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# Arete Insights

## Welcome

Value is the word for many folks these days. Households are burdened by record debt and a combined $6 trillion in losses suffered between June 2008 and March 2009 in stocks, mutual funds, and real estate. Mike Duke, president and CEO of Wal-Mart captured the environment well in his second quarter conference call, "There is a new normal now where people are saving more, consuming less and being more frugal and thoughtful in their purchases."

With such forces impinging upon many investment plans, value is even beginning to enter the lexicon of the money management business. As a result, this is a great time to assess the value provided by various investment products and services.

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What do I mean by value? I think simple concepts such as "more for your money" and "over and above what is expected" serve well to capture the meaning. I founded Arete with the mission of delivering extremely high quality investment product at a very fair price. In other words, there is a terrific opportunity for Arete to deliver a better investment value than many existing offerings. There is also an opportunity for investors, whether they are considering Arete or another manager, to apply some basic research in order to find investment bargains.

Skeptics may argue that doing some basic research is not worth the effort, but the evidence points to a very different conclusion. The *Economist* recently noted a Lipper report that showed, "Between the end of 1994 and the end of 2008 the equity funds in the lowest quartile for costs returned 7.24% a year; those in the highest quartile returned just 4.65%." Interestingly, higher costs are highly correlated with lower returns. With this simple bit of knowledge, investors have an opportunity to realize better investment value.

The inverse relationship between costs and returns is counter-intuitive and awkward to grasp. A big part of the reason for this is because we are accustomed to seeing the price-quality relationship that generally holds with most consumer products. Higher quality things cost more, and price can signal quality.

To be fair, there is some truth to the notion that better managers may charge higher fees, but far less than many believe. The reason this is so is because investment products are unique from consumer products in that investment quality (measured by returns) is a direct function of fund costs. Better managers may charge more, but only very rarely are they so much better as to generate superior returns after fees are deducted. The simple rule of thumb is higher fees = lower performance = lower investment value.

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Conscientious managers who are dedicated to delivering superior performance fully appreciate the deleterious effects of high fees. Managers who are overwhelmingly compelled to deliver superior performance know they need to manage expenses closely to maximize returns for their clients. In that effort, they set expenses that are fair to their investors and allow for an economically viable return for themselves. The Lipper results demonstrate clearly that a lot of managers fail to manage this tradeoff in a way that provides a good value to their investors.

The discussion about investment value has thus far considered only operational differences in fund firms. To be sure, fund companies provide a variety of marketing and distribution services that may deliver some value, exclusive of investment returns, for their investors. Such benefits deserve to be included in the consideration of overall investment value.

Two of the largest categories of marketing expenses for funds are advertising and distribution. The large fund families try to create a degree of comfort and familiarity with their brands by spending a lot of money advertising. Many fund companies also try to make their products widely available by investing heavily in a multitude of sales channels. Strong distribution means investors can find funds to buy wherever they may be shopping.

While such marketing services may very well provide some benefit to investors, the important question is, do they provide a good value? Much like it costs more to buy a soda at a convenience store than at a Target store, it costs more to buy a mutual fund at a convenient location. Is the convenience worth the extra cost?

The same *Economist* article that cited the Lipper study went on to opine, "If the government really wants a scandal to attack, it is the way the finance sector enriches itself at the expense of retail investors." This statement, which is a clear rebuke of much of the mutual fund industry, also answers the question. Too often, the advertising and distribution services are not worth the extra costs to the investor.

In fact, my frustration with the poor value delivered from much of the industry motivated me to create Arete. I always enjoy talking about how Arete strives to deliver an outstanding investment value and about the money management business in general. If you are going to be in downtown Baltimore, I'd love to chat with you.

Thanks and take care!

David Robertson, CFA
CEO, Portfolio Manager

## Market Overview

With the strong market recovery since early March, it is a convenient point to evaluate where the market is and what we might expect going forward. Public commentary has spanned the gamut from expectations of a double-dip recession to exhortations of panic buying. As usual, we care less about ratings than reality, so our opinions are often less dramatic.

In order to cut through the noise of such commentary and to get a clearer look at the underlying economic reality, we find it useful to track earnings reports and to

listen to commentary on conference calls at the end of each quarter. These reports often provide the best data from the front lines of people doing business and making sales. As such, insights gleaned from these communications are often much freer of bias than top-down assessments from economists or politicians.

The economic downturn, and hence market decline, was greatly exacerbated by inventory de-stocking and the withdrawal of credit.

