Research conducted a 39-point confidential employee survey at Innovest and compared our results to hundreds of businesses in Denver. The result: Innovest was named one of the best places to work in Denver by the *Denver Business Journal.*

We also survey our clients on an annual basis, and in 2012 our clients gave us an overall 4.7 on a 5.0 scale—equaling the best mark that we've ever received. Additionally, for the first time, we did not have a single client give us an overall rating of less than 4.0. We will make improvements every year based on these surveys in areas such as reporting, communication, and approach. As a response to prior client surveys we have created a blog and developed a one-page manager due diligence report card in clients' quarterly reports. We are in the process of developing a summary of all client decisions and

portfolio changes that will be reflected in each client's performance report. We believe that this history will be a helpful record for our clients to memorialize their fiduciary compliance.

Innovest and our professionals are widely known for our expertise and accomplishments. In 2012 we gave 11 speeches at conferences to benefit our clients and the investment and fiduciary industry. We authored articles that were published by the likes of *Pensions and Investments*, *Philanthropy Management*, and *PlanSponsor Magazine*, and in the year we were mentioned 14 times by the financial press. Innovest was also retained as an expert in nine cases in 2012.

Our 2013 plan, the Innovest Playbook, highlights our goals for the year including our most important goal. We are consolidating and migrating to Junxure, our new client relationship management (CRM) system to better serve our clients. Our number-one goal at Innovest is for each employee to embrace Junxure and all its capabilities. We expect Junxure to create enormous efficiencies for operations, research, consulting and marketing, and in turn will benefit our clients.

While we are pleased with 2012, we are also happy to have it behind us. We are excited about 2013 and the opportunities for our clients and team at Innovest. Once again, thanks for your confidence!

DISCOUNTING THE FUTURE: DECONSTRUCTING EQUITY FUNDAMENTALS IN A LOW INTEREST RATE ENVIRONMENT

W. Eric Overbey, CFA and Phil Eichhorn, Senior Analyst

Since the economic crisis of 2008-2009 investors have become acutely aware of the structural problems facing the capital markets. Whether PIMCO's ad nauseum references to the "new normal" or Jeffrey Gundlach's prediction of the next "kaboom," investment income managers across the board are beating the drum of "expect lower returns." Slow GDP growth, political uncertainty, regulation, and other exogenous risks (e.g., North Korean and Iran) are factors supporting an anemic equity return environment. Innovest believes, however, that this view focuses too myopically on the growth aspect of equity returns, and completely ignores other factors that impact future market performance.

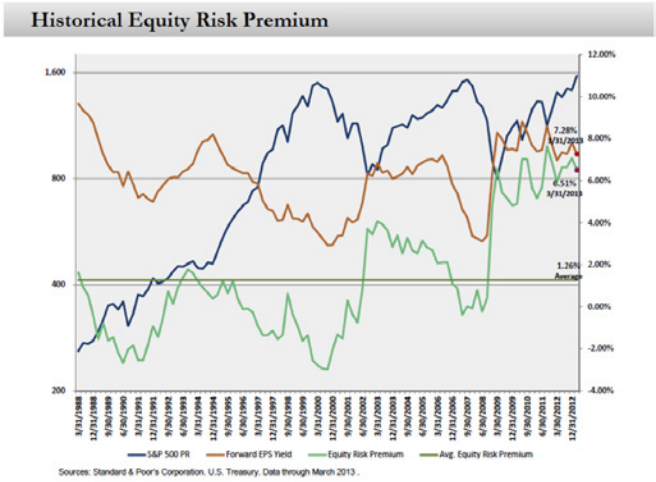
INTERMEDIATE-TERM OUTLOOK (THREE TO FIVE YEARS)

While we do not dispute the challenges for equity returns, we believe equity prospects remain attractive for investors with an intermediate-term time horizon.

Equity Risk Premium

The concept of the equity risk premium assumes an investor should be compensated for taking more risk over the long-run. When equity prices fall in the near term due to anxiety about world events and future corporate profitability, the equity risk premium tends to increase, indicating better future returns. The current equity risk premium, measured by earnings valuations and interest rates, is above long-term average levels. Not only does this indicate better future returns, the premium is enough that it could also act as a cushion in a rising interest rate scenario.

