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INNOVIEWS

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NEW INSTITUTIONAL CLIENTS

Catholic Benefits Association

Fender Musical Instruments

San Diego Union Tribune

Union Square Advisors

University of Mary

It is not known whether the listed clients approve or disapprove of the services provided. The new clients on page one are listed with their approval and permission.

Will Higher Cash Returns Hurt Hedge Fund Managers?

Sloan Smith, CAIA, MBA, CPWA®
Principal, Director

In 2022, the Federal Reserve increased short-term interest rates at a historically fast pace in order to hinder inflation. This had a massively negative effect on equities and fixed income, where both were down 18% and 13%, respectively. However, these decisions by the Federal Reserve created an interesting dynamic, not only in the greater fixed income market but in cash, treasury bills, and money market funds.

As of August 2023, Treasury bills and money market funds were providing an annual yield of approximately 5%, a return profile that has not been seen in these asset classes since the 2008 global financial crisis. For close to fifteen years, low interest rates were the norm and alternative strategies such as hedge funds were able to charge significant management and incentive/performance fees without any substantial issues. But the market environment has changed. Investors are questioning whether a hedge fund should implement a hurdle rate that is close to a money market or treasury bill return before collecting performance fees. In addition, investors are questioning the validity of some hedge fund strategies, especially if they are unable to generate a return premium to Treasury bills or money market funds. The hedge fund landscape is heavily scrutinized and it will be important for the asset class to show its ability to create better fee alignment with its investors while generating a risk and return profile that is more favorable than cash equivalents.

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Continued from Page 1

Key areas to monitor:

1. Management and Performance Fees

Historically, hedge funds have followed the typical "2 and 20" model, a 2% management fee and a performance or incentive fee of 20%, wherein they collect 20% of the fund's profits if they generate positive over a particular period. However, we have seen the hedge fund space experience some downward pressure when it comes to fees. As of the end of 2022, the average hedge fund fee was 1.4% and the performance fee was approximately 17.3%.[1] Hedge funds are under a lot of pressure to justify their larger fees, especially due to the increased return profile of cash equivalents. Therefore, it is important that hedge funds provide favorable fee terms for their investors where their differentiated return profile relative to equities and fixed income adds value to a greater portfolio. If there is contrary behavior found in this space, then it might make sense to reevaluate your allocations in this asset class.

2. Hurdle Rate

Treasury bills, money market funds, and other cash equivalents are yielding close to 5% as of August 2023. In the hedge fund space this should be a discussion point when it comes to potentially implementing a hurdle rate, or the minimum acceptable rate of return needed. Most hedge funds receive most of their compensation through the incentive fee. In many cases, fees should not be collected unless the hedge fund manager can exceed the 5% cash return threshold. There may be exceptions to this rule, particularly with high quality, hard to access managers that have consistently generated a return profile more favorable than cash. However, this should be discussed heavily while performing future due diligence on hedge funds strategies.

3. Redemption Activity

If hedge fund managers are unwilling to make changes to their investment terms so they are more investor-friendly or are unable to clearly outline how they can deliver a return over cash equivalent, then it is important to monitor redemption activity. Money market, Treasury bills, and fixed income have become more favorable due to higher current yields. It might make sense for more investors to redeem capital from hedge funds and allocate more to the fixed income, where they may find greater return potential with more liquidity and, potentially, less risk. If hedge funds managers are unable to evolve and manage this new dynamic, then outflows should be expected.

