

# ARETE INSIGHTS

## Welcome

Technology is a great force that has been sweeping through the economy and labor market and in doing so, has been imparting big changes in business models. While these changes can no doubt be disruptive and detrimental to certain individuals and companies, in a broader sense they are undeniably beneficial to society as a whole. Nobody complains any more that there just aren't enough jobs turning grindstones.

I am especially interested in how technology has, and has not, created benefits for investors along the way. What advantages have been gained and what great opportunities await us? In short, I believe we are on the cusp of a new generation of businesses which I'll dub Investment Management (IM) 4.0. These new organizations will combine new and existing technologies in unique ways in order to provide fundamentally better value propositions for investors. Once adapted, nobody will want to go back.

First, let's look back at earlier versions of investing. In the early twentieth century, for example, simply having access to stocks was a costly privilege. Commissions weren't cheap. That system of access was vastly improved by discount brokers and mutual funds, which I'll call IM 2.0. This gave smaller investors much cheaper access to the market, but also provided access to

professional management and diversified portfolios. The next major improvement, IM 3.0, came with index funds and ETFs. These vehicles gave investors very cheap access to a wide variety of market exposures.

A key element of each phase was that technological and organizational development combined to facilitate better and cheaper access to investment products. This benefit arose in large part because technology created efficiencies which reduced waste. In doing so, investing became much more democratized by making benefits that had only been available to the relatively select few available to a much broader array of people.

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Another key element of each phase was that none of the transitions were fast or comprehensive. Partly it just took time for the value of each new version to bear out. Partly though, individuals and companies whose business models were being disrupted resisted the change. They each had a vested interest in maintaining the old ways because their existence depended on it. Unfortunately, this resistance served both to perpetuate inefficiency and to milk excess fees from naive or passive clients.

Of course different technologies have different effects on business and society and the giant technology of our era is the internet. The broader implications of the

internet were captured brilliantly in a recent book, *Race Against the Machine*, by Erik Brynjolfsson and Andrew McAfee.

The authors describe, "The economics of digital information, in short, are the economics not of scarcity but of abundance. This is a fundamental shift, and a fundamentally beneficial one. To take just one example, the internet is now the largest repository of information that has ever existed in the history of humankind. It is also a fast, efficient, and cheap worldwide distribution network for all this information. Finally, it is open and accessible so that more and more people can join it, access all of its ideas, and contribute their own."

The "economics of abundance" suggests an entirely new source of value creation. Since information and market access are so readily available, these factors no longer provide incremental value to investors. Rather, what investors need is a resource that can *leverage* technology to effectively filter through vast amounts of information, manufacture that information into knowledge, and then convey that knowledge in a way that makes them noticeably better off. Essentially the question becomes not how do we race *against* the machine, but who can *run with* the machine? In other words, who is developing IM 4.0?"

Other than Arete, I really don't know. I don't know of anyone who has leveraged technology so comprehensively in order to confer benefits to investors. Arete's clients get intensive stock selection in the dynamic mid cap universe in separate accounts for a lower fee than most mutual funds. They benefit from transparency in costs, holdings, and research. This

combination of benefits used to only be available to investors with tens of millions of dollars.

If and when you want to test out the new version of IM, I suspect you're going to be amazed at how much better it is.

Best regards,

David Robertson, CFA  
CEO, Portfolio Manager

## Insights

Seventy is the new fifty and beta is the new alpha. In the parlance of investing, beta is the measure of market exposure and alpha is the measure of active management, often security selection. In normal times, market forces function well enough such that the primary opportunities to outperform the market are confined to a relatively small number of instances of inefficiently priced securities. In other words, through alpha. The Fed's determined policy of loose money supply has turned market logic upside down, however, rewarding (at least short-term) aggressive exposure to the market as a whole instead of through studied security selection.

One clear result of Fed policy is that the excess liquidity is flowing into nearly all asset markets and is certainly boosting stock prices. With many participants worried more about losing their investment job or missing the market than analyzing risk or exercising investment discipline, the valuation of the market has become significantly detached from underlying fundamental reality. John Hussman reported the consequences in his recent

[weekly letter](#) in a directly practicable way: "As for valuations, our present estimates indicate the likelihood of sub-4% 10-year total returns (nominal) for the S&P 500 . . . and negative total returns over horizons of 5-years and shorter."

This comment corroborates and complements our own valuation work. We see precious few companies which look cheap and several that look downright dangerous. The key point for investors is to exercise significant caution regarding exposure to risk assets right now. If your horizon is less than five years, be prepared, financially and psychologically, to end up with less than you started with. That is the risk. If your horizon is longer, consider the option value of waiting for cheaper prices that may emerge between now and then.

The low rates engineered by the Fed (and other central banks) end up doing more than just compelling people to buy risk assets in the short-term, however, it affects how they opt for exposure. On one hand, persistently easy monetary policy has artificially subdued risk perception for the market as a whole. On the other, monetary policy itself does nothing to solve structural labor problems or deficient demand. As such, the nasty realities of business often still have unnerving consequences for individual stocks.

As a result, traders have had an unusual opportunity to benefit from Fed policy by taking on exposure to the market as a whole through index funds and ETFs while eschewing individual stocks. For the last few years anyway, beta has been the new alpha.

Not surprisingly, the herding of lots of people into similar buckets of market

exposure has consequences. These were addressed in a paper entitled, "How index trading increases market vulnerability" by Rodney N. Sullivan, CFA, and James X. Xiong, CFA in the *Financial Analysts Journal*.