Exhibit A



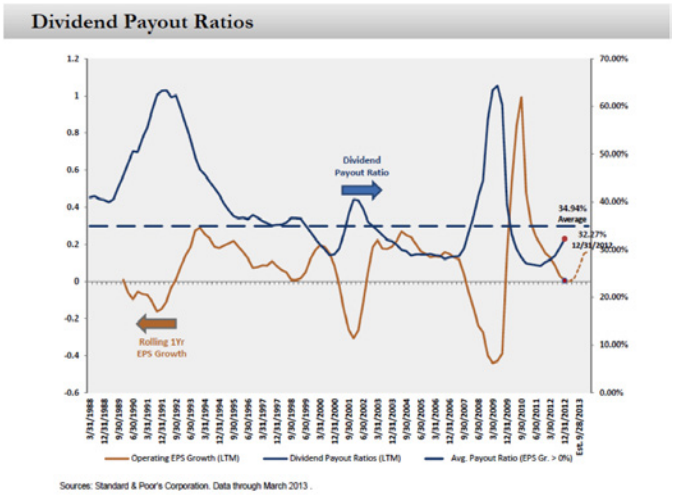
Capital Allocation

What makes capital allocation prospects particularly intriguing today is the large amount of cash and incredibly low levels of debt on corporate balance sheets. New capital investment, dividends, share buybacks, and a releveraging of corporate balance sheets are a few themes investors should expect in coming years as benefits from strong corporate finances.

What will drive companies' revenue growth in the future? Companies may either invest in new capital projects or acquire new business segments. Another option for corporations flush with cash is to return capital to shareholders via share buybacks and/or dividends. The current dividend payout ratio (the percentage of earnings paid in dividends) is near 32% (see Exhibit A) and has ample of room for improvement. Just a 3% increase in payout ratios

and an estimated mid- to high- single-digit earnings growth rate would equate to a 10% annualized increase in dividends over the next few years.

Exhibit B

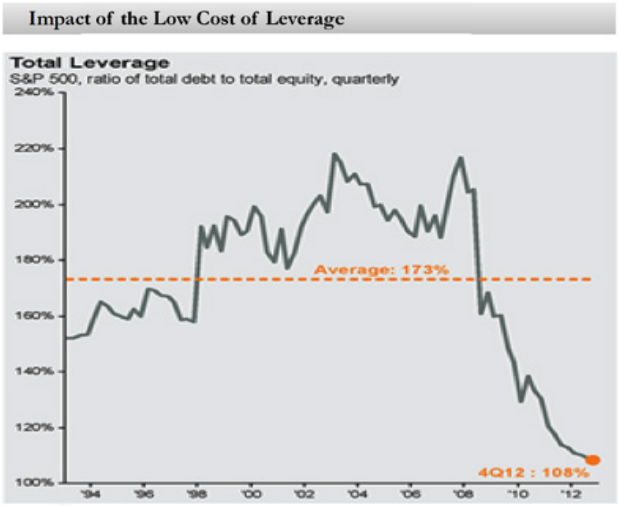


As of 3/31/2013. Sources: Standard & Poor's.

Leverage

The Fed's continuing use of Quantitative Easing--keeping rates low to facilitate borrowing and forcing investors in to riskier assets—has allowed companies to refinance their outstanding debt at very low interest rates. Having locked in low fixed rates on outstanding debt should provide a tailwind for companies for the next several years.

Exhibit C



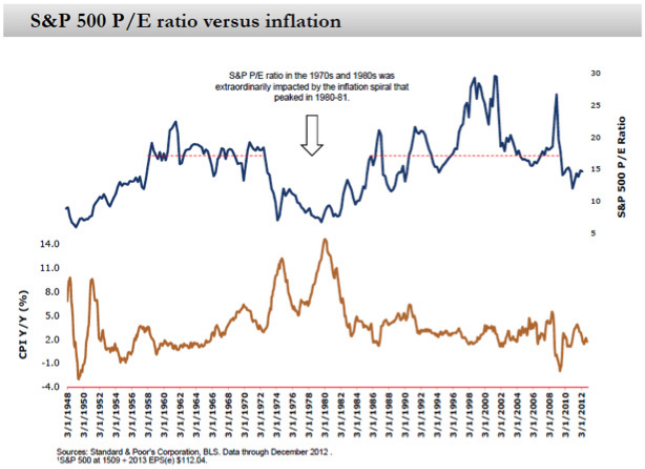
We expect mid- to high- single-digit equity returns over an intermediate-term time horizon. Although our market return forecast falls short of long-run historical averages, fundamentals suggest we are far from the dire return environment espoused by many sensationalist market pundits.

