INNOVEST'S **RESEARCH** REPORT

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NEW CLIENTS

Innovest was recently selected to provide investment consulting services for:

Grand Junction Police
Metro Wastewater Reclamation District
Santa Clara County

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.

THREE QUESTIONS WHEN NAVIGATING VOLATILE MARKETS

Scott Middleton, CFA, CIMA Principal, Director

Kristin Lee
Analyst Assistant

Early in February 2018, the U.S. stock market experienced something that everyone had anticipated for many months: an abrupt decline. The Dow Jones Industrials dropped more than a thousand points in a week, and the S&P 500 Index had its first month with a negative return since October 2016. In the span of 10 trading days, the S&P 500 dropped 10%. Events like these reminded investors that bull markets cannot last forever and the stock market is inherently risky.

While a 10% decline in equity prices is very unpleasant, steeper periodic losses are also part of investing in stocks. Average intrayear market declines over the last 20 years have been 14%. In addition, according to Ned Davis Research, U.S. stock market declines of 20% or greater have occurred on average about every three and a half years since 1900. While most investors would affirm that their goal is to sell high and buy low, the persistent human behavior for decades has been for investors to sell stocks after very steep and emotionally painful losses of 20% or greater. In the midst of severe market declines, the economic and market news is persistently negative, tempting even the most resilient investors to sell, avoid further losses and wait for the outlook to improve (see "The Cycle of Market Emotions" on the next page). Inevitably, investors feel much better about getting back into stocks after their prices have moved higher.

Adopt a Valuations-Based Methodology?

Is there a proven method for stock investors to buy low and sell high? A 2017 study by Goldman Sachs Asset Management examined the merits of selling out of stocks entirely at peak valuations and buying them back when they became more favorably priced. The study measured S&P 500 returns and valuations from January 1957 to September 2017 based on the S&P 500's forward 12-month price-to-earnings (P/E) ratio.

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The study examined a strategy of selling S&P 500 equities at the top decile of valuations (10th percentile), and buying back when stocks traded at their bottom half of valuations (50th percentile).

The result? The valuation-based market timing method underperformed a buy-and-hold strategy by 100 basis points (1.00%) on an annualized, total return basis. Investors will likely be disappointed with the results of their intent to sell all of their equities when they become expensive and to buy them back when they are cheaper. In addition, being out of the market for extended periods of time waiting for cheaper valuations can be a severe test of any investor's resolution. As affirmed in the Goldman study, the much better approach is also the much simpler approach: staying invested.

Set It and Forget It?

Naturally, most investors' portfolios are much more diversified than 100% in large cap U.S. stocks. The allocation to various equities, fixed income, and diversifying strategies will depend on an investor's time horizon, tolerance for risk, return expectations and other factors. Assuming that these factors do not change significantly, should an investor maintain a buy-and-hold strategy for each asset class?

While patience is essential to long-term investing success, a set-it-and-forget-it approach can be problematic. For example, a 60% portfolio allocation to equities at the beginning of a bull market might grow to 70%, 75%, or more by the time that equities reach their subsequent peak. A time-tested discipline to avoid being overallocated to equities at the peak of a market is to prudently rebalance the portfolio back to its target allocations (60% equities, in this example). Alternatively, the main way to avoid having below-target allocations to equities at the bottom of a bear market is to rebalance back to target allocations, regardless of how uncertain the future may appear.

Ignore Valuations?

When designing investment portfolios, a simple, but dangerous, methodology is to assume that long-term historical investment returns will be a reliable guide to future investment returns. In reality, both valuations and investment returns are far from constant. At the tech-bubble height on March 24, 2000, the S&P 500 Index was priced to perfection at a forward P/E ratio of 27.2 times. Less than nine years later on March 9, 2009, following a 17-month decline of 57%, the S&P 500 was priced at a bargain multiple of only 10.3 times expected earnings.

At these two valuation extremes, should investors have expected returns on equities to be about the same going forward the next five to 10 years? The subsequent returns from these aforementioned high and low points were dramatically different: In the nine years following the 2000 peak, the average annual total return on the S&P 500 was -5.0%. Alternatively, the annualized nine-year total return from the 2009 low was +19.2%. While these examples measure returns from peak and low valuations, a broader set of data points reaffirm that future returns are significantly influenced by starting valuations.

