INNOVEST'S RESEARCH REPORT

A NEWSLETTER BY INNOVEST

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NEW CLIENTS

Innovest was recently selected to provide investment consulting services for:

Arapahoe House
Mercy Housing

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. Asterisk indicates a project.

ACTIVE AND PASSIVE, NOT ACTIVE OR PASSIVE

Rick Rodgers, AIFA®
Principal

The seemingly unending debate of active versus passive investment management has increased in intensity during recent years, and investors have reacted by shifting record amounts in 2016 from more expensive actively-managed funds into lower-cost passively managed funds. According to Morningstar, passively managed U.S. equity funds had inflows of $239 billion last year, while their actively managed counterparts lost $249 billion. However, one must question whether this is a reasoned reaction or one simply explained by "recency" bias, under which investors are tempted to flock toward recent performance patterns, rather than focusing on long-term fundamentals. Without question, passively managed funds have enjoyed an outperformance cycle for the past seven years, and such performance has influenced investor behavior.

The quantity of online articles, stories in print, white papers and investor blogs concerning the active vs. passive debate has helped fuel the argument and resulting shift of assets. However, many of the articles and studies supporting both sides are often flawed, because the time periods selected for comparative purposes tend to be representative of shorter timeframes that are beneficial to their respective arguments. Passive enthusiasts frequently refer to five-year or 10-year periods that help their argument, and active management supporters are often guilty of the same practice.

For example, in Morningstar's Domestic Large-cap Blend category, the average net returns for active managers trailed the S&P 500 index in six of the last seven calendar years. Likewise, the average return for active managers beat the index in nine of the 10 calendar years during the period 2000 to 2009. Considering just these two data sets it's easy to see how advocates for either strategy could make compelling arguments.

We know the performance of all long-term investment markets is cyclical, and it's apparent the same rule applies to both active and passive strategies when we look at long-term performance patterns. The chart on the next page shows the percentile rankings for the actively and passively managed Domestic Large-cap Blend categories for rolling monthly three-year periods since 1985.

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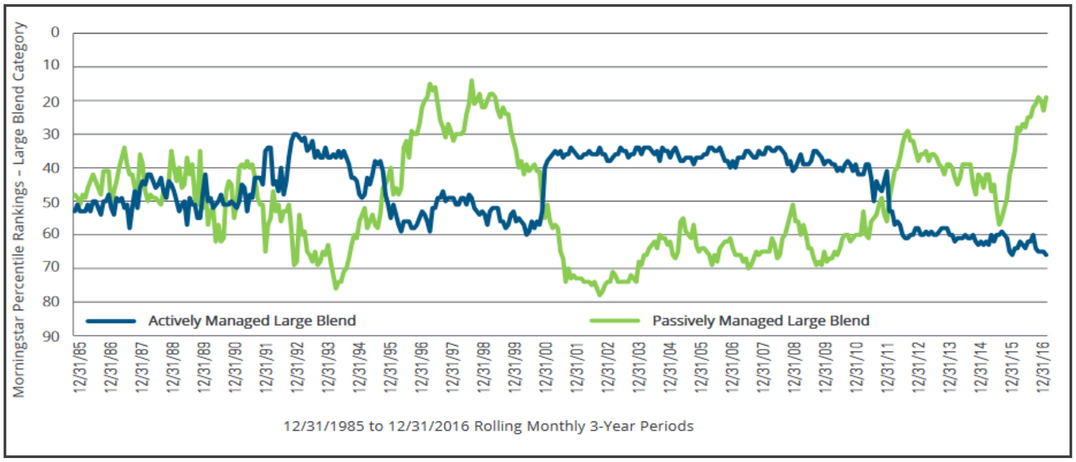
The results clearly show the active and passive strategies are cyclical and both strategies have extended periods of performance above and below the median.

Percentile Rankings for Active and Passove Domestic Large Cap Blend



Morningstar, 1/17

Another set of long-term data supports our position that there's no clear winner or loser. During the 32 calendar years since 1985, the average return of active managers has outperformed in 15 calendar years, while passive managers outperformed 17 of the calendar years.