LONG-TERM OUTLOOK (GREATER THAN FIVE YEARS)

In contrast to our intermediate-term outlook of three to five years, we foresee notable challenges for long-term equity returns.

The Fed has made it clear they intend to raise the Federal Funds Rate as unemployment approaches 6.5%, which is currently expected within the next two years. A rise in rates has two implications: 1) an increase in the cost of debt and 2) a decrease in current valuations due to higher discount rates.

Exhibit D



In addition, over the long term equities tend to provide a decent inflation hedge, as companies pass along rising costs to consumers. Short-term spikes in inflation, however, can cause equity valuations to decline. Despite the recent subdued pace of inflation, unprecedented easing by the world's Central Banks has the potential for money velocity to increase, resulting in higher inflation.

While these pressures do not appear to be imminent risks to the equity markets, we are closely monitoring their movements.

Innovation and Growth

In an effort to have a balanced view of long-term equity returns, we believe it is important not to underestimate the market's ability to reinvent business models and to compound long-term earnings growth. Just ten years ago no one could have predicted the how a single company (i.e., Apple) could revolutionize information through mobile computing. Broader innovation could easily become a long-term growth catalyst for the economy.

Horizontal fracturing and the resulting downward pressure on energy prices could translate into sustainable long-term earnings growth. In addition,

the cost of labor in many emerging markets has increased significantly in recent years, which decreases the relative benefit for U.S. companies to send their manufacturing offshore.

The U.S.' ability to innovate, which is engrained in our entrepreneurial culture, is unparalleled in the world. We expect over the long term that our economy will reinvent business models, improve efficiencies, and alter entire industries through new product development.

SUMMARY

Equity return prospects appear to be destined for a much different path than what many market pundits or headline news would lead you to believe. While extrapolating historical performance into the future would save us significant time, we would rather know the looming challenges and exploit market mispricings. Patient and forward-looking equity investors should continue to be rewarded.

A COLLECTION OF IDEAS OF BEST PRACTICES FOR A PROVIDER RFP

Gordon Tewell, CFA, CPC, Principal

The selection of a plan's service provider is a fiduciary act. As such, it is governed by the duty of prudence under the plan fiduciary's responsibilities. When examining the fiduciary standard's most essential requirements, it may be easier to state what will not meet the test. Fiduciaries may not select a provider simply because it is the least expensive, because they heard from a colleague that a provider offers great service, or because they get along well with the provider on a personal level. While all of those elements may contribute to the ultimate selection of a service provider, a procedural-based investigative process must be used to ensure that the plan is hiring the best provider for the task. The best way to meet this objective is to employ a Request for Proposal (RFP) process.

We have compiled from a variety of retirement industry sources a compendium of informative and creative ideas, analysis, and how-to tips on managing an RFP for recordkeeping and administrative services. Here are some best practices from industry authorities that you can implement in managing your next RFP:

HOW DO YOU KNOW WHEN IT IS TIME FOR AN RFP?

Certain events may provide an obvious indication, such as the incumbent provider no longer providing the services needed or desired.

Other triggers may be less apparent, but just as problematic for the plan. For instance, the needs of the plan may have shifted such that the current provider may no longer be the best fit. Boards should be mindful of the changing needs of the plan and, when necessary, investigate whether moving to another provider warrants investigation. On occasion, the call for an RFP may be awkward and uncomfortable, particularly where the service provider has a long history with the plan and personal relationships have developed. However, fiduciary responsibilities do not make allowance for hurt feelings.

Service providers understand and respect that a plan, through its board of trustees, must ensure that the best providers for the plan are in place and that a call for an RFP is not a reflection on the providers' overall merit. An established relationship with a service provider that knows the plan, its board of trustees and its history inside and out is invaluable. This type of long-term service allows for a familiarity and depth of knowledge that is beneficial to the operation of the plan and, ultimately, its participants. Don't forget that the RFP process still has a role even for those boards fortunate enough to have these types of relationships with one or more service providers. While "change for change's sake" is certainly not required, a due diligence RFP is appropriate and should be conducted periodically. A due diligence RFP allows the board to review available options and compare them to the service currently being provided.

Parisi, Rachel (November 2011). "Making a perfect match takes a great RFP." International Foundation of Employee Benefit Plans, *Benefits Magazine*, Volume 48, No. 11, 40-44.