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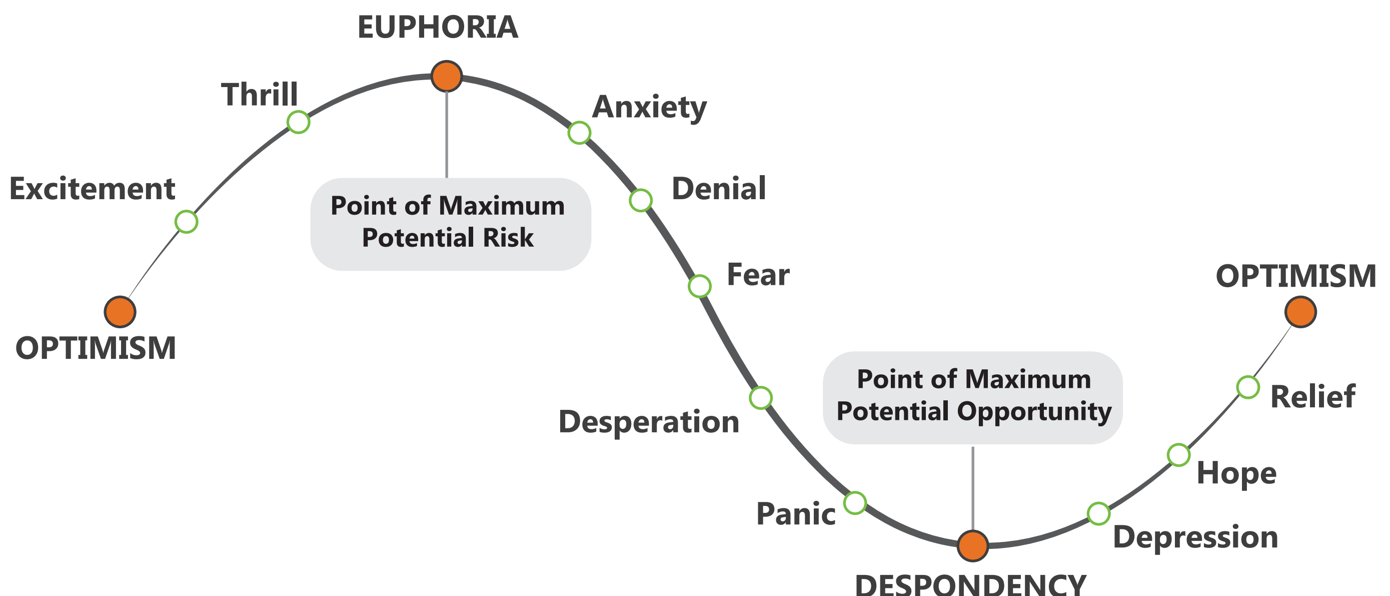
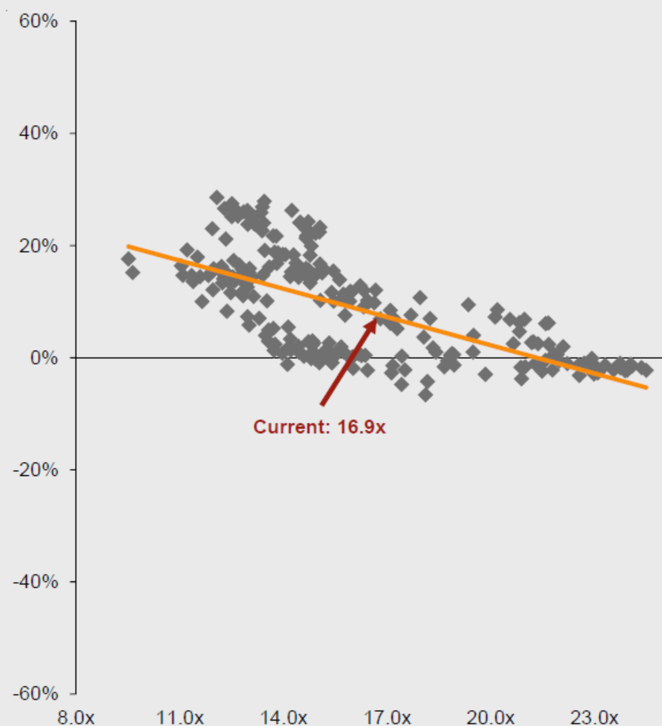
The Cycle of Market Emotions





Returns are 60-month annualized total returns, measured monthly beginning 2/28/1993. The R2 of 43% explains the percent of total variation in total returns that can be explained by forward P/E ratios. Source: J.P. Morgan Asset Management.