In 2015, Morningstar began publishing a semi-annual Active/Passive Barometer Report (see table below) that analyzes the performance of several active and passive asset classes. Unfortunately, the report only covers performance for the previous 1-, 3-, 5- and 10-year periods, which provides a skewed set of data that favors the strategy benefiting from the most recent cycle. However, the report does show that active managers in certain asset classes demonstrate greater probability than others of outperforming their respective index, and lower-cost active managers have a clear and distinct advantage over their higher-cost counterparts. The disparity between the bottom quartile expense managers and top quartile expense managers is quite expansive in the majority of categories.

Active Funds' Success Rate by Category (%)

Category	5-Year	10-Year	10-Year (Lowest Cost)	10-Year (Highest Cost)
U.S. Large Blend	12.3	14.8	19.3	7.6
U.S. Large Value	9.5	20.6	31.1	10.1
U.S. Large Growth	7.4	7.1	11.6	7.1
U.S. Mid Blend	23.1	6.9	5.4	0.0
U.S. Mid Value	13.0	26.9	44.4	3.7
U.S. Mid Growth	27.5	22.7	30.6	15.5
U.S. Small Blend	31.9	26.1	40.9	18.2
U.S. Small Value	22.6	28.6	21.9	19.4
U.S. Small Growth	21.3	17.6	24.2	12.3
Foreign Large Blend	44.7	33.1	45.2	19.5
Diversified Emerging Markets	51.6	32.4	61.1	11.8
Intermediate-Term Bond	53.3	39.0	47.3	30.1

Morningstar. Data and calculations as of 6/30/16.

Yet another consideration is contamination of the average active manager returns in these studies because of a large stable of very poor active managers. Based on Innovest's research on active managers for more than 20 years, Innovest has concluded that active managers with a disciplined philosophy and style can produce returns in excess of the median and index over long time periods that encompass various market cycles. Therefore, manager due diligence and analysis that goes far beyond comparing the average of an entire universe is required to identify managers that possess a greater probability of producing excess returns.

Effective portfolio construction requires consideration of multiple asset classes, including those that do not offer a passive investment option and/or where active options demonstrate an extraordinarily high probability of exceeding index returns. Such categories include emerging markets equities, core fixed income, floating rate corporate loans and various forms of hedging strategies.

Conclusion

We believe a diversified approach to investing includes both passive and active managers. Long-term data clearly shows performance of these two styles is indeed cyclical, which warrants allocations to both strategies. Our research of active managers has produced undeniable evidence that managers in certain asset classes demonstrate greater probability of producing returns in excess of the index, while the probability of excess performance by active managers in other asset classes is limited. Furthermore, we believe that alternative asset classes, which do not offer passively-managed options, are worthy of inclusion in an efficient portfolio. Consideration of managers should not be limited to a simplified consideration of active or passive, and should be expanded to active and passive.

YOU CAN'T RUN A PORTFOLIO LIKE A BUSINESS, PART 2 OF 2

Scott Middleton, CFA, CIMA
Principal, Director

Cecelia Crossen
Senior Analyst

The first of this two-part article published in the last *Research Report*, examined the merits of businesses responding to buyers' demands, while portfolio allocation decisions need to avoid chasing what is popular. Part two of this article examines the importance of identifying and utilizing the "right" people in business, while stubborn devotion to fund managers – through good times and bad – can be a secret to portfolio outperformance over time.

Human Capital

"Effective leadership is not about making speeches or being liked; leadership is defined by results not attributes."
—Peter Drucker (1909 – 2005)

Considered a founding father of modern management theory, Peter Drucker spent his career studying the importance of human capital and challenging common thinking about how organizations should be run. He believed that organizations struggled because of outdated ideas, in-the-box problem solving, and internal misunderstandings. His solution – and ensuing work with the heads of giants like General Motors, General Electric, and IBM – stemmed from his conviction that people are an organization's most valuable resource. Drucker's work paved the way for today's emphasis on the importance of leadership to companies' outcomes.

Hiring and firing decisions have enormous opportunity costs for companies: resource drain, bruised employee morale, diminished productivity, and worst of all – unfulfilled potential and unrealized upside. A 2009 study by AIMM Consulting indicated that the cost of a mis-hire is 25-times base compensation for those earning less than $100,000 and 40-times base compensation for those earning between $100,000 and $250,000. Identifying and diminishing the impact of a noxious individual is important, but what differentiates the good from the great in business is the ability to get the right fit. The opportunity cost of a "do no evil" leader can be the difference between "cutting edge" and "run-of-the-mill."