WHO WILL CONDUCT THE RFP?

The first task in the RFP process is establishing the composition of the team who will create and review the RFP. Businesses that sponsor qualified plans often wrestle with the question of who should be involved with an RFP, and what their roles should be. Since most companies have standing Investment Committees, the formation of an RFP task force is a crucial first step in this process. Our experience has shown that a smaller team allows you to include individuals with a variety of perspectives and skills while remaining focused enough to keep accountabilities clear and decisions streamlined. If your investment committee is large, consider designating a subset of the members to handle the RFP. The investment committee can then be pulled in to review the RFP team's recommendations.

The Vanguard Group Inc., (2012). "Creating an effective RFP process."

SHOULD YOU USE A CONSULTANT?

By hiring an outside investment consulting firm, a 401(k) plan sponsor receives the objective expertise of an independent reviewer and helps eliminate any strain on potentially less-qualified, internal staff.

Further, your investment consultant is compensated only by you, the plan sponsor, thus ensuring that your interests are incorruptibly aligned and that all portfolio recommendations and decisions are based on the best, long-term interests of the plan participants. Your investment consultant will help prioritize salient issues, develop effective RFPs, distill appropriate fund options, detail true plan costs and choose vendors. And, once an investment is made, your consultant will monitor the vendor's reliability and performance for you.

Bidart-Ross (2007). "Taking your 401(k) plan out to bid: how to attract and select the right vendors through a well-developed request for proposal (RFP)."

At Innovest we believe a thorough understanding of your consultant's fee structure and their alignment with your plan participants' interests are the keys to your consultant relationship. When utilizing the services of a consultant to assist with an RFP, we believe it is critical to the success of a prudent RFP process to use a fully independent consultant who receives no compensation from any type of vendor and who can act as a plan fiduciary.

DETERMINE WHAT SERVICES THE PLAN SPONSOR AND THE PLAN'S PARTICIPANTS NEED

When considering a provider change, it is normal to focus on the negative aspects of your current provider relationship, including the things that are not working and the things you and/or your committee always wanted to do, but were told you could not, either directly or indirectly. In fact, since many provider changes are given impetus by service problems, it would be natural to seek assurances that those issues would not be replicated.

However, a good provider relationship—like any good human relationship—is best based on a good understanding of who you are, what you want, and what you expect from your partner. For a retirement plan, that includes knowing what your objectives are for the plan, what your participants are like and what they need in terms of service and support, and, yes, what you expect to pay. If you have an existing plan, your current plan document is a starting point, primarily in terms of provisions that must be accommodated, but also in terms of a design baseline. However, if you are going to consider making a change, this can be a good opportunity to rethink some things: how long you make employees wait to participate, for instance, or what is designated as the default investment option. Are you ready to adopt automatic enrollment? What about adding a Roth option?

Adams, Nevin (June 2011). "Recordkeeping survey: tying it all together, picking the best provider." *PlanSponsor*.

We also believe providing the providers with the best information available on your plan will lead to a smooth RFP. Plans should provide background information to help prospective firms customize their proposals. Consider including your investment policy statement (IPS), holdings information, and required reporting as part of the RFP. These documents provide useful context for the candidate firms and help firms tailor their responses.

The Vanguard Group Inc., (2012). "Creating an effective RFP process."

WHAT A "GOOD" RFP QUESTIONNAIRE LOOKS LIKE

While the potential service providers' responses are of course critical to the resolution of the RFP process, nothing is more crucial that the RFP questionnaire itself. When it comes to the questionnaire, there is no truer case for the maxim, "You get out of it what you put into it." If a board wants to receive robust and detailed information about the potential service providers for the benefit plan, then significant time and energy must be put into developing the RFP questions. Do not attempt to accomplish this task by doing a Google search for "RFP template." Each plan is unique, and it is necessary to tailor the questions to ensure that the full picture of the candidates is being generated.

Parisi, Rachel (November 2011). "Making a perfect match takes a great RFP." International Foundation of Employee Benefit Plans, International Foundation of Employee Benefit Plans, *Benefits Magazine,* Volume 48, No. 11, 40-44.

Keep questions clear and direct. The clarity of your questions will drive their usefulness. Indirect questions will likely result in indirect answers that don't provide the information you need. Also, if questions are too vague or open-ended, you can't make comparisons across potential investment providers. In some cases, requesting an example or case study will be helpful.

The Vanguard Group Inc., (2012). "Creating an effective RFP process."