Sullivan and Xiong found that with the proliferation of index trading, "the average beta for all equity segments over 1997-2010 shifted meaningfully higher." They determined: "In short, the growth in trading of passively managed equity indices corresponds to a rise in systematic market risk. From this finding, we can infer that the ability of investors to diversify risk by holding an otherwise well-diversified U.S. equity portfolio has markedly decreased in recent decades...All equity investing, indexed or otherwise, is thus plainly a more risky prospect for investors."

Thus, another key point is to be aware of the increasing risk associated with the market as a whole. For one, this means that a fixed amount of market exposure today is far riskier than it was 15 years ago. Your portfolio may not have changed much in terms of holdings, but it may very well be much more volatile. In addition, just as we saw in 2008, when things change, they can change too fast for most investors to react to. You need to be positioned ahead of time.

Finally, Bridgewater Associates has done some nice thinking about managing through all types of market environments with their "All Weather" fund. They start with a very simple exercise of deconstructing returns by recognizing that:  $\text{Return} = \text{Cash} + \text{Beta} + \text{Alpha}$ .

This is also an especially useful exercise for investors today. With returns on cash

essentially at zero, one can't count on that for long-term returns. With valuations and correlations at historical highs, raw exposure to markets through beta also looks like a very risky endeavor, at least over the next few years. This really just leaves active management (alpha) as a reasonable source of future returns.

The *Financial Times* recently also reported on opportunities for active management: "A 'risk-on, risk-off' herd mentality could create opportunities for active investors who take time to scrutinize fundamental factors that should determine bond or share prices over the long-term. Paul Woolley, from the London School of Economics, elaborates, "It suggests things are being mispriced. If your valuation model is good and seriously applied, then rising correlations are a wonderful opportunity," says Paul Woolley.

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First, it's important to appreciate that stocks are long-term assets. Corporations have no pre-set expiry and technically can last forever. Therefore, any valuation process ought to represent

a long period of time and incorporate the vicissitudes of business cycles, competitive markets, and changes in the cost of capital.

A final key point, then, is that returns of the past three years or so have largely been driven by simple exposure to the market, which is becoming ever-riskier. The best opportunities to realize *future* returns will come from alpha -- from finding undervalued stocks and by being selective in only allocating capital to projects likely to produce attractive returns.

## Lessons from the Trenches

One of our goals with the *Arete Insights* newsletter is to share our insights into how the investment management business really works. "Lessons from the Trenches" highlights our approach to stock research. Our intent is to share with you some of the

tips, tricks, and other tools we have incorporated into our work that may provide you some insights into how we engage in our craft.

As we have mentioned repeatedly, we believe one of the best ways to produce superior performance over time is by buying cheap stocks. We apply a variety of means to establish "cheapness" and it makes sense to better understand some of these methods and why they tend to be more effective than others.

Second, it helps to understand the nature of the task at hand. Investing is fundamentally a process of deferred gratification. The concept is that a small sacrifice today will provide something enough bigger and better tomorrow to be worth waiting for. Since short-term swings in prices contain a great deal of noise, investing is best-suited to those with long time horizons.

The best model we have found that incorporates these tenets is one we license from the Applied Finance Group (AFG). While it involves significantly more work than glancing at a P/E ratio, it allows us to do things most models and metrics cannot.

First, since it specifically integrates pro-forma income statements, cash flows and balance sheets, it directly ties forecasts to returns on capital. Those returns are then decayed in a way that fairly accurately represents the real world of business competition. Second, the AFG model allows us to adjust any of the key valuation drivers in order to conduct “what if” scenarios. This allows us to identify specific risks and opportunities for future stock performance.

A big part of why the model works so well is because it provides such a nice complement to some human weaknesses. People tend to be pretty good at spotting big contrasts -- like stock prices jumping up or down. We aren't as good at keeping track of changes that occur only very slowly over longer periods of time. In this sense, the AFG model provides a terrific “corrective lens” through which to better see stock valuations. Because we can see with greater clarity, we can have greater conviction in our ideas.

The strengths of the AFG model and how we use it also helps highlight many of the mistakes made by other market participants. One common mistake is to rely heavily on a P/E ratio. Many do this because it is quick and easy -- and it is. Unfortunately it can also be worse than inaccurate; it can be downright misrepresentative. Businesses with any variability in profitability, any cyclical, or any variance in capital spending can be significantly misrepresented by a single year's P/E ratio.

Another common mistake which we increasingly see is that of applying today's artificially low discount rate to the entire long-term stream of cash flows. The

argument goes something like, “When rates are this low, P/E ratios deserve to be higher.” This flawed logic masks over a huge risk: We don't know when rates will change or by how much. Since these rates are used to discount cash flows over a very long period of time, the overall valuation is very sensitive to this variable. If rates go up a lot, and in just a few years, the discounted value of cash flows will be very substantially lower. Applying a very short-term perspective to a very long-term proposition can result in painful disparities when things change and these misperceptions are preventable.

The AFG model is very sophisticated and we continually update and refine our work with it. This effort gives Arete an enormous advantage in calibrating what to pay for various stocks. Nonetheless, the basic lessons of our valuation work are very accessible: Beware of undue emphasis on short-term metrics that do not reflect the patterns and volatility that can be expected over the life of the asset.

While there are many investment management shops with different strengths, it really is amazing how superficial most valuation work is. Most people care a lot about not spending too much on things. They should make sure their investment managers are just as frugal in buying stocks for them.

## 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 significant 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."

There are many indications of conscientiousness and most focus on fidelity to fiduciary principles. The avoidance or forbearance of conflicts of interest, independent ownership, and sincerely helpful advice are all good signs of conscientiousness.

**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.