Take the case of Walt Disney Company. In 2005, Bob Iger replaced Michael Eisner as CEO of the production powerhouse. Nothing catastrophic happened under Eisner's 20-year command. In fact, the company did well under his leadership: Disney acquired Miramax Films, and many animated hits were released, including Aladdin, Toy Story, and Monsters, Inc. The stock price grew substantially, though it largely tracked the growth of the S&P 500. However, by the end of Eisner's regime, Disney was becoming eclipsed by Pixar, and shareholders feared the company was living off past successes. Eisner was no longer the right fit for Disney, and the opportunity cost of his "do no evil" approach was endangering the long-term success of the company.

Within Iger's first year, he led Disney to acquire Pixar, which paved the way for later acquisitions of Marvel entertainment in 2009 and Lucasfilm in 2012. These tactical acquisitions helped solidify Disney's relevance amongst 21st century producers and realize the potential of the brand that Eisner was unable to tap. Shareholders have been rewarded under Iger's leadership: the stock price more than quadrupled in value in little more than 10 years and vastly outperformed the S&P 500.

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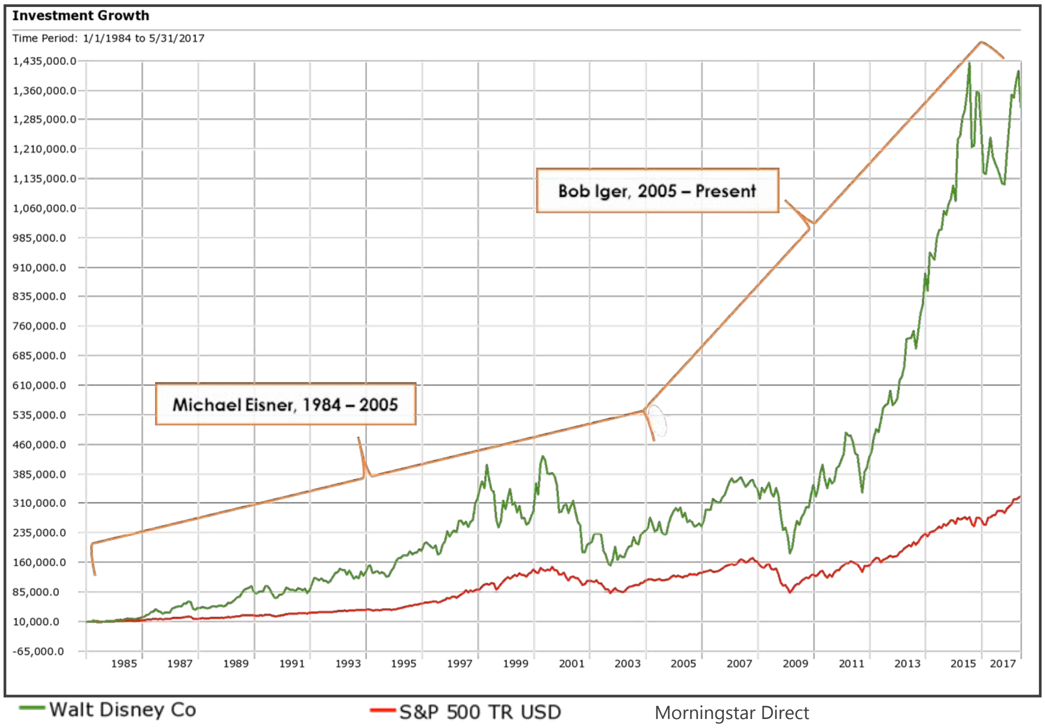
Walt Disney Company: Leadership Matters



Morningstar Direct

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Manager Selection and Buffett's "Fourth Law of Motion"

In his 2005 letter to shareholders of Berkshire Hathaway, Warren Buffett added a fourth law to Sir Isaac Newton's famed three laws of motion: "For investors as a whole, returns decrease as motion increases." With so much focus on finding the right fit in business leadership, the typical behavior with firing or hiring investment managers is to fire underperformers once patience has run out. Investor impatience during periods of underperformance violates the principle "buy low, sell high."