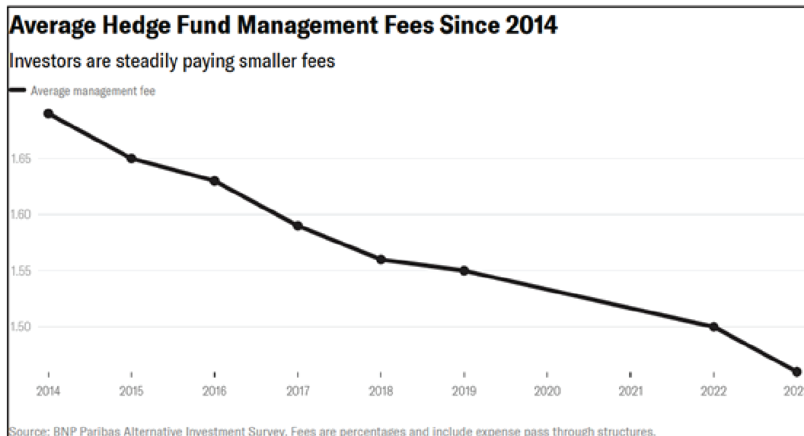
4. Track Record During a Higher Rate Environment

Hedge funds have historically proven their worth during a higher interest rate environment when volatility is more elevated and there is greater return dispersion in various assets classes such as equities, fixed income, commodities, etc. In hedge fund due diligence, the fee and potential hurdle rate component are important. But it can be advantageous to look at more tenured strategies that found success in generating robust return in a higher rate environment. Their success during these time frames could provide comfort in knowing that they have a proven ability to find success in this type of market environment.

Overall, the hedge fund industry is going through a makeover, where they need to show their value over less risky asset classes. This dynamic should lead to stronger conversations that create more alignment with investors and, hopefully, a more enhanced risk/return profile. The bar has been raised for hedge funds, which will ultimately lead to winners and losers in the space. Investors must pay attention to these key trends so that they can remain comfortable with their hedge fund allocations. They should feel that their underlying managers are truly creating a diversified risk/return profile that is more favorable than simply holding cash or purchasing a money market fund or Treasury bill.

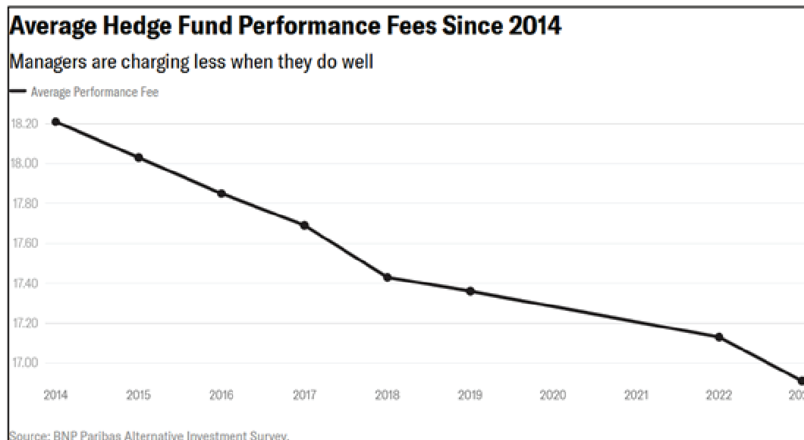
1 "Interest rate rises heap pressures on hedge funds to perform." https://www.ft.com/content/3e500ade-fd6d-4657-b734-90a0ac445a6f

Figure 1



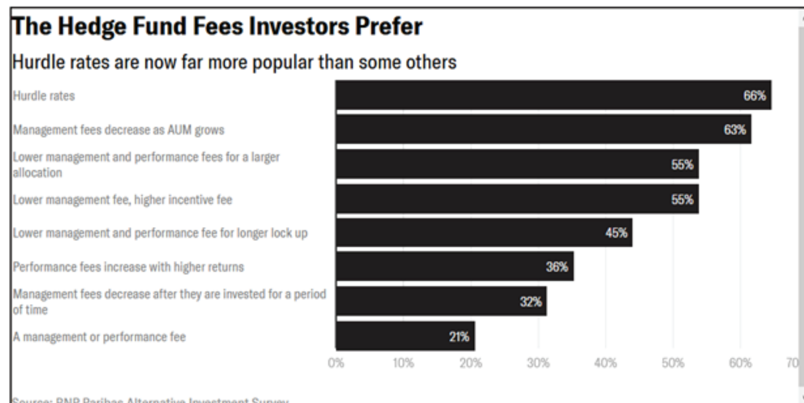
Source: https://www.institutionalinvestor.com/article/2bstrhmu4clmmg8ns07wg/portfolio/allocators-increasingly-push-for-hedge-fund-hurdle-rates

