THE RESEARCH REPORT

A NEWSLETTER BY INNOVEST WINTER | 2012-13

NEW CLIENTS

Innovest was recently selected to provide investment consulting services for:

City of Lakewood

Loveland Police

Larimer County

Poudre Fire Authority

City of Wheat Ridge

*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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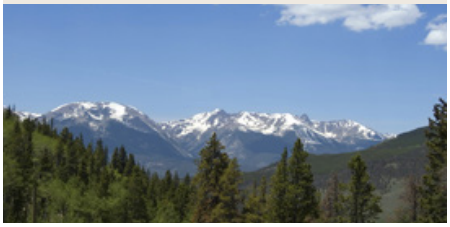


INNOVEST RECOGNIZED AS ONE OF DENVER'S BEST PLACES TO WORK

Rich Todd, Managing Principal, CEO and Wendy Dominguez, MBA, Principal, President

It is a tremendous honor to announce that an anonymous survey of employees at companies throughout the Denver metro area has led to Innovest being recognized by the *Denver Business Journal* as one of the best places to work in the area. Conducted by Quantum Workplace, the survey asked employees to rate their respective organizations in 39 areas, including teamwork, manager effectiveness, trust in coworkers, trust in senior leaders, feeling valued, job satisfaction, and benefits.

We are very proud of Innovest's fine collection of talented and hard-working professionals who have the strongest character and work so well as a team. Looking back over our 16-year history, we believe that we can identify specific business practices that have helped to develop a culture that engenders pride in what we have accomplished for our clients and one another. These business practices include hard work, honesty, integrity and dedication to the client.

While some of these business practices were adopted by design and others by happenstance, over time we have learned how to become a better employer and consulting firm. This is not to say that we have cornered the market on best business practices. Great firms have faltered, often out of arrogance, as Jim Collins, author of *Good to Great* and *How the Mighty Fall*, can attest. While we can bask in the glory of our recognition for a few days, we still can improve; our culture and team strive to do so.

LEARNING FROM THE BEST

In addition to Jim Collins, other business experts offer valuable experience and knowledge about what it takes to become a great company. We have received excellent advice from Patrick Lencioni in *The Five Dysfunctions of a Team*, *Speed of Trust* by Stephen R. Covey, *Execution* by Larry Bossidy and Ram Charan, as well as *The Trusted Advisor*, by David Maister, Charles Green, and Robert Galford. In addition, our interviews with past winners of the *DBJ*'s "Best Places to Work" led to numerous ideas about how Innovest could become a better employer.

We have also appreciated the advice of our Advisory Board (click here for our current Advisory Board and alumni), our executive coach Mickey Fain of Powerhouse Strategies, and various

consultants including Rich Rinehart of Grant Partners, and A.J. Steger of EKS&H. They have taught us valuable lessons about leadership, management, and team building that have empowered each of us to strive to provide the best results and service to our clients, and help our team understand the benefit to "Ride for the Brand" a lesson from our Colorado roots; loyalty is too unfamiliar on Wall Street today. While our team can have lively discussions and even disagreements in the boardroom, we leave it with common goals, missions, and methods.

TRUSTING EACH OTHER

Why do so many successful people in our world seem to be unhappy? Conversely, there are others who have gone through brutal life experiences and seemingly shrug off their problems and take on the next challenge with a smile. It is clear to us that success *will not* ensure happiness, but happy people have a much better chance of being successful. Happy people are more productive. Innovest's core values—dedication to our clients, hard work, honesty and integrity—can help to ensure success. Balancing the four Fs—firm, family, faith, and fun—is our mission at Innovest.

Growing Innovest from five professionals in 1996 to nearly 30 today has been rewarding, yet challenging. Innovest isn't just about Rich and Wendy anymore. As our organizational chart flattens and responsibilities are distributed, it is vital that we create and maintain trust in each other. We work as a team at Innovest, and in that environment, communication is crucial. There are always occasions when someone needs help to meet a deadline or accomplish a task, responsibility, or goal. We have always been performance driven, but we do not try to make people what they are not. Developing a team with complementary strengths can virtually eliminate personal weaknesses, but only with quality management. We are fortunate to have hired and developed outstanding managers over the years.

