

ARETE INSIGHTS

Welcome

There is no doubt that there are some significant challenges to the economy and markets in today's environment. While some of the conditions undoubtedly make life more difficult, I can't help but to be fascinated by the constant change and complexity of the issues and opportunities.

In this edition, I am going to discuss a couple of different challenges. One is the challenge to the U.S. economy. Clearly high unemployment and fiscal deficits are big problems that need to be addressed. Despite this challenge, we see silver linings in the process.

The second is a challenge within the money management business. Because so much of the nature of the business is intangible, it is difficult to judge quality. As a result, many investors use size as a proxy for determining "quality" of a money manager. If we have learned anything over the last two years though, it is that size can just as easily impinge upon quality as enhance it. In fact, I founded Arete two years ago, with the mission of delivering functional excellence in money management — because I thought a small, independent firm had structural advantages in delivering active investment performance and high fiduciary standards.

I always enjoy talking about the money management business in general and about Arete in particular. If you are going to be in downtown Baltimore, please let me know, I'd love to get together. I enjoy

sharing the ideas I have to try to make things better and it also helps me to hear what investors are most concerned about.

Thanks and take care!

David Robertson, CFA
CEO, Portfolio Manager

Insights

Citizens from all walks of life are becoming extremely concerned about the multitude of challenges facing this country. Huge fiscal deficits, high and enduring unemployment, and potential for significantly higher inflation are all very serious problems. It is especially troubling that wherever we turn, we see institutions that are woefully deficient in constructively addressing such problems.

While we do not dispute the severity of such issues, we are not fatalistic about them either. This position was brought into clear relief in a presentation we attended a couple of weeks ago in which the speaker asked the audience two questions. The first was, "Are you optimistic?" The second was, "Do you expect your children will be better off than you are?" Most of the audience, including us, responded positively to the first question and negatively to the second.

This struck us immediately as interesting because at the very least, our responses were superficially inconsistent. At worst, they were logically inconsistent. So the

questions forced us to better-understand, or at least to better-articulate, the rationale behind the responses.

Let's start with the second question first. Why do we believe that our children will not be better off than we are? We see all of the issues listed above as being part of a bigger problem: This country has been spending more than it takes in for a long time. The problem, however, is more onerous than this because it does not account for the liabilities of Medicare and Social Security. As a country, we have been mortgaging our future. In order to restore balance, we will need to redefine the social contract and the costs will necessarily fall on future generations.

Nobody likes picking up the tab for someone else which is why we believe our children will not be better off than we are. Importantly, however, we don't believe they will be much worse off either. We actually see several reasons to be optimistic about the future.

First and foremost, we see the populist outrage towards unemployment and the deficit as providing important impetus to finally address problems that have been lurking for many years. The biggest of these problems is the cost of large entitlement programs such as Medicare and Social Security. We know the dollar amount of promised benefits of these programs will eventually dwarf our ability to pay for them.

While the annual fiscal deficit is just the tip of this big iceberg, at least people see it now and know that it represents a big risk to the future of this country. We believe this recognition is an important step in the right direction.

We don't have any delusions that the political path to fiscal prudence will be an easy one. We don't view the problem as being intractable, however. We see it more as an issue of proper communication and education.

For example, A recent billboard stating, "Keep the government's hands off my Medicare!" we think captures some of the popular misconceptions well. The link between benefits and costs is apparently not clear to everyone. At the end of the day, however, we believe most parents want a better world for their children and will make the appropriate tradeoffs and sacrifices to accomplish that end.

What do investment prospects look like for young families? Again, we have several reasons for optimism. For those who are just entering the wealth creation phases of their lives, the first investment is often a home. With low mortgage rates, excess supply of homes, and a significant retrenchment in home prices, this is a great time to be looking for a home.

The opportunities for other investments are also attractive. Having just emerged from the worst ten year stock performance on record, we are at a much better starting point for those who are beginning to invest with a large allocation to stocks. Conversely, the outlook for fixed income investments is fraught with risk. With interest rates at rock bottom, they will almost certainly rise higher over the next several years. When they do, returns from fixed income vehicles will suffer.

In conclusion, we do believe there are very serious fiscal and economic challenges that need to be addressed. These problems are likely to make it difficult for "our children"

to be better off than we are. Nonetheless, we see many reasons to be optimistic. We believe widespread acknowledgement of fiscal deficits increases the chances of a solution. In addition, the opportunities for young families to invest in homes and stocks are actually extremely good. While there are concerns and uncertainty, we may very well look back ten years from now and marvel at the historic opportunity.

Insider's View

As in any business, the more familiar one gets with underlying structures, relationships, and incentives, the more likely one can identify disparities between common perceptions and underlying reality.