Figure 2



Source: https://www.institutionalinvestor.com/article/2bstrhmu4clmmg8ns07wg/portfolio/allocators-increasingly-push-for-hedge-fund-hurdle-rates

Figure 3



Source: https://www.institutionalinvestor.com/article/2bstrhmu4clmmg8ns07wg/portfolio/allocators-increasingly-push-for-hedge-fund-hurdle-rates

Have Your Cake and Eat It Too?

Richard Todd
Principal, CEO, & Co-founder

For certain investors, creating an insurance wrapper around some assets or a portfolio can create large tax advantages (Innovest does not sell or deal insurance and would refer you to a professional if appropriate). Private Placement Life Insurance (PPLI) is increasingly used to enhance after-tax returns for a suitable investor profile. While these products can, at times, be oversold, we are firm believers that PPLI is an ideal strategy to create a tax-free umbrella on long term assets in the appropriate circumstances.

What are the asset characteristics of an investor that should be considering PPLI?

- An expectation that the assets will primarily go to heirs or charity
- Asset returns are primarily taxable - private debt or hedge funds are examples of investments that are ideal in a PPLI wrapper
- Assets held in a grantor trust, where compounding and distributions can occur tax-free

Depending on the investment size, fees range from 0.40% to 1%. At the highest federal tax rate of 37%, plus state rates on top of that, high returning assets are most appropriate.

TAXABLE INVESTMENT

Return After Investment Management Fees	7.0%
Federal Tax Rate	40.8% (2.85)
State Tax Rate	4.9% (.34)
Net Rate After Tax Return	**3.8%**

PRIVATE PLACEMENT LIFE INSURANCE

Return After Investment Management Fees	7.0%
Federal Tax Rate	0.0%
State Tax Rate	0.0%
Average PPLI Fees and Expenses	0.7%
Net Rate After Tax Return	**6.3%**

There are some complications to PPLI, including insurance underwriting. While insurance is typically designed to maximize a death benefit, PPLI is designed to create the lowest cost possible. Most investors are insurable, but at times it is prudent to insure another family member.

If you would like to understand more about PPLI and how it might apply to your circumstances, we would be happy to discuss and refer you to an insurance expert.

Nonprofit Spotlight: WellPower

Innovest provides investment advice to many nonprofit organizations, and every month, we are honored to introduce you to one of our clients. This month, we are excited to feature WellPower.

WellPower, the largest community mental health center in Colorado, provides treatment, prevention, and crisis services to over 20,000 individuals at hospitals, assisted living centers, schools, shelters, and other locations. In addition, they reach 40,000 – 50,000 more people through outreach and community trainings. The organization was established in 1989 to serve the City and County of Denver and has since grown to nearly 1,000 staff members. WellPower stands behind the truth that treatment works and recovery is possible. WellPower's mission statement is enriching lives and minds by focusing on strengths and well-being.

WellPower wants to see Colorado thrive. They believe that they can and must change the landscape of behavioral health. WellPower has seen adults recover to live a more fulfilling life, children become more resilient, and families grow stronger foundations and healthier relationships through this work. To get involved with this mission, you can donate your time, talent, and skills by volunteering, contribute fiscally, join the community to share your personal experiences, or give other ways.

