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ARETE INSIGHTS

Welcome

People can do a lot of funny things and perhaps nowhere is this more evident than in the realm of investing. Oftentimes these funny things are simply a function of not having much background knowledge. Just like I benefit from the expertise of professionals in other fields to help me out at home and work, I believe many investors can benefit from the investment expertise Arete provides.

A great example of what can happen when people contend with challenges outside their realm of expertise appeared in the *Financial Times* a few weeks ago. The article featured Yale professor, Robert Shiller, who discussed the housing crisis. He noted:

"In a survey of home-buyers in four U.S. cities that Karl Case and I carried out in 2004, at the peak of the housing expectations, we found that the (trimmed) mean home price increase expected for the succeeding 10 years was 12.6 per cent a year. Maybe our respondents didn't quite understand what they were implying: that would mean more than a tripling of home prices in the succeeding 10 years from an already high level."

> "The price increases . . . were brought on by some massively unrealistic expectations."

This is interesting for several reasons. For one, the expectations defied all historical experience. Historically, home prices have risen in the low single digits. The 12.6 per cent was hugely anomalous to anyone with even passing familiarity of the historical experience. In addition, the implication of a tripling in prices should have provided a useful reality check. While the math is not something most people can do in their heads, it only takes a few seconds on a calculator. It seems like a fairly small effort to protect what comprises the largest investment for most people.

Finally, despite having incredibly high estimates of home price appreciation in 2004, home buyers' adjusted their expectations only very slowly and gradually. Shiller continues, "Already eight of those 10 years have passed, and the actual rate of increase in U.S. home prices on average for the eight years was minus 3.6 per cent a year." Despite this realized experience, expectations for annualized 10-year price increases over the same period dropped only to 5.6 per cent a year. This estimate still implies a doubling of home prices in about a dozen years!

I don't consider such misplaced expectations, by themselves, to be anything especially bad, let alone unforgiveable. We can't know everything and we're going to make mistakes. What we can control, however, is how we manage expectations, especially regarding matters that are outside our realms of expertise.

In fact, this is exactly why expertise is valuable — because it helps us establish more reasonable expectations — which provides for better decisions and fewer costly problems. I don't think I am different from most people when I take my car in to a mechanic to have it checked out if it is making a funny noise. The problem is that I just don't know if the sound represents a serious problem or not. I don't have the knowledge from which to base reasonable expectations of the seriousness of the problem. This modest effort in advance may very well save a breakdown on the highway later.

People seem to be able to go through this basic exercise with some things, but then have trouble with others. Unfortunately, as evidenced by Shiller's study, many people in the mid 2000s appeared to have some fairly unrealistic expectations for house prices. Stock prices are another area where people seem vulnerable to engendering unrealistic expectations.

Fortunately, Arete is very well positioned to help investors manage expectations in the realm of equity investing. The most important way is through a sophisticated valuation process that allows us to measure the expectations for individual stocks that are implied by current market prices. Once expectations are parsed out, we can direct our research to determine how reasonable the expectations are. This allows us to avoid stocks that are priced with overly optimistic expectations and also to target stocks that discount overly pessimistic expectations.

When it comes to expectations about stocks, Arete provides two advantages that are extremely rare in combination. One is a very sophisticated valuation model that helps us translate market prices into specific expectations for fundamental performance. These expectations can then be confirmed or disconfirmed by research.

The other advantage is the firm's independence. What this means is that I have the freedom to focus only on what I believe to be in the best interest of Arete's clients. If market expectations seem overly optimistic, I get to say so. Ultimately, this means the quality of Arete's work is unencumbered and undiluted by considerations that are not related to investment merit.

In conclusion, in the absence of good data, any of us can make mistakes as to what can be considered a reasonable expectation. What is clear is that these mistakes can be extremely costly and are often absolutely avoidable. By applying our investment expertise and extensive knowledge of mid cap companies, we substantially reduce the chances of falling prey to many of the subjective forces that can lead to unrealistic expectations.

Best regards,

David Robertson, CFA
CEO, Portfolio Manager

Insights

Last quarter we talked about some of the "nonsense" in modern investment practice and how many behaviors and incentives have evolved which can subvert the goal of serving the best interest of investors. One of the most important but least appreciated forms of nonsense is career risk.

Jeremy Grantham, one of the smartest and most brutally honest active investors, recently addressed this subject in his quarterly letter:

"The central truth of the investment business is that investment behavior is driven by career risk. In the professional investment business we are all agents, managing other peoples' money. The prime directive, as Keynes knew so well, is first and last to keep your job. To do this, he explained that you must never, ever be wrong on your own. To prevent this calamity, professional investors pay ruthless attention to what other investors in general are doing. The great majority 'go with the flow,' either completely or partially. This creates herding, or momentum, which drives prices far above or far below fair price. There are many other inefficiencies in market pricing, but this is by far the largest."

The implications of career risk in the investment industry are extremely important for investors. For one, it by no means suggests that professional investors are a homogenous group of bad people that are only looking out for themselves. Many, arguably most, care a great deal about their clients.

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It does suggest, however, that career risk can color a professional's views and affect his or her investment behavior. As a result, it can be extremely difficult for investors to get completely unbiased assessments of return and risk tradeoffs. This is extremely unfortunate because it raises yet another hurdle for people trying to be smart about investing. Not only do they need to identify the limits of their own ability to establish appropriate expectations for investments (see "Welcome"). They also need to find a source of investment expertise, and find a source that can be completely objective.