A variety of personnel practices are designed to foster great teamwork as well. We have flexible work schedules for many and unlimited vacation time for everyone. If you need it, take it. We also have a sabbatical program, where employees who have met tenure requirements can completely "check out" for a one-month period every three years. These benefits are balanced by 360-degree reviews where everyone in the firm is evaluated by each other to measure performance, strengths and weaknesses. Bonuses are tied substantially to these reviews and help to ensure accountability, communication, and trust.

We also try to give back to the community by working together outside the office. Our Charitable Donations Committee has facilitated service opportunities, including building a trail at Cherry Creek State Park, serving lunch at the Denver Rescue Mission, and volunteering in support of the Special Olympics. We also have a weekly, company-sponsored "Lunch Bunch" during which fines are levied on those who "talk shop" over lunch.

CHARACTER ABOVE ALL ELSE

While it is not always the case, many members of the Innovest team were known by a member or friend of the firm before they became a member of our team. In the event of an employment opportunity with Innovest, we ask our professionals, our clients, and our friends for referrals. We also keep a "bench" of prospective employees whom we know from business or prior employee searches. We love to hire people we know, since strong character and happiness are not traits that can be easily found on a resume or even when conducting interviews. Further, when someone is strongly referred by a friend, client or employee, they have a stronger will to succeed and not disappoint.

Also exciting for us is the development career paths for our employees. Young professionals who have started at entry-level positions have been provided with opportunities over the years to learn our approach to client service, research and due diligence, consulting and investment philosophies. Today, many employees have substantial client responsibilities. In addition, we have a very high regard for maturity and life experiences. Innovest has a number of professionals who have changed careers to come to Innovest and have been extremely successful with our firm.

While we are guilty of not saying "thank you" to our team often enough, we have made strides in recognizing accomplishments. We write a weekly newsletter "We Love Mondays at Innovest!", which contains a long list of firm successes, individual accomplishments, and examples of exemplary efforts in the prior week. Each month a team member is recognized and rewarded by our Directors for providing excellent service to our fellow Innovest professionals. Two annual awards with monetary bonuses are given to outstanding individuals. The 212-Degree Award is given to an Innovest professional who has gone beyond the standard in providing great client service. The other,

the Founders Award, is given for demonstrating exemplary dedication to the Innovest's Core Values.

We are fortunate to have such a wonderful team and hope that our clients agree. We strive to hire the right people, and through a rewarding experience, we expect to have our professionals with us for many years. In our latest client survey, the measure of "Treatment by our Entire Team" scored 4.9 on a 5-point scale. We are honored to have such high marks, but truly understand that without our great clients, having an outstanding team of professionals would be all for naught. Thank you to our clients and the Innovest team for making Innovest a great place to come to every day!

A LOWER RETURN ENVIRONMENT: THE IMPACT ON FOUNDATIONS AND ENDOWMENTS

Martin Walsh, Vice President

The past few years has been especially challenging for foundations and endowments to keep their investment portfolios focused on long-term growth. The deep financial crisis and bear market of late 2007 to early 2009 led to substantial portfolio drawdowns and a resulting decrease in organizational spending. Despite the severity of these and other near-term challenges, all endowments and foundations are charged with the central task of growing their investment portfolios to maintain the long-term purchasing power of their spending.

While the capital markets have recovered since the lows of 2009, the investment environment has become only more opaque. Politics in the United States and Europe surrounding fiscal issues continues to weigh on investment returns. Bond yields have dropped to generational lows. Stock market valuations, while not expensive, are not as compelling as a few years ago. Hedge fund returns have plodded along in recent years.

Bill Gross, managing director at PIMCO, famously coined the term "new normal" with respect to the lower return environment that investors now face. Writing in late 2012, Gross noted: "The 30-year Treasury hit its secular low of 2.50% in July and such a yield may seem ludicrous a decade hence. Investors should expect future annualized bond returns of 3-4% at best and equity returns only a few percentage points higher." Gross's lower expectation for investment returns is not atypical for forward-looking investment forecasts.

In May 2012, another of PIMCO's commentators, CEO Mohamed El-Erian, offered this commentary on the future for investment returns: "...(S)ociety will need to lower its return expectations in general, and particularly its risk-adjusted return expectations. Having produced what Scott Mather calls a period of 'false economic prosperity,' the enormous multi-year levering of both the public and private sectors in advanced economies...can only be maintained and enhanced through additional leverage..."