A study published in The Journal of Finance in August 2008, "The Selection and Termination of Investment Management Firms by Plan Sponsors" surveyed the manager hiring and firing decision of more than 3,000 plan sponsors with hundreds of billions in assets under management over an eight-year period. When making fund manager changes, the newly hired managers had notably better performance track records than the fired managers over the preceding one-, two-, and three-year time periods. However, these newly hired managers underperformed the fired firms over the one-, two-, and three-year periods following a change. Impatience-induced manager churn can lead to significant underperformance over time.

Impatience-induced manager churn can lead to significant underperformance over time.

Even the best funds inevitably spend some time out of favor. One notable example is Dodge & Cox Stock Fund. The highly respected large cap value fund, on top of underperforming in 2005 and 2006, the fund lagged its peer group and the S&P 500 Value Index by more than 4% from November 2007 to 2008, losing 46.33%. For the three-year period of 2006 to 2008, the fund underperformed its benchmark by more than three percent annualized, ending in the 96th percentile (the bottom four percent) of its peer group.

Innovest noted that Dodge & Cox Stock Fund's managers, philosophy and process remained unchanged during its period of underperformance. The recommendation was to stay the course with the fund, which was especially frustrating for clients who were already spooked by the bear market and were hungry for action. However, patience yielded excellent results for investors in 2009 when the fund returned to the top-quartile relative to peers and outperformed the S&P 500 Value Index by more than 10%. As of the end of 2016, the fund was in the top decile of large value managers for the trailing three, five, and seven years.

Particularly over the short term, unexpected market events can waylay even the highest quality portfolios. Economic cycles can favor certain companies over others, and sometimes a company's thesis can take more time to materialize than anticipated. In investing as in life, bad things can happen to good managers.

Like a Bridge Over Troubled Waters: Rules to Avoid the Fourth Law of Motion

Good advisors and successful investors use three proven strategies to avoid the trap of impatience-induced underperformance:

1. Remember that performance does not exist in a vacuum. Do not focus primarily on performance when deciding whether to hire or fire a manager. Instead, center primarily on qualitative catalysts, such as the organization, people, philosophy, investment process, style consistency, and asset base of a fund. If one or more of these factors has begun to deteriorate (in addition to, or even in isolation from performance concerns), find out why and decide if a change is warranted.

2. Distinguish characteristic performance from uncharacteristic performance, positive or negative. Understand the nuances of manager processes: their biases and which market conditions should support, vs. harm, their approach. Investors pay managers to stick to their style in good times and in bad. Uncharacteristic performance can indicate a change in process, which might merit a switch.

3. Don't live and die by comparison metrics. Relative performance versus an index or peer percentile reporting can exacerbate investor impatience. Peer metrics are important for accountability and transparency, but they also frequently initiate a return-chasing mentality in investors whose funds didn't place at the top of the pack. Rather, maintain focus on longer-term rankings and performance consistency.

Successful businesses are set apart from their competitors by the drive to respond quickly to consumer demand and the "quest for best" in executive staff. However, successful portfolio management requires a different, and somewhat counterintuitive, approach. This two-part article has focused on the skills necessary to avoid chasing consumer demand in asset allocation decisions and avoid chasing performance in manager hiring and firing decisions. In investing, acting on regret is usually an exercise that leads to poor results. Instead, a forward-looking view and patience are essential.

EMPLOYEE SPOTLIGHT

CHRISTIAN O'DWYER- VICE PRESIDENT, CONSULTANT

Christian is a Vice President and Consultant at Innovest. He is a member of the Due Diligence Group, responsible for both qualitative and quantitative manager due diligence and making recommendations to Innovest's Investment Committee.

WHERE IS YOUR HOMETOWN?

While I was born in New Orleans, Louisiana, I moved to Denver at a young age and have always considered Denver my hometown.

TELL US SOMETHING UNIQUE ABOUT YOU.

We take family vacations to south Louisiana to fish the bayous for speckled trout and red fish.

WHAT DO YOU LIKE BEST ABOUT WORKING AT INNOVEST?

Working on both investment research and our consulting teams gives me the opportunity to find the best solutions for our clients and directly communicate with them about their unique circumstances. We truly strive to help our clients.