Equity Market Concentration and the AI Revolution

Steven Fraley, CFA, MBA
Principal, Director

Brett Minnick, CFA
Vice President

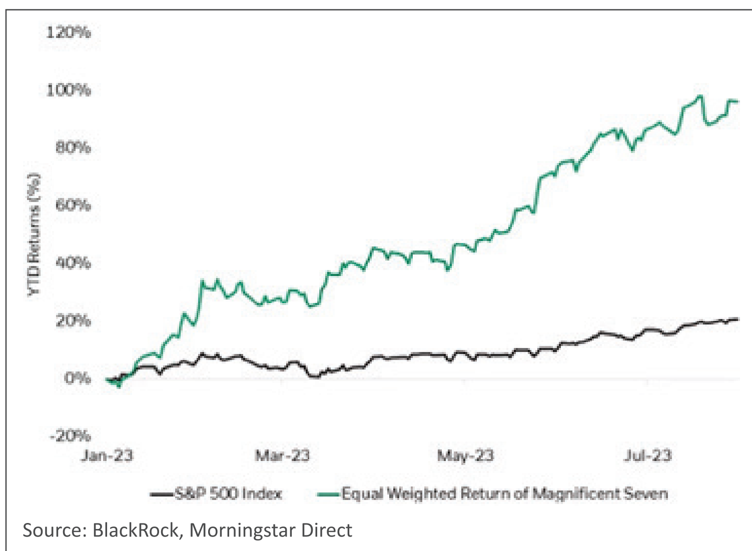
The Rise of Market Giants

Equity market concentration has been a topic of growing concern as seven mega cap tech giants, Apple, Microsoft, Amazon, Nvidia, Alphabet, Meta Platforms, and Tesla, have dominated the global stock market. There has been so much hype around these companies that they have commonly been referred to as the "Magnificent Seven," the largest U.S. companies by market capitalization.

The performance of these stocks has been predominant, contributing nearly 65% of S&P 500 returns, through July, from just ~28% of the S&P 500 Index. This means that most of the other 493 stocks in the index are generally underperforming. A large driving factor of strong performance so far in 2023 has been the latest boom in artificial intelligence, bolstering the success of these high-growth stocks.

Impact on Diversification

Why does this matter and why should investors care if the market is concentrated? Many indices are market capitalization-weighted,



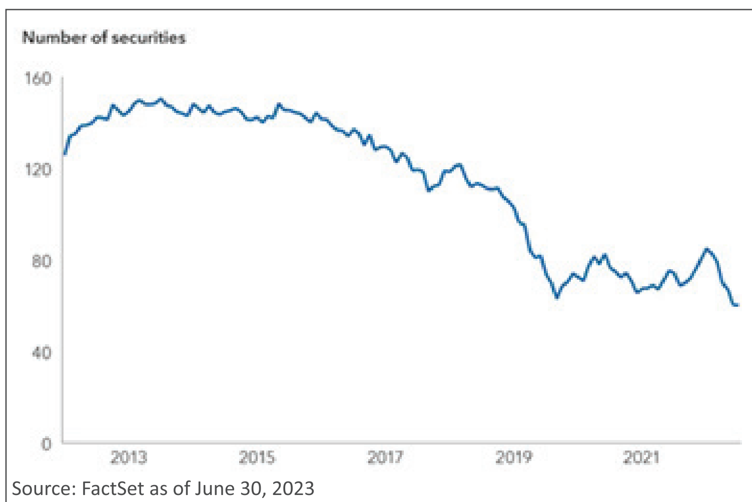
Source: BlackRock, Morningstar Direct

meaning that the larger a stock's size, the larger their share of the overall index. As these companies become a larger portion of the global stock market, they have a bigger impact on overall returns, which could lead to greater portfolio risk. The concentration of market returns in just a few mega-cap stocks, dominated by the information technology and communication services sectors, could lead to heightened volatility, reduced diversification, and increased systematic risk for investors.

Most of these companies are more alike than different and are, in various ways, exposed to the same secular trends. Consider artificial intelligence, cloud technology, augmented/virtual reality, and autonomous vehicles as examples. This overlap increases the systematic risk of owning these stocks within an index or portfolio, as these companies generate a large portion of their revenues and future expected returns from similar risk factors, diminishing diversification and its related benefits.

We have seen a significant decrease in the effective number of securities in the S&P 500 index, as measured by the Herfindahl-Hirschman Index (HHI). The HHI seeks to measures how many securities it would take to create an equally-weighted portfolio with the same level of diversification as the S&P 500 index. This figure is at its lowest level in recent history, which means the index itself is thereby also providing the least amount of diversification.