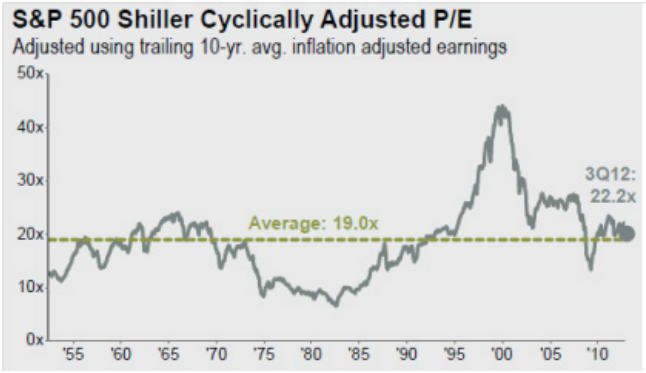
Of course, this additional leverage of which El-Erian speaks is bound to come to an end at some point. The United States' federal debt has already reached 100% of GDP, not including unfunded liabilities like Medicaid and Social Security. Japan has issued sovereign debt several times the size of its national production. Western Europe has its own severe leverage problems, which are frequently seen on front page headlines in places like Greece and Spain. If sovereign debt were a game of musical chairs, the music would be close to stopping.

US Federal debt projection. Source: Congressional Budget Office 2012.

This environment brings a new set of challenges to investment committees: how to invest for the long term?

Innovest projects inflation to average 2.75% per year over the next five years. If a foundation maintains a 5% spending policy from its endowment, the portfolio would need to earn an average of 7.75% per year just to maintain its spending in real dollars each year. This projection assumes no net inflows from fundraising, which will likely become an increasingly important part of an organization's financial health.

A traditional, classically balanced investment portfolio for an endowment has been a 60/40 mix of stocks and bonds. This mix of assets may not be enough to keep pace with a foundation's future income needs. With the Barclays U.S. Aggregate Bond Index currently yielding around 1.7%, bonds are poised for very low forwarding-looking returns. Innovest's projection for high quality fixed income returns is 2.5% annualized over the next five years. To get to a 7.75% return, the stocks in a 60/40 portfolio would need to earn 11.25% each year. While stocks are still reasonably valued, an 11.25% annual return seems overly optimistic in the current economic environment.



Valuations are a major driver of future stock market performance over the long term. Looking at today's valuations, cyclically adjusted earnings for the S&P 500 are within a normal range, but certainly not cheap. Above average stock returns, therefore, are difficult to get to given where we are starting from today.

Investment committees should consider a mix of the following strategies to meet their long-term goals: cut spending, increase fundraising, shift away from high quality fixed income and add alternative investments to their portfolios. While each of these strategies on their own may provide only modest improvements to an organization's financial picture, the incorporation of several will likely have a real impact.

Foundations may need to tighten their fiscal belts in the coming years. While a spending policy of 4.5% to 5.0% may have been within a reasonable range in years past, spending will likely need to be in the range of 3.5% to 4.0% for the coming decade. AllianceBernstein estimates that a traditional 60/40 portfolio will need to limit net spending to 3.5% in order to keep up with inflation.

Fundraising will become ever more important as we enter the "new normal" investment environment. Should an organization need to limit itself to a sub-4% spending policy, it will need to make up the difference in incoming cashflows. To the extent that a foundation can spend less out of its endowment by fundraising, the chances of keeping up with inflation rise dramatically.

For a foundation with a long-term time horizon, a more aggressive asset allocation probably makes sense in light of the meager projected bond returns for the next decade. Adding to equities, floating rate loans, commodities and hedging strategies are the most likely candidates for receiving the money from reduced allocations to high quality fixed income. While the portfolio would become more volatile from overweighting these riskier asset classes, the risk/reward trade-off would be superior to a portfolio with heavy allocations to long duration fixed income strategies.

Importantly, there are very few free lunches in investing. A move away from high quality fixed income into riskier asset classes will likely increase the risk of a major drawdown in the portfolio. Stock market corrections happen fairly often, usually at the most inconvenient times. Still, the additional risk is probably justified over the long term. While workers need to become increasingly conservative as they approach retirement age, foundations are theoretically built to last into perpetuity. With this longer term perspective, investment committees should feel more comfortable with an asset allocation that has a higher likelihood of beating inflation over the long term.