As shown in the graphic above, very high valuations (the right side of the chart) have led to very low equity returns over the subsequent five-year periods. Alternatively, low starting valuations have been a tailwind for future equity returns. While the relationship between starting valuations and subsequent returns is not guaranteed, it is only reasonable for projected future returns to take into account starting valuations and not rely exclusively or even predominately on historical returns.

What would be a prudent use of this information? In contrast to the Goldman Sachs study, which sold out of stocks entirely at peak valuations, a better approach would be to underweight or overweight strategic allocations based on valuations. When stocks are very expensively priced, it makes sense to have more modest expectations of future returns and therefore consider trimming equity allocations to some degree. With the proceeds investors could increase allocations to fixed income and diversifying strategies with more attractive risk/reward outlooks. Alternatively, astute investors should consider adding equity exposure when prices are depressed and have a tailwind for more promising future returns. While massive changes in equity allocations from year to year, as well as being completely in or out of equities are not prudent, making modest allocation changes can help investors take advantage of long-term opportunities and manage portfolio risk.

Conclusion

Jolts of market volatility are often a significant test of investors' self-control and adherence to a successful long-term strategy. Hallmarks of prudent investing include the avoidance of being completely in and out of major asset classes, portfolio rebalancing, and making modest asset allocation changes based on valuations and a forward-looking view of the markets. Adhering to these principles is likely to benefit long-term investors in the coming years, just as they have in the past.

BENCHMARKING YOUR RETIREMENT PLAN – IT'S PRUDENT

Marianne Marvez, RPA
Vice President, Director

Benchmarking the fees and services provided to retirement plans by their recordkeepers is not only a prudent practice, it is a fiduciary obligation. Employers who sponsor retirement plans have a fiduciary duty to act in the best interests of their participants.

Why should you benchmark your plan?

1. Fulfill your fiduciary obligation to monitor your current service providers by gathering information required to review the quality of the services provided and assess the cost of those services to determine if they are reasonable.

2. Compare your current service provider against the competition to determine if the current provider is still a good fit for your plan. Do they actually offer the services you and your participants are looking for, or are there better, more comprehensive retirement planning tools available from another provider for a similar or lower cost?

3. Potential cost savings for both the plan sponsor and participants in the form of lower recordkeeping and investment costs. Depending on how vendors are paid, fees can have a significant impact on retirement savings for employees.

4. Refresh your plan design. It is prudent to review your objectives for offering a retirement plan. Have those goals changed, and if they have, what service enhancements might you consider adding to facilitate participant engagement, add value to the company and improve your ability to attract and retain talent?

There are no set industry standards that mandate how often a plan sponsor should benchmark their plan. Many industry experts suggest benchmarking recordkeeping fees every three to five years. Some plans may have pre-determined benchmarking frequency requirements written in their plan document or policy statement. You and your consultant can work together to determine what timeframe makes sense for your plan.

There are several different ways to benchmark a retirement plan. One method specifically designed to gather data on recordkeeping fees and services is a Request for Information (RFI). The RFI is customized with your plan's information including demographic and cash flow data, and specific plan design and service requirements you wish to review. The documentation is prepared and the RFI is sent to several recordkeeping firms which have experience with your size and type of plan. Each firm is asked to prepare a pricing proposal using only the specific customized plan data provided, to ensure an apples-to-apples comparison.

This benchmarking method provides insight as to what other recordkeeping providers are willing to charge to service your plan and helps verify whether or not your current provider's fees are deemed reasonable for the services provided. Issuing the RFI sends a message to your current recordkeeping provider that you are comparing their services and fees against their competitors and may cause your current provider to sharpen their pencil and renegotiate their contract resulting in a cost savings for the plan and your employees. Having this plan-specific fee data gives you the information necessary to determine that your current fees are either reasonable and compare favorably with the fees of similar recordkeeping firms, or allows you to weigh the value of staying with your current provider against making a recordkeeper change. Changing providers can be costly in time, lost account history and stressful for you and your employees. It may be reasonable to pay a higher fee if the quality of service and measureable outcomes align with the purpose for offering the plan.

> ***The landscape of retirement plans has changed dramatically in recent years, especially in the way recordkeeping fees are paid.***

The regulatory guidance on what constitutes "reasonable" is a bit gray, and nowhere does it say a plan sponsor has to choose the least expensive service provider. However, it is clear that as part of a prudent process, employers must be able to justify their choices and maintain documentation to validate their decisions. The majority of lawsuits brought against plan sponsors in the past 10 years have not only centered on fees, but also the failure to monitor.