WHOM DO YOU INVITE?

Whether "solo" or accompanied by an adviser, you will want to narrow your focus to providers

who, in the words of the Department of Labor (DOL), have "experience with retirement plans of similar size and complexity." Some providers specialize in certain segments of the market, and some simply have a client base that, for any number of good reasons, reflects a certain focus.

Adams, Nevin (June 2011). Recordkeeping survey: tying it all together, picking the best provider. *PlanSponsor*.

TIME TO CHOOSE

Ideally, once the interviews are completed the board will have a tough selection to make because it has seen a number of top-quality candidates, any of which would make great partners in the operation of the plan. How does the board choose? As in other plan business, the board must exercise its fiduciary duty in making the selection. Specifically, the board must review the candidates' written responses in the RFP questionnaire, discuss the candidates' performance in the presentation phase, compare the candidates and measure what each candidate can offer the plan—with thorough discussion and debate throughout.

Once a provider is selected, formal letters (to the selectee, those not selected and of course the provider who is being replaced) should be promptly prepared and issued simultaneously as a courtesy to the candidates.

Parisi, Rachel (November 2011). "Making a perfect match takes a great RFP." International Foundation of Employee Benefit Plans, *Benefits Magazine*, Volume 48, No. 11, 40-44.

CLOSING THE DEAL

Finally, make sure you understand the terms of any agreements or contracts you sign with service providers and the fees and expenses associated with the contracts. Understand that these agreements generally are written for the benefit of the plan provider, not the plan (or plan sponsor), and, while they can be a valuable reference, they, like any legal document, should be reviewed by someone with the interests of the plan uppermost in mind.

Adams, Nevin (June 2011). "Recordkeeping survey: tying it all together, picking the best provider." *PlanSponsor*.

The RFP process can be time consuming and resource intensive. Some trustees may have developed a personal relationship with their service providers, which can make the RFP process difficult. Nonetheless, a breach of fiduciary duty is possible if the plan's service providers are selected without following the obligation to use due care. Likewise, a failure to properly select and monitor your provider can also result in a breach of fiduciary duty. Given the high standards required of the plan fiduciaries, and despite the inconvenience of the process, there really is no better way to select the best service providers for a plan than through a well-executed RFP process.

CLIENT SPOTLIGHT

REGIS UNIVERSITY

Founded in 1877, Regis University is the only Jesuit Catholic university in the Western U.S., and is one of twenty-eight Jesuit colleges and universities in the United States. The University has a 16-year consecutive ranking as a top school in the Western United States, by U.S. News.

Inspired by St. Ignatius Loyola, the mission of Regis University is to educate men and women of all ages to make a positive impact on society and live a life of purpose. Creating leaders in the service to others remains a goal of the University, and many students participate in service learning activities by volunteering with various organizations throughout the Denver area.

In 1998, the University created the Institute of Common Good. A forum for dialogue, the Institute seeks to provide Regis students with world-renowned speakers as a fresh avenue of education. Past Institute speakers have included:

- Nobel Peace Laureate Archbishop Desmond Tutu of South Africa
- The 14th Dalai Lama of Tibet
- President Oscar Arias of Costa Rica
- Elizabeth Dole, former President of the American Red Cross and U.S. Senator
- Sister Helen Prejean, author of Dead Man Walking
- Somaly Mam, Cambodian anti-trafficking proponent
- Elie Wiesel, author of Night

Altogether, 13 Nobel Peace Prize recipients have visited Regis University.

Regis University tailors learning to meet the needs of its 15,000 students in three separate colleges. Each of its three colleges—Regis College (2,000 students), Rueckert-Hartman College for Health Professions (3,000 students), and the College for Professional Studies (10,000 students)—offers a distinct voice for the University's mission.

Innovest is proud to provide investment consulting services to Regis University.

*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.

AROUND THE FIRM

RECENT EVENTS

Innovest is pleased to have been ranked third among Colorado-based investment managers and financial planners by the Denver Business Journal. A list of the top five firms was published in the March 8 edition of the Journal.

Innovest has been nominated as one of the *2013 Colorado Companies to Watch*. Presented by CapitalValue Advisors, *Colorado Companies to Watch* is an awards program designed to celebrate companies that are growth-focused, privately held, headquartered in Colorado, and have between six and 99 employees. Innovest is proud to have received this nomination. The theme, *Fueling the Economic Fire in Colorado*, focuses on companies that have a positive economic and community impact on Colorado.

