

# *the* Research Report

2ND QUARTER 2008



## SUPREME COURT SAYS DC PARTICIPANTS CAN SUE

By Brad Brewer, CPA

The United States Supreme Court decided the case of *LaRue v DeWolff, Boberg & Associates, Inc.* on February 20, 2008. The unanimous decision declared that defined contribution participants can bring fiduciary breach lawsuits to recover individual damages.

In summary, LaRue participated in an ERISA regulated 401(k) plan sponsored by his employer and he was allowed to direct the investment of the monies allocated to his account. LaRue's claim centered on the grounds that the investment changes he provided to his employer, DeWolff, in 2001 and 2002 were never carried out. LaRue alleged he lost approximately \$150,000 as a result of DeWolff breaching its fiduciary duty to make the investment changes. LaRue lost at the trial level and also lost his appeal to the Fourth Circuit Court of Appeals before appealing the decision to the Supreme Court.

It is helpful to understand the basis of the lower courts previous rulings. The case relied upon by the lower courts was *Mass Mutual Life v Russell*. Russell filed a disability claim under an ERISA-governed employer sponsored disability plan. Russell claimed that the plan fiduciaries breached their duties in delaying payment of her claim, and as such, she sustained damages. In that case, the Supreme Court held that the provision of ERISA authorizing monetary damages was limited to the recovery of damages to "the plan." After the Russell case, some courts interpreted the decision to mean that money damages were not available to individual participants unless the entire plan was damaged.

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Performance Powered by People



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The Supreme Court Justices unanimously concluded that the lower court ruling was wrong in the LaRue case. The majority of the Justices based their decision on the fact that the defined contribution plans, not defined benefit plans, are the primary retirement vehicle for today's workforce. As such, a breach of fiduciary should not have to damage the entire plan for an individual who has sustained damages to have a basis for relief.

Some of the comments expressed by the Supreme Court are worth noting. Stevens' writing recognized the evolution from defined benefit plans to participant directed individual account plans: "Defined contribution plans dominate the retirement plan scene today." Stevens' comments also suggest the view that focusing only on damages to the plan as a whole in a 401(k) environment is an out-of-date viewpoint.

It is too early to tell whether the LaRue case will significantly increase ERISA litigation. However, if the losses resulting from fiduciary breach are substantial, a hurdle has been removed for attorneys to pursue litigation on behalf of plan participants. Consider one of the fixed income products caught up in the sub-prime meltdown.

Regions Morgan Keegan Select Intermediate Bond I Fund (RIBIX) is a fixed income fund with a fairly broad set of investment opportunities ranging from regular corporate bonds to manufactured housing loans to aircraft leases. Through June 30, 2007, the fund's five year performance was ahead of 98% of its peers and it was ranked a "five star" fund by Morningstar.

In July of 2007, problems with the fund's investments began to surface. In the month of August of 2007, the fund was down over 15%. It's interesting to note Morningstar dropped the fund's ranking to one star from five within 60 days after the fund was crushed (another article altogether). Problems continued through the remainder of 2007 and the beginning of 2008. As of February 2008, the 12-month trailing return was negative by more than 60%. Investors fled the product to only compound the problem. In early 2007, the fund had over \$1 billion in assets. That number stood at approximately \$125 million in early 2008.

The primary driver leading to outperformance through June 30, 2007, was the same driver leading to the fund's prospective implosion: risk. The fund has 60% of its assets in lower quality fixed income instruments rated BBB. That is approximately three times its peers' average weighting. Risky securities, illiquid credit markets, and investor redemptions created a downward spiral for the fund.

If you place the fund's name in an Internet search engine, the first entries are not the fund family or financial institution. The entries are plaintiff's attorney looking for additional fund holders to join the lawsuit. Litigation is a real risk and plan sponsors should protect themselves. Actions plan sponsors should consider include:

- Review 404(c) compliance, particularly the timely processing of participant investment changes.

- Educate plan fiduciaries on their responsibilities.
- Ensure the Investment Policy Statement is up to date and that the process for reviewing the plan's investment options are prudent, objective, and documented.
- Engage an objective investment adviser to take co-fiduciary responsibility and monitor the plan's investments; relying on a bundled service provider is not sufficient.
- Review fiduciary insurance policies to ensure coverage is adequate and up-to-date.
- Review all administrative and investment practices and benchmark them to industry best practices.
- Benchmark the plan's investment and administrative fees to ensure the fees are reasonable.