In the case of Tussey v. ABB[1] the court ruled that the plan sponsor had a "duty to obtain market data" and that in not doing so, had no way to measure if the recordkeeping fee arrangement with their provider was reasonable. ABB had not gathered any competitive data for purposes of comparison. A formal recordkeeping fee benchmarking proposal may have helped the plan sponsor justify staying with their current provider or facilitated a change that likely would have resulted in a different outcome.

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The landscape of retirement plans has changed dramatically in recent years, especially in the way recordkeeping fees are paid. Due to the consolidation of providers, the increased use of technology, the move away from funds that share revenue, and the fear of litigation, recordkeeping firms have seen their fees decline.

If your plan has been with the same recordkeeper for several years and you have not discussed renegotiating your Fee and Services Agreement, now would be an appropriate time to benchmark the plan to ensure you are monitoring the quality of your recordkeeper and collecting the information to determine that their fees are reasonable for the services provided.

NONPROFIT SPOTLIGHT
CRANE TRUST

Located in Wood River, Nebraska, the Crane Trust works to preserve the habitat of the whooping crane and other migratory birds in the Big Bend Region of the Platte River Valley. Since whooping cranes use the Platte River area to roost during their migration, the Crane Trust manages approximately 10,000 acres of land to maintain a suitable habitat for the cranes. The Trust provides this habitat through land management practices and extensive research on what whooping and sandhill cranes need to survive during migration. This research includes fitting the cranes with GPS devices to track patterns during their 5,000-mile round-trip migration from the Gulf Coast to Canada and as far north as Siberia.

In 2015, the Crane Trust re-introduced a herd of genetically-pure American bison to roam the property they manage. Bison have a surprisingly crucial impact to the ecology of the land for cranes and other migratory birds. The bison's grazing disturbs the soil and allows for new plant and animal species to grow. The introduction of the bison not only represented an important step in maintaining a native environment for the cranes, but it also marked a milestone in its conservation and ended a 150-year absence from the land.

The Crane Trust is celebrating its 40th anniversary in 2018 and is hosting special events including a bike ride, art show, and the 13th Platte River Basin Ecosystem Symposium. The Crane Trust also provides numerous opportunities for visitors to learn more about cranes and the ecology of the Platte River Valley. They introduced "Crane Excursions" in 2013. Sponsoring organizations stay in all-inclusive overnight private accommodations and participate in crane viewing, nature programs, prairie hikes and up-close viewing of the bison. They also host public Crane Migration Tours each year that feature group viewing blind tours, private overnight blind viewings and a VIP experience. Since 2012, the Crane Trust Nature & Visitor Center has featured an art gallery, educational exhibits, butterfly garden, gift shop and more than 10 miles of walking trails.

Innovest congratulates the Crane Trust on 40 years of conservation work! We are proud to provide consulting services to the Crane Trust.

DID YOU KNOW?

- The whooping crane is the tallest North American bird at five feet.
- Protected under the Endangered Species Act, whooping cranes are one of the more rare birds with 757 individuals in the world. 80% of this population migrate through Nebraska.
- Whooping cranes mate for life and migrate in family groups between five and 12 individuals.
- The American bison in the largest mammal in North America standing at six feet tall and weighing up to one ton. The bison's top running speed is 35 mph.

Information and Photo Source: The Crane Trust
www.cranetrust.org

EMPLOYEE SPOTLIGHT

KENNY SENOUR- SENIOR ANALYST

Kenny is a senior analyst at Innovest. He is a member of the Due Diligence Group, responsible for independently sourcing investment managers, as well as monitoring recommended products and strategies.

WHERE IS YOUR HOMETOWN?

I grew up in Monument, CO.

TELL US SOMETHING UNIQUE ABOUT YOU.

I grew up in a big family. I am one of seven siblings!

WHAT DO YOU LIKE BEST ABOUT WORKING AT INNOVEST?

The people and team environment. Many employees spend time with each other outside of work and have developed great friendships. All of the analysts work as one team to solve problems and develop solutions across our diverse client base.

HOW DO YOU GIVE BACK TO THE COMMUNITY?