The implications of career risk are further articulated by Grantham: "Picking cash or 'conservatism' against a roaring bull market probably lies beyond the pain threshold of any publicly traded enterprise. It simply cannot take the risk of being seen to be 'wrong' about the big picture for 2 or 3 years, along with the associated loss of business."

Another well-respected writer and analyst, John Mauldin, put it a slightly different way in his recent newsletter, "Wall Street is like the carpenter who only has a hammer: everything looks like a nail." In other words, investors just need to buy more investments — at least as seen through the eyes of most investment people. "The problem with Wall Street," according to Mauldin, "is that most of what it sells does poorly in secular bear markets, so most traditional portfolios have suffered since 2000."

These insights really highlight the natural tension that resides between any agent's fiduciary duty to his or her client and the agent's own self-interest. How this tension gets resolved speaks volumes about the degree to which the agent really serves his or her client. In the case of the law profession in the U.S., for example, such conflicts of interest are considered to be such an important threat to the profession's integrity that non-lawyers are prohibited from becoming shareholders in law firms.

We also take the issue of conflicts of interest very seriously at Arete and seek to avoid them to every extent possible. As an independent money manager, Arete is completely free from interests other than those of serving our clients. In addition, we try to go even further in serving our clients and other investors as well. For example, the primary purpose of this newsletter is to share some of our knowledge of the industry in order to help all investors navigate the difficult, and crowded, landscape.

The market for investment services is a large one and a lot of different offerings with different tradeoffs can be appealing to different types of investors. For those who are looking for objective and accessible expertise, Arete represents a unique choice in a very crowded field of investment firms. In fact, two of the words we most often hear from people who are new to Arete are "refreshing" and "different." We find this very encouraging feedback because we are working hard to give investors a better choice. We invite you, or anyone you know who may be interested, to check us out.

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.

One of the most visible parts of the investment process is the purchase of new securities. This is partly due to the fact that most managers trade their portfolios much more actively than Arete does and as a result always have a lot of new things to discuss. In addition, the novelty appeal of new stocks tends to garner interest which also increases visibility.

It is a shame that new ideas so often steal the spotlight because there are many other factors that can have an equally great impact on portfolio performance. One of the most important and under-appreciated drivers of performance is the set of stocks that are researched, but not purchased. Sometimes these are great investments that just don't make it into the portfolio for whatever reason. Sometimes these are ideas that are initially compelling but upon further investigation, fail to satisfy rigorous criteria for purchase.

As part of our ongoing effort to evaluate new companies, we recently took a look at Tempur Pedic (TPX). We have been keeping an eye on the company for over a year marveling at its incredibly high economic returns on capital and impressive growth rates. The company sells unique mattresses and pillows and has been growing many times faster than the industry as a whole. Fundamentally, the stock looked interesting.

When we first ran TPX through the valuation model in February, we ran a scenario assuming that it could grow as fast as its internally generated cash flow would allow. This resulted in growth rising from mid teens to 26% over the next five years and produced a price target of $100. Relative to the price of $71 at the time, there appeared to be significant upside.

While this upside was certainly significant enough to get our attention, there were reasons to investigate further. For one, it was a troubling that the model implied that 83% of the valuation was attributed to the value of future investments. It isn't rocket science to figure out that cash flows to be produced from investments that haven't even been made yet are a whole lot riskier than cash flows from existing assets. This suggested the $100 target was more of a "suggestion" than a concrete measurement of value.

One of the great things about companies with high economic returns on capital is that much of their destiny is under their own control. Most importantly, they can fund very high growth on their own; they don't need to rely on banks or the capital markets for financing. This makes very high rates of growth *possible.*

The greater and more important analytical challenge, however, is determining what range of growth rates is *reasonable*. The challenge is exacerbated in companies like TPX because the combination of high returns and high growth is essentially multiplicative to the firm's valuation. In other words, the valuation is extremely sensitive to the expected growth rate and therefore it is important to focus on establishing reasonable bounds for growth.

As a result, we went back to the valuation model and challenged our original assumption of growth ramping up to 26%. Industry growth rates are only low single digits. How long can TPX outperform the industry by that much? Further, since growth is comprised of both volume and pricing, such high revenue growth implies that not only must unit growth continue, but the company's premium pricing must be maintained as well. We ran another, more modest, scenario which started with similar mid teens growth rates the next two years, but which scaled back growth rates to 8% in the out years of the five year forecast horizon.

With these changes, the target price for TPX dropped from $100 to $45. Since the assumptions behind the $45 target still seemed somewhat generous, we decided to forego purchasing TPX, at least for the time being.

At first we watched the price of TPX continue to climb, along with many other stocks early this year, from $71 to over $87 in mid April. Then, in early May, the stock fell below $50 in just a few days based on concerns about mattress prices being discounted.

While this is by no means the end of the story for TPX, it does provide a really good example of the importance of Arete's valuation-based investment philosophy and process. In the grander scheme of things, there is very, very little we can know with any certainty regarding short-term stock movements. What we can evaluate with much greater certainty, however, is the set of expectations implied by stock prices. This is a task which often makes the difference between temporary movements in price and permanent impairments of capital. It is also one which Arete is especially well-equipped to manage.

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 *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."

There are many indications of conscientiousness and most focus on fidelity to fiduciary principles. The avoidance or forebearance 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 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 (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.