The addition of hedge funds to a portfolio can actually improve the risk/reward profile of an asset allocation. If a foundation currently lacks hedge fund exposure in its asset allocation, it is missing out on a key driver of diversification and is not managing portfolio risk in the most efficient manner.

A recent study ending in 2011 compared twenty-year returns and risk of a traditional 60% equity, 40% bond portfolio to one that was 40% equity, 40% fixed income and 20% in

a diversified hedge fund basket. Over the long term, performance was equal or better for the portfolio that included 20% in hedge funds, and with significantly lower volatility.

A recent white paper issued by KPMG compared a 60/40 traditional portfolio to one allocated one-third each to equities, fixed income and hedge funds. Their study concluded: "We document that an equal weighted portfolio containing hedge funds, stocks and bonds has significantly higher performance with lower tail risk than a conventional portfolio based on the 60/40 allocation of stocks and bonds."

While all organizations would like to have the return of higher investment returns and more confident spending from endowments, facing into the current environment will require difficult decisions. There are no perfect outcomes or recommendations resulting from this shift to a lower investment return environment. Each move out of bonds into stocks and alternatives is matched concurrently with more risk. Each spending cut that a foundation makes to save its long-term purchasing power results in fewer dollars today to fund valuable programs. While there are no easy answers, a mixture of spending less, raising more and adopting a more aggressive asset allocation is most likely the path for financial success in the endowment world.

THE EVOLUTION OF A SOUND RETIREMENT PLAN: HOW A NEW EXECUTIVE TEAM ACCOMPLISHED A PLAN OVERHAUL

Gordon Tewell, CFA, CPC, Principal

A company's new executive team recently was tasked with becoming the fiduciaries for the company's 401(k) plan. This study reviews how the team took significant actions and made effectual plan changes in an effort to fulfill its fiduciary responsibilities.

The team's goal through this process was to improve fiduciary oversight of the plan and prudently review its retirement plan service providers. Through the process the leadership team discovered a significant information gap: providers typically withhold information from plan sponsors, thereby inhibiting the team's duty of acting in employees' best interest. The policies, vendors and expectations which had been in place for many years were not necessarily in line with fiduciary standards. The team ultimately took on an overhaul of fiduciary processes to create a new age of stewardship and fiduciary responsibility.

The team was relatively unfamiliar with their fiduciary responsibilities and if the plan was fiduciarily sound. The team met with a few fiduciary consulting firms and explored having these firms conduct a fiduciary review and benchmark their plan. The team eventually engaged one of the firms (Innovest) to complete a fiduciary review of all aspects of the plan's governance. While many aspects of the plan were sound, other issues came to light that needed action, and the team engaged Innovest to help them manage changes to the plan.

One of the main goals of the new team was for a newly established plan committee to become an independent entity receiving full disclosure from the providers from whom they enlisted help and expertise. In order to achieve this goal the team realized they needed experts in their respective areas of plan advisement. The team came to understand that provider relationships should be a clear, straightforward partnership where their clear responsibility is to work in the best interest of plan participants.

Upon reviewing the fiduciary review of the plan's structure, the team found several areas of sound plan governance were lacking: a formally structured investment committee holding regular meetings, an Investment Policy Statement directing the plan fiduciaries on how they should select and monitor the plan investments, and a process to formally understand and determine the reasonableness of the fees paid to the plan's providers. Other issues which were highlighted by the fiduciary review were the single fund family and commission-heavy investment approach, which may not have been in the best interest of their participants.

Due to longstanding provider relationships, the firm had contracts that had been in place for many years. Some of the most enlightening information in the process related to contractual restrictions and caveats that interfered with creating a best-practice fiduciary approach.

The plan advisor who had been serving the plan for years challenged the team's authority to act in the best interest of their plan

participants. This action by the plan advisor highly motivated the team to move forward with a consultant to structure a completely new fiduciary model. Their objective became to adhere to industry best practices and become responsible stewards of their participants' assets. Engaging Innovest and completing the fiduciary review provided the specific roadmap on how to proceed.

In spite of the obstacles faced throughout the process, the team was able to elevate their approach and create a clear-cut fiduciary system that established new practices and ensured they were doing what was best for their employees. In order to address all of these areas, the team worked with Innovest to update their service model. They started with detailed due diligence to understand all that was included under their current contracts, and in what areas the plan may be falling short.