HOW DO YOU GIVE BACK TO THE COMMUNITY?

I give back to the community through service as treasurer of Boys Hope Girls Hope of Colorado, a member of the Investment Committee of Regis Jesuit High School, and a mentor at Arrupe Jesuit High School. At Innovest, we also do a number of volunteer activities throughout the year and I enjoy participating in those as well.

WHAT ARE YOUR HOBBIES AND INTERESTS?

I enjoy spending as much time as possible with my immediate and extended family. We play baseball in the yard, go to Rockies games, barbecue, swim, boil crawfish, and travel.

TELL US ABOUT YOUR FAMILY.

My wife, Lilla, and I could not be more blessed to be parents to two wild, fun, beautiful boys: Paul (4 years old) and James (3). They are fortunate to have three great-grandparents and four grandparents all in Colorado, as well as five aunts and uncles and three cousins (so far).

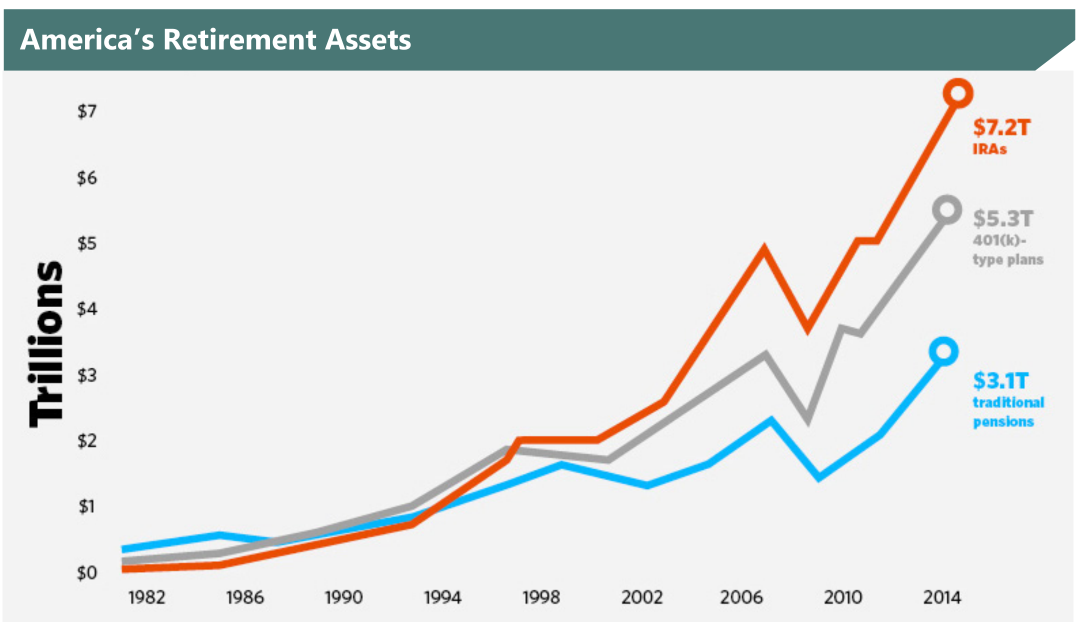
WHAT STANDARD OF CARE SHOULD YOU EXPECT FROM YOUR ADVISOR?

Jared Martin, CFP®, AIF®
Vice President

Kenny Senour
Analyst

In June of this year the Department of Labor (DOL) began implementing "The Fiduciary Rule." The ruling was created to ensure that financial advisors dealing with retirement plans and IRA rollovers always act in the best interests of their clients. The recent focus on the DOL rule is an ideal time for investors to ask: "What standard of care should I expect from my financial advisor?"

Whether an individual is concerned about the oversight of their personal investments, or serving in a fiduciary capacity for a retirement plan, there are many complexities to standards of care. The challenges have led many to seek the guidance of a financial advisor. However, there are many options when considering the merits of an advisor. Banks, independent financial advisors, and brokerage houses are competing for clients. How does one make a sound choice? Examining the standard of care, as well as the investment process an advisor uses, can be very helpful in making the right decision.