In conclusion, the LaRue case serves as a good reminder that serving as a plan fiduciary carries material responsibility. Plan sponsors should review their existing practices and procedures to ensure they are mitigating their liability. Time will tell if the LaRue decision significantly increases the amount of ERISA litigation over plan investments. What is certain is that plan sponsors who neglect their fiduciary duties have increased risk after the LaRue case. •

## BANK LOANS: A SILVER LINING IN THE DARK CLOUDS OF THE CREDIT CRUNCH

By Steven Karsh, Director of Research

Over the past 12 months, it has been difficult to go two consecutive days without seeing an article on the ongoing credit crisis in The Wall Street Journal, the Financial Times or most any other financial news source. To put things in perspective, if you Google the phrase "credit crunch," over nine million links are generated! What started out in the sub-prime mortgage market eventually led to the downfall of Bear Stearns, one of the world's largest investment banks. The crisis permeated the capital markets, creating much uncertainty. It seemed that the availability to obtain credit dried up overnight. Banks shut off lines of credit, not even lending to other banks with the highest credit quality in some cases. Credit spreads widened significantly as borrowing money became much more expensive due to the perceived increased riskiness of these loans. This spread-widening has created an opportunity, or 'silver lining,' in the senior bank loan market.

**What is the Senior Secured Bank Loan Market?** The senior bank loan market is made up of loans issued by banks to companies that have less than perfect credit. These companies often have balance sheets that are highly levered (more debt than equity), and therefore have the potential to default on their loan obligations.

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## AROUND THE FIRM 2ND QUARTER 2008

### WELCOME

As Innovest continues to grow, we have committed to our clients that we will add talented, dedicated people to our team to maintain the highest level of customer service to which they've become accustomed. We would like to introduce you to our newest editions:

*Sergio Gutierrez* – Sergio is Vice President at Innovest. He is responsible for business development in the non-profit and wealthy family communities. Most recently, Sergio founded and was Managing Director for Montero Capital, L.L.C., a private investment company in Denver focused on equity investments for small local businesses. As Managing Director, Gutierrez led the firm's overall research program and investment strategy.

Gutierrez spent more than nine years working in the government sector and in the area of public affairs. He previously served as Director of Communications for the Archdiocese of Denver as well as General Manager for the two diocesan newspapers the Denver Catholic Register and El Pueblo Católico.

Prior to joining the Archdiocese of Denver, Gutierrez served in the administration of President George W. Bush where he was appointed to various positions in the U.S. Department of Commerce, the Federal Emergency Management Agency (FEMA), and the White House Office of Management and Budget. He began his career in government serving as Special Assistant to former Colorado Governor Bill Owens.

Gutierrez serves on the Board of Directors for the Alliance for Choice in Education as well as the Catholic Association of Latino Leaders. He is a graduate of Mesa State College with a B.A. in political science and is currently

an M.B.A. candidate in the Daniels College of Business at the University of Denver.

### EVENTS

Innovest was a key sponsor of Community First Foundation's event featuring Jim Collins, author of *Good to Great*, on May 14, 2008. Jim helped the audience build a framework for greatness by understanding that the critical distinction is not between business practices and social-sector practices, but between great and good.

Brad Brewer helped organize the "Homestead Community Run", an annual 5k race which benefits the Wiley, Morgan, and Parker Fund. The fund is in memory of Homestead Elementary children Morgan and Parker Reed, and their father, Wiley, who were killed in a tragic plane crash. Grants from the fund make dreams come true for families who want to adopt Chinese children with minor handicaps, but are faced with the high cost of adoption fees and medical expenses.

Steve Karsh attended the JP Morgan, 10th Annual Wealth Symposium in Chicago, April 30th - May 2nd.

Rick Rodgers presented a "Defined Benefit Plan Communication Case Study" at the Mountain PERS conference in Denver, CO on April 30th.

### ARTICLES

The Denver Business Journal ran Rich Todd's monthly column (the first Thursday of the month) with: *Bad Markets can Create Some Good Investing Opportunities, Understanding Private Equity and its Role in the Economy, and Market Timing Works: Emotional Investing Doesn't*. Articles can be found on our website, [www.innovestinc.com](http://www.innovestinc.com).

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These loans are “senior” in the capital structure. Holders of these loans are paid first before any other creditors in the event the company defaults on its loans or goes into bankruptcy. These loans are also “secured.” In the case of a default or bankruptcy, the company must sell off enough assets to pay back the senior secured bondholders.