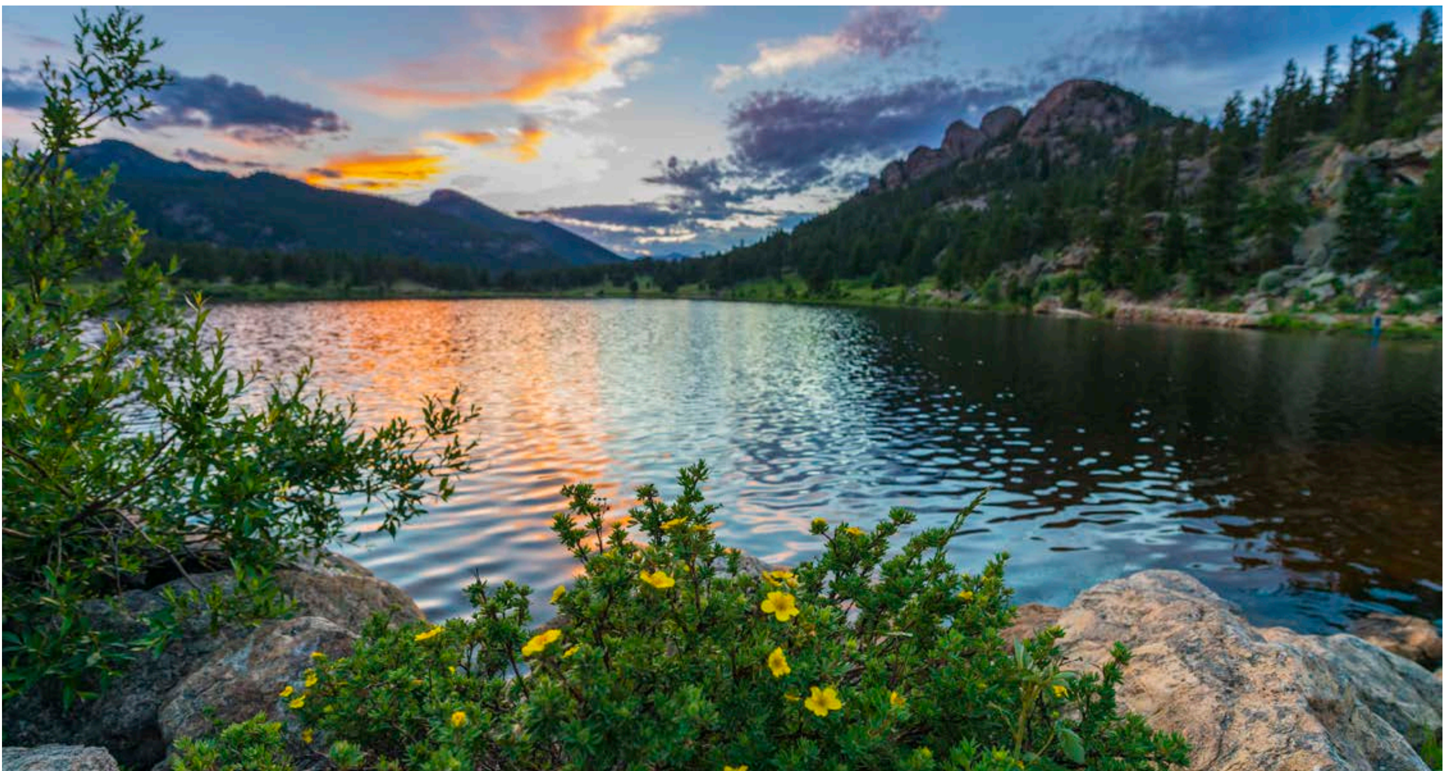
I enjoy participating in our Innovest community activities and supporting various missions in Colorado including FOCUS and Creatio.

WHAT ARE YOUR HOBBIES AND INTERESTS?

I enjoy snowboarding, hiking, golf and spending time with friends and family.

TELL US ABOUT YOUR FAMILY.

I have five sisters and one younger brother. I married my wife, Catie, last December which means she bravely inherited 12 new nieces and nephews in addition to many sisters-in-law.



RISKY BUSINESS

Kristy LeGrande, CFA
Vice President

Acclaimed investor Warren Buffet summed up risk when he said, "Risk comes from not knowing what you are doing." So, what is risk? How do we measure and monitor it? How can we protect against it? How much risk should we take? There are numerous types of risk in the investment world and it is crucial that investors understand these risks and take steps to monitor them.

In an attempt to educate investors, below is a list of some of the main types of investment risk, and, importantly, how they can be prudently monitored.