DOL.gov and Forbes

In the past all Registered Representatives regulated by Financial Industry Regulation Authority (FINRA), had to follow a Suitability Standard. This standard allowed advisors to provide advice as long as the investment suitably fit a client's objectives, experience and time horizon. While the Suitability Standard is meant to ensure that the investment is appropriate for the client's situation, the investment may not necessarily be in the best interests of the client.

An example could be an advisor selling a proprietary mutual fund to a client that costs more than similar investments. Proprietary means that the company that manages the fund or investment also offers a service to the investor, such as financial advice.

Alternatively, the Fiduciary Standard is the highest standard of care for an advisor delivering investment services. The Fiduciary Standard includes:

1. Always acting in the best interests of clients,
2. Providing full disclosure at all times (including fees and conflicts of interest), and
3. Placing clients' interests first.

Registered Investment Advisors, who are regulated by the Security Exchange Commission (SEC), are required to follow a Fiduciary Standard. Under the Fiduciary Standard, an advisor must take into account the reasonableness of the fees of the investment and any other conflict of interests.

Under the DOL rule, all financial professionals who provide advice in connection with retirement plans or IRA rollovers are now obligated to adhere to the Fiduciary Standard. This is a big change for Registered Representatives who have been obligated to follow only a Suitability Standard.

However, financial advisors who do not work with retirement plans and IRA rollovers may elect to work under either the

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Suitability Standard or the Fiduciary Standard. The Suitability Standard is often financially more beneficial for the advisor.

Another consideration when an investor is evaluating a financial advisor is how the advisor is compensated for the services provided to the client. Advisors can charge for services in a few different ways.

Fees may be paid by a flat fee (fee-only), charged as a percentage of assets (fee-based), or through commissions from the investment products that the investor purchases. Some firms charge commissions on trades in addition to a flat or asset-based fee. Commissions paid on a particular investment recommendation could be a conflict of interest and lower the standard of care a client receives. Although the Fiduciary Standard requires the disclosure of all fees, all three of these fee options may still be available.

Trust, integrity, knowledge, and reputation are vital considerations when evaluating an advisor.

Understanding how advisors are compensated for their advice is essential in making an informed decision. Transparency of costs and fees is important for a client or participant to understand, as they have a direct effect on their investment earnings.

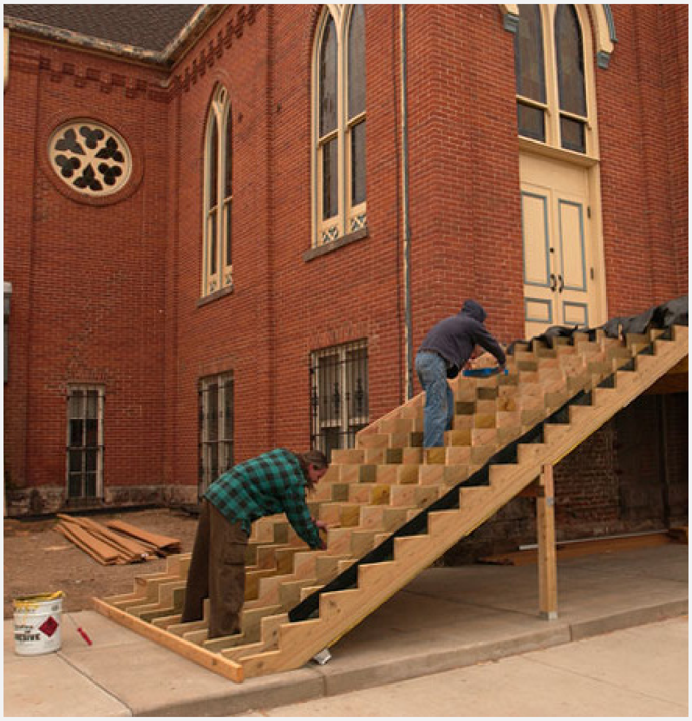
Advisors who use the Suitability Standard may have determined how to accomplish a client's goals after just one or two meetings. However, investment goals can change, and the investment process should reflect that reality.

The Fiduciary Standard encourages a much more in-depth relationship with the advisor. The financial advisor should be monitoring a client's personal situation and making changes accordingly. The best way to execute a successful investment plan is for the advisor and the client to meet regularly on an ongoing basis to monitor and update investment goals and strategies.