Now that most of the numbers and reports are in for the second quarter, some useful conclusions can be drawn. First, it is now clear in hindsight that the severity of the economic downturn was very significantly exacerbated by inventory de-stocking and the withdrawal of credit. This is no trivial point. Last fall many investors were scared by the sharp drop-off in demand. We can now see that a good chunk of the decline was due to credit and inventory adjustments and therefore was relatively short-term in nature.

In our last version of Insights we said, "Amid an environment of uncertainty, truly capable management teams and strong business models will increasingly differentiate themselves from weaker ones." Differentiation among management teams has very much proved to be the case as many have aggressively moved to reduce costs, cut back on inventory, and re-size their businesses to lower expected demand. Conversely, some management teams have responded by doing little else than to express hope for sustained economic recovery.

Many market participants and commentators have noted that second quarter earnings were better than expected, but they have complained that improvements due to cost cutting are not sustainable. This is true enough, but it misses the key point. Management teams have virtually no control over aggregate demand. Management teams do, however, have a great deal of control over their expenses. That many teams have responded quickly by adjusting factors that are under their control seems to us like a good thing. In fact, we would argue that the thorough assessments, quick responses and pragmatic adaptations that many teams have demonstrated are exactly the types of actions that lead to differentiated performance.

Despite the impressive rebound in the market since our mid-Q2 edition, we are still finding very interesting stock ideas. Much of the original decline in stocks last fall was caused by transient factors that did not significantly impair intrinsic values. In addition, there still appears to be a great deal of noise trading which adds to volatility and perpetuates mis-pricings. As a result, we continue to view current conditions as being extremely conducive to stock selection with a long-term time horizon.

## Insights

We regularly review the business landscape for money management as part of the process of reviewing and updating our business plan. In the course of doing this over the past several quarters, the most interesting developments we have seen emerge from the market turmoil are the severe and fundamental challenges to the money management industry.

It is no surprise to anyone in the industry that the basic business model of money management is extremely attractive. Pricing is based on assets under management (AUM) and assets grow by mid to high single digits (for equity managers) by virtue of normal investment returns. Most investors do not switch managers frequently so revenues tend to recur for several years. Finally, returns on the business tend to be extremely high with forty percent operating margins being the norm for larger shops.

High margins have allowed for very attractive compensation for many participants. A recent study by Boston Consulting Group which was reported in the *Financial Times* provides some perspective. The BCG study found, "[Money management] participants have been used to earning 1.7 times what they might have earned in other professions with similar levels of qualification." Anecdotal evidence suggests the 1.7 times estimate is too low.

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So where is the problem? The problem is that the market decline has reduced revenues for a business model that is especially vulnerable to revenue declines. Further compounding the problem is that the money management industry is not well-prepared to cope with what may well be a sustained squeeze on profitability.

The business model for money management is characterized by a high proportion of fixed costs. When revenues tread inexorably upwards, so do profits. This is a double-edged sword, however, and when revenues decline quickly and steeply, like they did last fall, profits suffer disproportionately. Bob Doll, the vice-chairman of BlackRock, recently estimated in the *Economist* that, "As many as half the world's asset managers are breaking even at best."

We don't believe the problem stops with managing through temporarily lower revenues. Evidence is also accumulating that secular forces are pressuring industry profitability. A McKinsey study claimed in the *Economist* that due to changes in asset mix and consolidation of retail fund distribution, "The revenue generated per dollar of assets may be about to decline by around a third." In other words, the pressure on margins and profitability is not likely to subside any time soon.

For better or worse, the industry is not well-positioned to meet such challenges. The long run of strong revenue and profitability growth enjoyed by the industry also bred a great deal of complacency. Historically high margins have fostered a degree of laxity regarding expenses that is unknown to other industries. As a result, the industry has precious little experience from which to navigate the newly emerging landscape.

In addition, the industry is further handicapped in its capacity to adapt by its culture. Years and years of high compensation have bred a self-image of superiority which is oddly disconnected

from the actual performance of money managers in aggregate. Such levels of self-importance are unlikely to improve strategic responses.

The tentative reaction by money management firms thus far is a good indication of the problems that may lie ahead. Many firms have begun to make some headcount reductions and to reduce some bonuses, but most actions thus far have been relatively small. If we accept Mr. Doll's conjecture that half of asset management firms globally are breaking even at best, we can infer that many firms are either well behind the curve of re-sizing their businesses, or are betting on a massive and sustained market recovery. Neither of these inferences suggests firms are managing for the possibility of a fundamentally different, and more difficult, investment environment.