Our goal in this section is to share our insights into how the investment management business really works. One way we hope to do this is by wading through the blizzard of information that surrounds the business and distilling the most salient points for investors. Another is to identify and forewarn investors of some of the business practices in the industry that can work against investors' objectives. In both instances, we hope to provide greater clarity.

We discuss these ideas for a couple of reasons. First, we want to share our knowledge of, and experience in, the money management business to help people better achieve their investment goals. Second, we do this to help differentiate the value of our services. We believe the more we can help you understand the underlying reality of the investment management business, the

more you will appreciate what we do and why we do it.

Arete Asset Management was founded with the mission of delivering "functional excellence in money management." Indeed Arete's creation arose from two related premises. One is that while there are thousands upon thousands of money managers, there are too few exceptional ones. The second is that there will always be demand for excess performance (alpha). In this section, we describe how we view "quality" and in doing so, will clarify the logic for how we pursue business.

One of the seminal works of research in finance is called "The Limits of Arbitrage" by Andrei Shleifer and Robert W. Vishny. For some background, arbitrage is not some obscure or trivial exercise. Instead, at its essence, arbitrage is the effort to find disparities between value and price. Colloquially, this essentially means "buy low and sell high." Any effort to "outperform" the market through active management is an exercise in arbitrage.

As the world of investing has become democratized over the last thirty to forty years, an important change has occurred. Now, "Arbitrage is conducted by a relatively small number of highly specialized investors who take large positions using other people's money." This relationship between investors, who act as principals, and money managers, who act as agents, has important implications for asset pricing.

A key insight of the report is that the arbitrage exercise can become ineffective in "extreme circumstances when prices

diverge far from fundamental values.” The explanation is that some nervous investors can pull capital out of money managers at the worst possible time — the time of greatest opportunity for the money manager. In doing so, investors themselves actually limit the ability of their money managers to outperform.

An excellent example of the limits of arbitrage occurs with mutual funds. When market prices fall, and the gaps between prices and fundamental values widen, some investors get nervous and withdraw funds. Withdrawal of funds forces the mutual fund manager to sell stocks at exactly the same time that manager is finding the greatest opportunities to buy. Research points to the fact that such fickle fund flows impair a manager’s ability to perform, *regardless* of that individual’s level of talent.

Given this insight, it is clearly incumbent upon a money manager set on delivering outperformance, to find client investors who are committed to riding out market volatility. Such “patient” capital allows the manager to leverage his or her skills of effectively exploiting arbitrage opportunities. In short, there is a distinct benefit to the money manager for having client investors with long time horizons.

This is not a one-way street, however, because there is also a distinct benefit to client investors for being patient. That benefit comes in the form of enhanced performance opportunities! In other words, superior performance derives at least partly from a symbiotic relationship between manager and client. In a very important way, quality in money management is a function of the nature of that relationship.

We find it worth noting that one of the most successful investors of our age, Warren Buffett, does not run a money management firm. He has insulated himself from the vagaries of nervous client fund flows and instead substituted the regular inflows of insurance premiums. As a result, he can pursue arbitrage opportunities without undo constraint.

Since an important part of the proposition of delivering investment quality is finding the right clients, Arete places a great deal of emphasis on this. We very much believe that our ability to leverage arbitrage opportunities and deliver performance is contingent upon it.

In doing so, we consciously resist the temptation to grow for the sake of growing, to take in whatever assets we can. Based upon our experiences, when small money managers overreach to gather assets, principles of stewardship are almost always compromised. For one, weak and/or inappropriate relationships can hinder performance through the limits of arbitrage. In addition, once a firm prioritizes asset gathering over performance, it is almost impossible to go back — the culture is set.

Of course this presents a paradox rich in irony. Our mission of delivering quality investment management services largely prescribes deliberate and measured business development. Yet many investors use size as a proxy for quality, or at very least as a minimum standard of entry. Unfortunately, we believe this state of affairs often leaves both parties worse off.

We and plenty of other emerging managers start our businesses because we feel strongly about delivering superior

investment value to an undersupplied market. Arete specifically was built on the principles of sharing our investment skills and providing exceptionally high standards of stewardship. To any investors who complain of high fees, mediocre returns, and/or unreasonable terms from their money managers, we would very much enjoy having a conversation.

Arete's Value Proposition

The specific features of our investment package, highlighted below, describe exactly what we try to do, and how we have organized our business in order to deliver an extremely attractive value proposition to our investors.

Commitment to putting our clients first

We are completely committed to putting the interests of our clients first. We do not employ any soft dollar arrangements because we believe these essentially end up being hidden fees for customers that are appropriately business expenses and should therefore be covered by the management fee. We do not operate in any other businesses that may provide conflicts of interest. All client accounts are treated exactly the same; no preferences are shown because the same trades are placed for every account at the same time. We also provide performance reporting so you can judge for yourself how we are doing.