Many factors need to be considered when selecting a financial advisor to help guide you through investment decisions. Trust, integrity, knowledge, and reputation are vital considerations when evaluating an advisor. While all of these factors are extremely important, understanding that your advisor is acting at the highest standard of care and always putting your interests first should be the main consideration. The Fiduciary Standard is the highest legal and ethical standard and should be the standard you require of your financial advisor.

NONPROFIT CLIENT SPOTLIGHT

THE CATHOLIC FOUNDATION OF NORTHERN COLORADO



The Catholic Foundation of Northern Colorado was established in 1998 as a separate legal entity from the Archdiocese of Denver to help facilitate gifts to Catholic parishes, schools and other charitable organizations. Donations are divided into six categories of grants: Caring for our Community, Teaching our Children, Spreading the Good News, Strengthening our Parishes, Preparing our Priests, and Bridging the Gap.

Donations come in a variety of forms. The Catholic Foundation created the Holy Family Legacy Society for those planning for future gifts. Those gifts can be in the form of a bequest through a will, establishing a charitable trust or annuity, or adding the Foundation as a beneficiary on retirement funds. Donors can also give cash, stocks or bonds, or real estate through a Donor-Advised Account. Because the Donor-Advised Account uses Morally Responsible Investing guidelines, donors are assured that their gift will be managed to reflect their values.

The Catholic Foundation takes the grants entrusted to them and faithfully distributes them to Catholic missions and ministries in Colorado. Since 1998, The Catholic Foundation has granted more than $80 million.

Innovest is proud to provide consulting services to The Catholic Foundation of Northern Colorado!

AROUND THE FIRM

RECENT EVENTS

Innovest recently welcomed Joe Lemming, Thomas Martin and Kirstin Lee to our team. Joe was an intern last summer and we are happy that he is back as an analyst assistant on the portfolio accounting team. Thomas and Kristin interned for us this spring, and we are excited to welcome them aboard as full-time analyst assistants. Thomas designs and produces client performance reports and Kristin is part of the Due Diligence Group.

Four college interns joined Innovest for the summer. Brooks Urich is entering his senior year at Miami University. Brooks is majoring in finance and is also on the baseball team. Jake Moses will be a senior at the University of Colorado Boulder and is majoring in finance. Matt Trujillo is making his return to Innovest from being an intern through the Arrupe Jesuit High School Corporate Work Study program for his junior and senior years of high school. Matt is now entering his sophomore year at the University of Colorado Boulder and is majoring in finance (inspired, in part, by his time at Innovest). Finally, we are happy to welcome Ryan Buchanan. A junior at Santa Clara University, Ryan is majoring in economics and is contemplating a second major.

Innovest Vice President Chris Meyer's article, "Fostering a Culture of Compliance" was published by *Advisor Perspectives*. *401(k) Specialist* published Vice President Jared Martin's article, "Managed Accounts: Are They Right for your Plan Sponsor Clients?" In addition, *Kiplinger* interviewed Innovest Vice President Nick Rotello for the article, "Boost Your Income with Stock Options."

In June, Innovest employees volunteered at Central City Opera House by planting flowers outside the venue in time for the opening of the 2017 opera season and the annual Yellow Rose Ball and Flower Girl Presentation. As the second-oldest professional opera festival company in the country, Central City Opera Company presents a range of productions each summer, including opera favorites, new and rarely performed pieces, and American works. This summer's performances are Carmen, Così Fan Tutte, The Burning Fiery Furnace, Cabildo, and Gallantry.

Top photo: Innovest employees volunteer at the Central City Opera House Guild Planting Day.
Bottom photo: Innovest employees and their families display their hard work at the Brothers Redevelopment Paint-A-Thon.

Also in June, Innovest employees and their families participated in the 39th season of Brothers Redevelopment Paint-A-Thon. Since 1971, Brothers Redevelopment has provided affordable and accessible housing and services to more than 83,000 low-income, elderly, and disabled Colorado residents. Volunteers spent the day painting the exterior of a deserving Aurora resident's home.

On June 29 the Innovest Family Office Forum was held at Cherry Hills Country Club. Al Mueller from Excellence in Giving presented on engaging the next generation in philanthropy.

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