In January, Innovest hosted its annual "Economic Forecast and Outlook." This year's presenter, Rob Stein of Astor Asset Management, spoke on "Economic Fundamentals with the Impact on Stock Portfolios." More than 100 of our clients attended the event at History Colorado.

In February, Innovest joined CliftonLarsonAllen and Gabriel, Roeder, Smith & Company to present a half-day event on the impacts of GASB on pension plan accounting standards and the state of the markets. Scott Middleton and Gordon Tewell presented, "The Economic Environment" to more than 80 attendees.

Scott Middleton presented at the Mountain States Institutional Investors Forum in March. The forum provided a detailed overview of fiduciary obligations and investment strategies to help investors navigate the market. The forum included speakers from Colorado, Wyoming, Montana, Idaho, New Mexico, Oklahoma, and Utah.

Innovest and Citywide Banks were pleased to welcome the Honorable Bob Shaffer to present "Revolutionary Approaches to K-12 Education," in March. From 2006 to January of this year, Schaffer was chair of the Colorado State Board of Education. He also was a candidate for the United States Senate 2008, and a former representative in the U.S. House. Bob founded the Liberty Common Charter School in Fort Collins, in the Poudre School District, which has been recognized as a top-performing K-12 institution. Liberty Common's students consistently score at the top in multiple performance ratings, including the highest 2012 ACT scores in Colorado.

Also in March, Innovest hosted the 13th Annual Rocky Mountain Nonprofit Conference with EKS&H. The mission of the conference is to provide an educational forum on topics of significant interest to enable board members, trustees, and executive staff to improve management of their organizations and their investment portfolios. Rich Todd presented "The Top 10 Investment Committee Mistakes," and Gordon Tewell presented "Capital Markets Projections and Portfolio Construction." More than 120 people from nonprofits throughout Colorado

attended the conference.

Gordon Tewell was quoted in an Employee Benefit News article, "UTC Launches Game-Changing Lifetime-Income Strategy." The article was published on *Employee Benefit News'* website on March 1. Additionally, Jerry Huggins was quoted in *Employee Benefit Adviser* "DC Plan Regulations Highlight New Tasks, Opportunities for Advisers." The article was published on Employee Benefit Adviser's website on January 1. For all the latest articles and quotes from Innovest in various media, please visit innovestinc.com, In the News.

On April 18, Innovest presented its quarterly capital markets webinar. This quarter's topic was "Looking Forward in 2013." Thank you to all who attended.

EMPLOYEE SPOTLIGHT

NANCY SWANSON, MANAGER

WHAT IS YOUR ROLE AT INNOVEST?

I am a Client Services Manager, which provides me the opportunity to work with many great people at Innovest. For example, I work with Eileen Pohs and the consultants to onboard new Innovest clients. I also work with the consultants to resolve client issues. I am responsible for tracking new client implementation and any ad hoc client projects. I also work with Rosie Morris on custodial issues and help with workflow. I interact with custodians on daily transactions to ensure efficiency and accuracy for our clients. Additionally, I support the other Innovest analysts by conducting performance report reviews and providing support for anything they may need on a day-to-day basis.

WHERE IS YOUR HOMETOWN?

Grosse Pointe Farms, Michigan

WHAT DO YOU LIKE BEST ABOUT WORKING AT INNOVEST?

The people are dedicated, hard working, intelligent, respectful, fun, and kind. Everyone comes to work every day with the attitude that they are there to do their job, support each other, and serve Innovest clients.

HOW DO YOU GIVE BACK TO THE COMMUNITY?

I've mostly been involved at the school level throughout my children's education. I've been a Brownie/Girl Scout leader, Sunday school teacher, PTA President, and Parent Volunteer doing just about anything anyone needed. I've also worked at numerous soup kitchens, food pantries, and Race for the Cure.

WHAT ARE YOUR HOBBIES AND INTERESTS?

I enjoy getting regular exercise, whether it is running, heading to the gym, or taking a hike.

TELL US ABOUT YOUR FAMILY.

My son, Peter, 23, graduated from Regis Jesuit High School in 2007 and the University of Colorado in Boulder in 2011. He currently works for an advertising agency in Los Angeles. My daughter, Alyssa, who also graduated from Regis High School, is a senior at Denison University in Granville, Ohio. My husband, Steve, works for an advertising agency in Atlanta.

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