Other risks for investors to be aware of when constructing and monitoring portfolios include: tracking-error risk (an investment strategy's deviation from its benchmark), key person risk (risk of the departure of an investment strategy's key decision maker), headline risk (risk of adverse news stories impacting the price of individual securities, strategies, or asset classes), factor risk (risk of having intentional or unintentional factor exposures in the portfolio), interest rate risk (risk and impact of changes in interest rates), credit risk (risk related to the credit of a borrower), counterparty risk (possibility that the other party in an investment, credit, or trading transaction may default on the contractual obligation), maverick risk (risk associated with venturing outside investment best practices or engaging in overtly risky positioning or strategies, i.e. a highly concentrated portfolio), legal risk (potential financial loss due to a contract between two parties being considered unenforceable), geopolitical risk (chance that an investment's returns could suffer as a result of political changes or instability), currency/exchange rate risk (the possibility that currency depreciation will negatively affect the value of investments) and other macroeconomic risks.

Risk is unavoidable in the investment world. It is crucial that investors determine their risk tolerances and are aware of the risks they are taking in their portfolios. In addition, investors along with their advisors, must take steps to quantify risk when possible, understand the qualitative aspects of risk, and monitor risk on an ongoing basis.

Type	Definition	Who Monitors and How Monitored
Financial Risk	Risks from heavy use of leverage or unsustainable spending rate that could jeopardize corpus longevity.	**Client.** Monitors through financial statements, prudent decision making by Board of Directors/Investment Committee/Family Decision Makers. Innovest assists clients through education.
Volatility	Return fluctuation for a given security, strategy, market or portfolio, i.e. the potential range of a change in the security's value. Higher volatility means price can change dramatically over time in either direction while lower volatility implies less price fluctuation in either direction.	**Innovest.** Addressed through prudent asset allocation using non-correlated assets to mitigate portfolio-level volatility. Monitors volatility at the portfolio level and fund level in quarterly reports and annual asset allocation study.
Market Risk	The risk and impact of equity market moves on an investment and on the portfolio as a whole.	**Innovest:** Monitors through in-depth diligence and continual monitoring of each investment strategy as well as through careful portfolio construction, including the addition of diversifying, non-correlated investment strategies.
Liquidity Risk	Inability to sell an investment quickly either due to terms of investment contract or thin market with limited or no buyers.	**Innovest.** Monitors through a liquidity schedule for the entire portfolio that demonstrates the availability of invested assets over time based on specific terms of each investment.
Inflation Risk	The damaging effect that rising inflation rates can have on future purchasing power and erosion of real return on invested assets.	**Innovest.** Monitors through the portfolio return target, which is represented as the return in excess of inflation (CPI +) and tracked over time. Use of asset classes with above-inflation returns protects purchasing power.
Downside Risk	Estimation of the amount of loss a portfolio could sustain as a result of a decline arising from factors that affect the market as a whole or asset classes in particular (recession, loss of confidence, geopolitical events, etc.)	**Innovest.** Monitors potential downside risk at the portfolio level. Downside risk is reviewed and quantified annually in an asset allocation study.

AROUND THE FIRM

RECENT EVENTS

In February, Innovest hosted Dr. John Evans from Janus Henderson Investor Labs for a special presentation on "Reducing Stress to Manage Your Greatest Asset." Dr. Evans explained different types of stress, why stress is good, and how to manage your energy to wow your clients, participants, friends, family, and others.

Innovest employees and their families volunteered at Project C.U.R.E. this quarter. The Innovest team spent the day packing medical equipment to send to developing countries. Project C.U.R.E. works to bridge health resources by collecting medical supplies to send to developing countries to aid in the treatment of diseases, surgeries, vaccinations, and more.

Innovest in the News: *Real Assets* magazine featured Innovest CEO Richard Todd on the cover of their February issue. The article, "The Call of Stewardship", outlined Innovest's culture, attrition-based hiring, how Innovest began and a questionnaire featuring Rich's favorite quote and song. Innovest was named to *PLANADVISER's* Top 100 Retirement Plan Advisers list for the fifth time. Innovest President Wendy Dominguez was featured in the University of Denver Daniels College of Business *BizNotes'* article, "Strong Character." Finally, Innovest Vice President Christian O'Dwyer's article, "Q&A: Navigating the Social Security Puzzle" was published by *ColoradoBiz* magazine.

Photos: Innovest employees and their families volunteer at Project C.U.R.E.

On March 14, Innovest co-sponsored the 18th annual Rocky Mountain Nonprofit Conference. The conference featured speakers from Innovest, EKS&H, University of Colorado Foundation and BlackBaud Target Analytics. The day ended with a fiduciary/governance panel with contributors from Innovest, Snell & Wilmer and Rose Community Foundation.

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