**Normal Market Pricing and Coupon Payments** In a normal market environment, senior secured bank loans typically trade close to par (price of 100), with either a slight discount or premium, depending on the supply/demand balance. Owners of these securities also receive adjustable-rate coupon payments, which typically reset every 30 to 90 days based on a spread to the Libor rate. If short-term interest rates move lower, the coupon payments are reduced. Payments to the bond holders correspondingly rise if short-term rates move higher. In other words, these loans tend to yield more in rising rate environments, and less in falling rate environments. In the primary or new issuance market, bondholders are paid a spread over Libor (L), usually in the range of 200 to 300 basis points (L+2-3%). The secondary market typically trades in the range of Libor plus 300 to 400 basis points (L+3-4%).

**Market Dislocation – Today’s Pricing and Coupon Payments** Because of the credit crunch, there has been a major dislocation not only in the pricing of these loans, but in their coupon payments as well. Part of the disruption has been due to the perceived increase in the riskiness of these loans: the possibility of default increases in a slowing economy. Another aspect of the disruption can be attributed to the supply/demand factor. In the middle of 2007 there was an influx of new supply, roughly \$250 billion that was to be sold to market. As demand dried up in the credit crunch, there was an excess supply of loans totaling nearly \$130 billion. When supply far outweighs demand, prices must fall to entice investors to buy again. As a result of these factors, prices for bank loans have dropped dramatically to levels not seen before (see Chart 1). In addition, the spread-to-Libor in the secondary market for these loans has also risen substantially (see Chart 2). Spreads on new issuance are starting to rise, inching up toward secondary spreads.

**What About Default Risk?** The current “fly in the ointment” is default risk. What happens if a company defaults on these loans? Since these loans are senior-secured, bondholders are paid off first, usually at the typical recovery rate of 70 cents or more, on the dollar. This rate is far higher than for holders of subordinated debt (high yield) or equity, who may receive next to nothing in a worst-case scenario. Chart 3 shows the lagging default rate since 1998. Even with the economy slowing, defaults have not picked up significantly and may remain fairly benign unless we experience a deep recession.

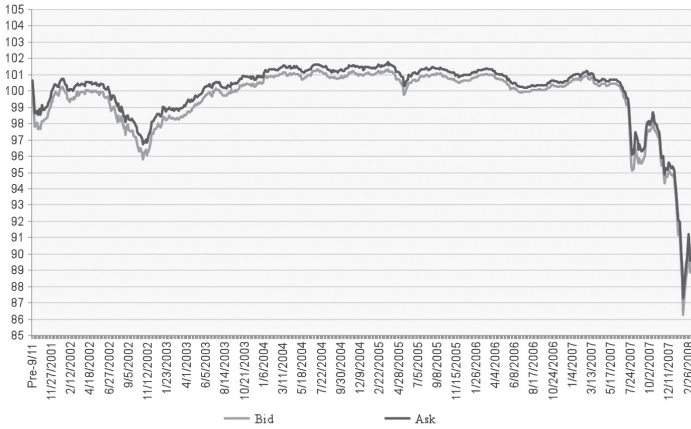
**So Where is the Silver Lining?** Investors who purchase these loans at the current 90% of par value would realize a 10% capital gain over the next three years — assuming the bonds are held until maturity and mature at par value.

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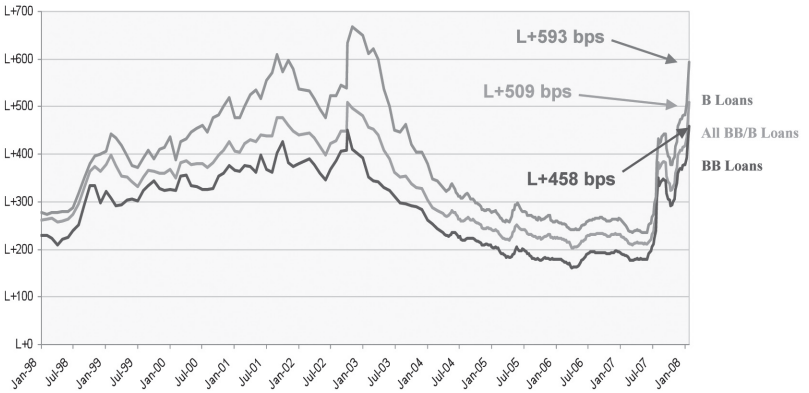
Additionally, because the spread-to-Libor has risen with the perceived increase in risk, investors are receiving higher coupon payments than they would in a normal period of declining short-term rates.