Initially, the team focused on the plan's investments. They sought greater transparency, both in allowing participants to understand where their investments were being made and how much they were paying for the plan. A best-in-class investment menu replaced the single fund family approach, and individual fund expenses were reduced through the use of institutional (versus retail) share classes. This new approach provided employees with the confidence that their plan was being properly overseen.

As the project progressed the group made other improvements, including: a better pricing structure with their providers, a higher level of service through better reporting mechanisms and tools for monitoring providers, the development of an independent fiduciary process which is conflict-free from the possibility of an advisor seeking higher commissions. Perhaps most importantly, the new team created a partnership with Innovest, allowing the new executives peace of mind regarding their fiduciary responsibility and decisions.

Over the course of time several additional steps were completed, and the plan established a solid base of plan governance. Changes included: the establishing a new plan committee, which includes the executives as well as other company staff, creation of an Investment Policy Statement thorough and prudent due diligence and fund analysis, fiduciary training for the plan committee members, a process to understand the plan's fees and their reasonableness, and documentation of the committee's meetings and decisions.

Innovest leads the investment committee in understanding how to make decisions that will comply with industry best practices and trust laws. The new committee feels confident and secure in their new approach.

In a recent discussion, the executives identified several recommendations and insights regarding the creation of a sound process:

- Don't implicitly assume that your fiduciary responsibility is being upheld because nothing bad has happened.
- Review your processes and providers—not just because it's a healthy exercise for the organization, but because fiduciary responsibilities require that of you.
- If you have not already done so, enlist the help of an independent fiduciary consultant. They can change the way you view fiduciary responsibility and assist with the fiduciary burden.
- Don't underestimate the power of stewardship. Doing the right thing by your employees will be one of the most rewarding things you can do for your corporation and yourself.
- It is OK to trust, but you must verify and ask hard questions of even your most long-term service providers.

The fiduciary status of the plan has come a long way, as the committee is now addressing more complex issues to improve employees' retirement outcomes, such as match optimization and automatic contribution and deferral escalation features. The committee has taken the additional step of measuring the effectiveness of their decisions on a regular basis using specific metrics. The plan has gone from being at risk to a robust, fiduciarily sound plan with a new focus of ensuring that employees have the tools to help them understand their needs for retirement and if they are saving enough to meet their long-term goals.

CLIENT SPOTLIGHT

NORTHERN WATER

In 2013, **Northern Water** celebrates its 75th birthday of providing a reliable water supply to northeastern Colorado. Put into action by Colorado lawmakers in May of 1937, Northern Water's mission is to help prevent 1930s-like dustbowls by consistently meeting the region's water needs.

The organization's first large-scale engineering task was the Colorado-Big Thompson (C-BT) Project, the largest trans-mountain water diversion project in Colorado. Built between 1938 and 1957, the C-BT Project provides supplemental water to 30 cities and towns in the region. The water is also used to help irrigate approximately 640,000 acres of northeastern Colorado farmland.

Since 1937, the population in the Northern Water district has grown more than ten-fold, from 75,000 to 850,000. Despite this tremendous growth, 60 percent of the project's water continues to be used for agriculture. Over the last 75 years, the organization's mission has expanded beyond providing water-related needs. Northern Water's responsibilities now include protecting endangered species, monitoring water quality, and generating hydropower.

Water flowing through the turbines of the C-BT power plants produce electricity that is virtually free of water or air pollution. Each year Northern Water sells approximately 770 million kilowatt hours of renewable clean energy, which provides power to nearly 68,000 homes for 12 months.

Building on 75 years of innovation, Northern Power looks forward to being at the forefront of providing water and clean energy for many years to come in northeastern Colorado.

Innovest is proud to provide investment consulting services to Northern Water.

*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 has been recognized as one of the **Top 10 Best Places to Work 2012** by the *Denver Business Journal*. Denver's finest companies were ranked by those who know them best—their employees. See the article on page one for details.

On November 14, Innovest and EKS&H co-hosted the Rocky Mountain Retirement Plan Conference. The all-day event at the Denver Athletic Club gave plan sponsors an opportunity to network and to learn about current developments in plan compliance, audit, investment trends, fiduciary obligations, and participant education. Speakers at the event included 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.

Also in November, the Innovest team and its families volunteered for Special Olympics. The team of Innovest volunteers had a great time supporting the athletes who worked so hard for months leading up to the competition. The event was great fun for the athletes and for Innovest's volunteers.