We believe these challenges to the business environment have significant implications that are under-appreciated. First, it seems likely that the industry's culture will insulate decision makers from responding fast enough to a changing environment. Second, when (if) they do respond, inexperience is likely to complicate, forestall, and/or derail the adjustment process. Finally, in a business that depends so heavily on its people, there is likely to be a great deal of consternation about lower pay and tougher conditions. In sum, the process is likely to be protracted, painful, and distracting.

Ultimately, we believe all of this points to what may be a long-overdue "soul-searching mission" for the business. The greatest challenges are likely to be in products, organizations, and structures that do not create enough value for clients relative to price. In other words, we believe the quest for better investment values will help fundamentally reshape the industry.

## Insider's View

As in any business, the more familiar one gets with the underlying structures, relationships, and incentives at work, the more often one can see disparities between the underlying reality of the business and the widespread perception of the business. Our goal in this section is to share our insights into how the investment management business really works. Some aspects of the business simply overwhelm investors with too much information while others can go as far as to work at cross-purposes with investor objectives. In both instances, we hope to provide some clarity.

We discuss these ideas for a couple of reasons. First, we want to share our knowledge and experience in the business in order to help people better achieve their investment goals. Second, we do this partly 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.

Our Insider's View topic for this edition continues the discussion of fund expenses that we began in the Welcome section. We continue with the discussion of expenses because we believe the issue of fund expenses is under-appreciated outside of the industry and because it is an enormously important factor that drives performance and investment value.

There are various reasons why the importance of fund expenses is not fully appreciated. For many, numbers like one percent or two percent seem to be negligibly small. They are almost trivial relative to the things we deal with on a regular basis. As a result, they are often dismissed as relatively unimportant.

To be fair to investors, most fund companies do everything in their power to encourage the notion that fees are unimportant. A story written by John Kay for the *Financial Times* on January 30, 2009 entitled, "The charges laid against us" describes the industry position well: "The marketing of financial services emphasizes quality, not price, and for good reasons. It would be worth paying more – a lot more – to get a good fund manager. But since it is hard to identify a good fund manager, good and bad managers all charge high fees."

In his analysis, Kay provides a dramatic illustration of the magnitude of harm that can be caused by management fees. He uses the example of Warren Buffett as the basis for a thought experiment. Notably, Buffett created his wealth at Berkshire Hathaway entirely through investment returns; he has not charged fees for management. While his performance has been extremely impressive, it has been even more so because no fees were assessed to impair performance.

Kay wondered how the picture of investment value would look if Buffett had charged a "two and twenty" fee typical of most alternative products. Such a structure would separate the $62 billion in wealth Buffett created between a client and a money manager. The original investment, less management fees, would accrue to an entity called the Buffett Foundation and the reinvested management fees would accrue to an entity called Buffett Investment Management.

Kay concludes, "The – completely astonishing – answer is that Buffett Investment Management would have $57 bn and the Buffett Foundation $5 bn. The cumulative effect of 'two and twenty' over 42 years is so large that the earnings of the investment manager completely overshadow the earnings of the investor."

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We find the insights of John Kay's analysis as instructive as striking. First, even the best performance records get crushed by high fees. Second, higher fees serve primarily to enrich money managers at the expense of their investors.

Kay concludes with the lesson, "So the least risky way to increase returns from investments is to minimize agency costs – to ensure that the return on the underlying investments goes into your pocket rather than someone else's."

We completely endorse the important message of scrutinizing agency costs. We also believe it is ultimately an extremely positive message for investors. As we have shown, fund expenses are extremely important and effective determinants of investment performance. In addition, fund expenses are fairly transparent and thus are easy for investors to ascertain and compare. As a result, evaluation of fund

expenses may be both the easiest *and* most effective tools for evaluating investment value for most investors.

## 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, given our discussion of fund expenses in this edition, that the three core concepts described below are general concepts. These general concepts form an overall framework for evaluation. Fund expense is a specific metric that also captures 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 *Uncoventional 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 signficant 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 (i.e. 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.

## 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.

**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.

**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.

**Separate Accounts**

We manage separate accounts for clients rather than pooling contributions from various clients. Assets are held in custody

by a national 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.

**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.

**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.

To receive a copy of the firm's Form ADV Part II, please contact David Robertson at 410/649-0086 x710, by email at droberston@areteam.com, or by mail at the address listed below.