**Chart 1**



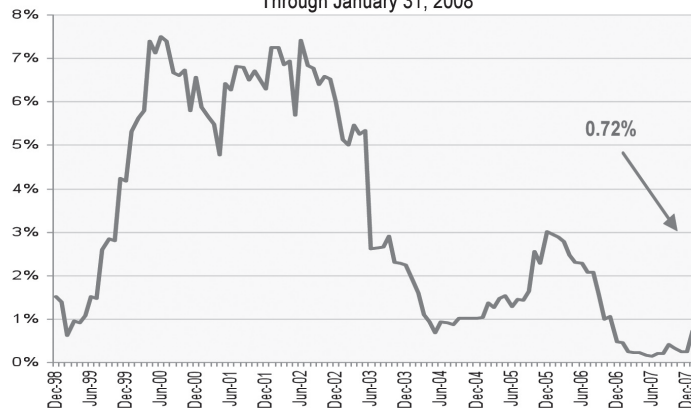
**Chart 2**

**Average Secondary Spreads by Rating**  
Assumes 3 Year Maturity  
Through January 25, 2008



**Chart 3**

**Lagging Twelve-Month Default Rate**  
By Principal Amount <sup>1,2</sup>  
Through January 31, 2008



## NEW CLIENTS JOIN INNOVEST

Innovest was hired by **The Geochemical Society**, a nonprofit scientific organization founded to encourage the application of chemistry to the solution of geological and cosmological problems.

**Arapahoe Douglas Mental Health Network** hired Innovest to benchmark their retirement plans and help negotiate their conversion to a mutual-fund platform plan.

**The Independence Institute** also hired Innovest this quarter. They are a non-partisan, non-profit public policy research organization dedicated to providing timely information to concerned citizens, government officials, and public opinion leaders.

We also added five new wealthy family clients during the quarter ranging from a few million to over \$50 million in assets. We are very proud to have earned their trust!

Factoring in a conservative default risk of 2% with a 70% recovery rate, we expect senior secured loans to provide an annualized total return above 7% over the next three years. Finally, because senior secured bank loans have a low correlation to other fixed income investments (i.e. – corporate bonds, treasuries, etc.) they provide great diversification benefits. Of course, these assumptions can change dramatically at any given time considering the very unstable nature of the current credit markets. However, because these securities are highest in the capital structure, we believe they present a great opportunity for many investors. If an investor were to allocate

to this segment of the market, we would suggest a professionally managed portfolio (mutual fund or separate account) which allows for credit and sector diversification as opposed to buying individual issues. •

*\* Data source for all charts from Standard and Poor's courtesy of ING.*

## DENVER BOTANIC GARDENS

### MAKING A DIFFERENCE

The mission of Denver Botanic Gardens is to connect people with plants, especially plants from the Rocky Mountain region and similar regions around the world, providing delight and enlightenment to everyone.

It began as the dream of local gardeners, botanists and civic leaders to build an oasis in the middle of the city. It became a reality in 1951 when members of the Colorado Forestry and Horticulture Association incorporated as the non-profit Botanical Gardens Foundation of Denver and hired legendary landscape architect Saco R. DeBoer to create a 15-year master plan. Located in the middle of the Mile High City, Denver Botanic Gardens was one of the first gardens in the country

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## MAKING A DIFFERENCE *continued from page 7*

to emphasize native plants and to champion environmentally responsible practices, such as water conservation and biological control of pests. Today, Denver Botanic Gardens continues this tradition at three unique sites: Denver Botanic Gardens, Denver Botanic Gardens at Chatfield and Mount Goliath. Each of these demonstrates the varied ecosystems of Colorado.

Denver Botanic Gardens' commitment to botanical heritage extends beyond these locations through their conservation and research programs. The Gardens is a regional leader in the protection of the diversity of Colorado ecosystems, with programs in documentation, scientific research, restoration and conservation education. Through these endeavors, they ensure that the flora of our region is available for future generations to use and enjoy.

Most of all, Denver Botanic Gardens offers spectacular plant displays, unlimited opportunities for lifelong learning and research that help preserve Colorado's precious natural resources. Innovest is proud to have Denver Botanical Gardens as a client. To learn more go to [www.botanicgardens.org](http://www.botanicgardens.org).

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## INNOVEST BLOG

**Please visit our blog through our website: [www.innovestinc.com](http://www.innovestinc.com)**

This is designed for our clients and friends to read our thoughts on a variety of investment and fiduciary issues. We have links to websites, research, and other blogs that can be helpful navigating the world of investments and stewardship. Keep us informed of your thoughts.



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