On December 4, Innovest was proud to be among the sponsors of *Colorado Gives Day*, through our client, Community First Foundation, which inspires support for local nonprofits. This year's *Colorado Gives Day* was the biggest day of giving in Colorado: more than 68,000 donors contributed $15 million to local nonprofits.

In December, Rich Todd presented, "What High Net Worth Investors Can Learn from Institutions" to the Purposeful Planning Institute. The interactive interview provided insight into strategies used by institutions that individual investors can implement in their own portfolios to improve results. A link to the interview is posted to the "In the News" section of www.innovestinc.com. The Purposeful Planning Institute ("PPI") is an educational and training platform for advisors to High Net Worth and Ultra High Net Worth clients. Interactive interviews are hosted weekly by the Purposeful Planning Institute. For details on upcoming teleconferences, visit Purposeful Planning Institute.

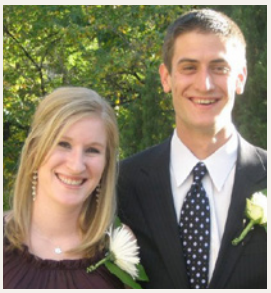
Each year Innovest recognizes two individuals that represent our firm to the highest standard. Congratulations to Gordon Tewell for winning the Founders Award for 2012—as the person most representing Innovest's Core Values: Honesty and Integrity, Hard Work, and Dedication to the Client. He goes beyond the call of duty for clients and staff, all while displaying the highest integrity and commitment to clients. Congratulations to Pam

Cruz for winning the 212-Degree Award for 2012. She is committed to going an extra degree for our clients and team.

Also in December, Innovest welcomed our newest intern, Kyle Stemper. Kyle is a sophomore in the Kelley School of Business at Indiana University, double-majoring in Finance and Accounting. Kyle plans to study in Prague next summer.

In January, Innovest will host its annual Economic Forecast and Outlook. This year's presenter, Rob Stein of Astor Asset Management and Knight Capital Group, Inc., will present, "Economic Fundamentals with the Impact on Stock Portfolios." The luncheon event will be held on January 31, 2013 at The Colorado History Museum. For more information about the event, please contact Gina Champ at 303-694-1900 x 322 or gchamp@innovestinc.com.

EMPLOYEE SPOTLIGHT



CAITLIN MARKEL, SENIOR ANALYST

WHAT IS YOUR ROLE AT INNOVEST?

I am a Senior Analyst at Innovest. My portfolio accounting responsibilities include supporting clients' CPAs with tax reporting and annual audits. In addition, I produce many monthly and quarterly performance reports for clients.

WHERE IS YOUR HOMETOWN?

I grew up in Independence, Kansas, but I now call Centennial, Colorado, home.What do you like best about working at Innovest?

WHAT DO YOU LIKE BEST ABOUT WORKING AT INNOVEST?

I love the fact that everyone knows each other on a personal level as well as a professional level. We are not just coworkers, but friends.

HOW DO YOU GIVE BACK TO THE COMMUNITY?

I head up the Innovest Charitable Donation Committee, which organizes volunteer projects throughout the year for employees. I am also a lector at mass at the Catholic parish to which I belong.

WHAT ARE YOUR HOBBIES AND INTERESTS?

My favorite thing to do is take my daughter for walks. With the weather being so nice here in Colorado, I am fortunate to do this almost year-round. I also tried my hand at golfing last summer and really liked it. I may be the one sneaking out to play golf on Saturdays instead of my husband!

TELL US ABOUT YOUR FAMILY.

I have a husband of just over two years, Tim, who has a fantastic sense of humor and is a great cook. Together we have a daughter, Genevieve, who turned a year old in December 2012. She already does things to get a laugh, so I may have a future class clown on my hands! As my husband and I are both the youngest of five children, we have a ton of extended family as well, which always means a good time.

EDITOR
GINA CHAMP

INNOVEST PRINCIPALS
RICHARD TODD
WENDY DOMINGUEZ
BILL FENDER
DONNA PATCH
PETER MUSTIAN
SCOTT MIDDLETON
STEVEN KARSH
GARRY BEAULIEU
GORDON TEWELL

INNOVEST
4643 S. Ulster Street
Suite 1040
Denver, CO 80237
303.694.1900
www.innovestinc.com