An overly concentrated market can also have a significant impact on active management and stock selection, as narrow leadership can be challenging for managers and strategies that favor greater breadth. When considering the Magnificent Seven, there is significant factor exposure to quality and momentum and negative exposure to size (small companies) and value (inexpensive companies), which has a big impact on the overall index.



Source: FactSet as of June 30, 2023

Influence of AI on Future Returns

Artificial intelligence hype hit an all-time high in 2023. A lot of this can be attributed to the belief that it is more than just a new market and, rather, is a foundational technology by which other markets will be created. Investors are expecting that the productivity increase realized from AI could drive macroeconomic growth for years to come.

We believe that AI will likely have a sustained, significant impact on market returns over the next decade and beyond as economic growth is primarily driven by three main factors: capital, labor, and technological advancement. Many countries and geographic regions around the globe are currently experiencing decreased labor and capital growth. We believe a growing portion of future economic growth will come from technological advancement, and specifically artificial intelligence. According to a recent study by McKinsey & Company, generative AI has the potential to deliver significant economic benefits, adding between $2.6 and $4.4 trillion in global corporate profits annually[1].

At a micro level, we are approaching AI-based investments with cautious optimism, as it often takes time to see meaningful adoption when it comes to disruptive technology. This is likely a major competitive advantage for early adopters, primarily the Magnificent Seven, who have spent billions of dollars building out their technology and have expansive customer bases to tap. While there will be several new entrants and disruptors, over time, it will likely take years to see meaningful market penetration.

How to Mitigate Concentration Risks

While risks are inherent with investing, we believe investors can reduce the overall risks in their portfolio by incorporating key best practices. Within the overall equity allocation, exposure to different investment styles (value and growth) as well as different-sized companies (large cap, mid cap, and small cap) to achieve broader diversification away from the largest names in the stock market can help reduce portfolio volatility. Beyond style and size, diversification outside of the United States provides exposure to investment trends and the economics in other growing parts of the world. Additionally, employing a prudent rebalancing process helps ensure that investors do not get overly concentrated in any particular asset class or style box.

Because of the robust performance of the Magnificent Seven, portfolios have generally become overweight to large cap stocks, resulting in an underweight to small and mid-cap stocks, as well as international equities. Rebalancing portfolios back to target weights helps reduce risk and prevent overexposure to high-performing assets, ensuring the portfolio remains consistent with the investors long-term risk and return objective.

1McKinsey & Company. (2023, August 25). What is the future of generative AI? An early view in 15 charts. Retrieved from https://www.mckinsey.com/featured-insights/mckinsey-explainers/whats-the-future-of-generative-ai-an-early-view-in-15-charts

Employee Spotlight: Steven Fraley

Where is your hometown?

I was born in St. Louis, Missouri and moved out to Denver with my family at the beginning of 2020.

Tell us something unique about you.

Not sure if it is unique or just crazy, but my wife and I took some time off from our careers to travel. We spent six months in Asia and Europe when our oldest son was nine months old. I truly believe that travel provides us with incredible opportunities to learn and grow by exposing us to diverse cultures, perspectives, and ways of life that we do not experience every day.

What do you like best about working at Innovest?

I really enjoy the people and culture at Innovest. We have an amazing team that always goes above and beyond for our clients, our community, and each other. This is embedded in who we are as a firm and makes coming to work every day very rewarding.

How do you give back to the community?

One of the great things about working at Innovest is our dedication to the community. We typically have monthly on-site volunteer opportunities I try to contribute to. Additionally, my wife and I are very active in supporting our local neighborhood/community and our sons' schools.

What are your hobbies and interests?

At this point, most of my time is spent running our kids from activity to activity. Right now, we have soccer, baseball, taekwondo, and horseback riding, to keep us busy. We also love to ski and hike as a family. When I do have time to sneak away, I am usually golfing or hunting.

Tell us about your family.