Independent

Our firm is independently owned and operated which we believe gives us the best chance to make the best possible decisions for our clients. We have no outside owners which may have interests

that could conflict with the interests of our clients. Some industry experts consider independence to be a competitive advantage.

Reasonable fee structure

We employ a very straightforward and reasonable fee structure of 1% of assets under management for assets up to \$1 million with lower rates beyond that. This compares to many mutual funds which have expense ratios in excess of 1.5%. In addition, we don't employ performance fees because we believe such fees often provide incentive to the manager to take inappropriate risks in order to realize those fees. Such fees also serve as a persistent drag on performance.

Separate Accounts

We manage separate accounts for clients rather than pooling contributions from various clients. Assets are held in custody by a nationally recognized custodian and clients receive quarterly statements of exactly what is in their individual account and a list of transactions executed for that account. There is no ambiguity. We believe the separate accounts structure greatly improves the visibility of the investment process as well as the portfolio accounting. We believe this high degree of visibility serves as a significant layer of protection for clients against neglect or malfeasance.

Distinctly mid cap

The aggregate characteristics of your mid cap portfolio will be anchored to those of the Russell Midcap Index. Since we find the mid cap stock universe very attractive for finding new stock ideas, we have no need

to look outside that universe. When managers venture outside of their universes, they can compromise the value the portfolio brings to a broader asset allocation scheme.

Actively managed

Your portfolio will be actively managed giving you a real chance to outperform the benchmark. Index funds seek to replicate benchmark performance, but fall short when management fees are included. Some funds try to stay close to their benchmark and “closet index” in order to minimize the chance of significant underperformance. You will get a portfolio that benefits from our experience and expertise in stock selection in the form of a diversified group of our best stock ideas.

Long-term perspective

Our research focuses on long-term insights, not on short-term noise and trends. We believe that over longer periods of time, stocks migrate toward their intrinsic values. We also believe this phenomenon can be exploited by those who are both skilled enough to make reasonably accurate estimates of intrinsic value and patient enough for them to be realized. During shorter, interim periods, however, the numerous and diverse effects of trading activity make it excessively difficult to consistently determine the direction of stock prices.

Relatively low portfolio turnover

Our investment style is oriented to a longer-term time horizon of three to five years. As a result, our portfolio turnover tends to fall in the 20-40% range compared to the industry average of over 100%.

Lower turnover means lower transaction costs for you and also tends to mean lower capital gains for taxable accounts.

Manager Evaluation

We very much appreciate the time and effort it takes to evaluate investment managers. As a result, we offer a few criteria for assessing quality investment management that we believe capture the vast majority of the issues that matter most in differentiating investment quality. The three core concepts of conscientiousness, commitment, and competence are simple, but effective. These criteria also serve as the foundation upon which we have built our service offering.

It is important to note here, that the three core concepts described below are general concepts. These general concepts form an overall framework for evaluation. Fund expense, for example, is a specific metric that represents elements of each the three general concepts.

Conscientiousness is the single most important characteristic in our minds. It is the foundation of fiduciary duty - putting the interest of the client first. It often, however, takes a back seat to conflicts of interest. As David Swensen describes in his book *Unconventional Success*, “The overwhelming number of mutual funds fail to meet the fundamental criterion of fidelity to fiduciary principles, as pursuit of profit overwhelms responsibility to investors.”

Commitment is the degree to which the performance and quality of the fund matters to a manager and captures how

hungry the manager is to perform. In his book, *Hedgehogging*, Barton Biggs presents the test: "Suppose the Devil came to you with a Faustian bargain and said: I will have you consistently scoring five [golf] strokes below what you are now if you will give me five performance points from what your fund would have returned over the same time period. Would you do it?" The answer often reveals where the manager is in his/her personal motivation cycle.

Positive signals for commitment include a manager's investment in the fund, investment in the organization, and personal sense of duty to his/her investors. Conversely, low or zero ownership serves as a warning flag because it identifies little economic risk to poor performance. Other warning flags include any signs of significant distraction such as excessively broad responsibilities within an organization, excessively broad obligations outside of the firm, and excessively strong commitments to personal hobbies or activities.

Competence may seem self-evident, but should not be taken for granted. While we are certainly not suggesting anything close to a perfect linear relationship between levels of education attainment and investment performance, it is important to note that unlike many other professions (e.g. law, medicine), there are no substantial formal educational requirements for most investment jobs. Also, importantly, research does indicate a relationship between higher education and more prudent risk-taking.

Obvious things that can help include strong academic backgrounds and CFA certifications. Less obvious things include an investment philosophy that articulates a reasonable and understandable way to generate returns, and transparency which indicates confidence in the process.