I am very lucky to have been married to my amazing wife, Meg, for over 11 years. We have been blessed with three wonderful and wild sons, Charlie (5), Harrison (3), and Weller (2). All of our immediate family is back in St. Louis, so we try to get back to visit when possible and love to host our families in Denver. We also try to spend a lot of time enjoying the mountains in Steamboat Springs.

What is your favorite dessert?

My favorite dessert is authentic key lime pie, you just can't beat it. Our favorite family tradition is walking or riding our bikes up to Bonnie Brae ice cream!

Around the Firm

Promotions & Team Updates

We are excited to announce the addition of exceptional talent to our team! Firstly, we welcome Tomas Jansson, our new Vice President and Consultant on the Retirement Plan Practice Group. Tomas brings more than two decades of experience in optimizing company-sponsored retirement plans. In addition, Christian O'Dwyer, CFA, returns to Innovest as a Principal. Christian, with a wealth of experience acquired during his previous five-year tenure at Innovest and roles at UBS Financial Services and BOK Financial, will guide families, foundations, endowments, and nonprofits in investment strategy and financial planning. Next up, Analyst Assistant, John Walsh, joins the team. John is a graduate in finance and business analytics from Santa Clara University. Finally, we welcome Analyst Assistant Austin Cleveland, a University of Missouri alum with degrees in finance and French. Welcome aboard, Tomas, Christian, John, and Austin!

School is back in session, and our Arrupe interns have returned to the office. We are thrilled to have Angel (senior), Osmar (junior), Diego (sophomore), and David (freshman) in our office this year!

Lastly, we would like to recognize the outstanding individuals on our team who embody our core mission of stewardship. In June, Sydney Aeschlimann and Joanne Cinalli, CPFA™ received the Service to Others monthly award, in July, the honor went to Lori Foster, in August, to Christine Hudek, and in September to Tracey Blackford. They inspire our team with their steadfast dedication to our core values.

Awards & Publications

Principal Sloan Smith, CAIA, MBA, CPWA®, recently shared his thoughts on "Private Debt – The Appeal After Bank Failures" in *Advisor Perspectives.* Vice President Frank Cornett, CFP®, provided a deep dive into the dynamics of cyclical markets with his article "What Cyclical Markets Mean For Clients," featured in *Financial Advisor*. Finally, Vice President Paul D'Alessandro explored the changing landscape of fundraising jobs in his article "The End of Traditional Fundraising Jobs and What to Do About It," recently published by NonprofitPRO.

Service

Innovest actively volunteers to support impactful organizations. This quarter, Innovest partnered with Brothers Redevelopment, Inc., an organization that offers affordable housing solutions for low income, elderly, and disabled residents, to complete a "Paint-a-thon." We also participated in the Denver Public Schools Foundation Back to School Bash 2023, where Innovest employees cleaned up a pavilion at a local elementary school. Finally, our team worked alongside Habitat for Humanity of Metro Denver, to assist in the construction of a home. At Innovest, we prioritize providing our employees with opportunities to actively engage with and serve our community.

Conferences, Speaking, Events, & Sponsorships

Innovest proudly supports community initiatives, emphasizing our commitment to social responsibility. We sponsored Sam's Supper, a fundraiser for Samaritan House at Mile High Station on September 16th. Additionally, we were honored sponsors of the Focus on Finance Gala with Economic Literacy Colorado on October 19th. Innovest also proudly supported the Dig Deep Community Block Party at DIRT Coffee in Littleton, CO. DIRT actively addresses neurodivergent employment disparities by collaborating with individuals, employers, and communities. Through training and support, they foster inclusive workplaces, promoting the hiring, promotion, and retention of neurodivergent individuals and enhancing organizational culture.

Finally, Innovest's Sloan Smith gave the Economic Update for AmPhil's Office Hours webinar on August 29th, discussing the projections of the world economy and financial markets for the next five to ten years.

Building Relationships that Produce Results

We bring the best ideas from the institutional community and apply them to the individual investor, providing unique access to investment opportunities and leveraging knowledge and aggregated reporting.

At Innovest Portfolio Solutions, we are more than an investment firm. We are thoughtful stewards responsible for our clients, professionals and community.

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