Mid-quarter Q2 2013
Volume 5, Issue 2

Arete Insights

Welcome

One of my personal characteristics is that I tend to gravitate to issues that are particularly uncertain and challenging. I do this partly because I always learn more from challenging issues and partly because it is more fun and more rewarding to find or create a way through a path of obstacles than to sit and do nothing. Needless to say, I get bored easily!

One consequence of these tendencies, however, is that they can send the wrong signals. Although my attention to potentially adverse outcomes is normally rooted in curiosity and concern for Arete's investors, I know that it can easily be (mis)perceived as a commentary on the probability and magnitude of such risks.

To be sure, I think there are plenty of chances for investors to lose money in the markets at these levels. That said, I also have a very significant part of my net worth tied to the long-term opportunities for active management of stocks. I wouldn't make those commitments if I wasn't extremely optimistic about the longer-term opportunity to improve one's well-being.

This partial paradox creates an opportunity to discuss some of the things I see on the horizon that I think will bode well for the economy and for stocks. While part of my optimism is rooted in my belief in the ability of humans to successfully adapt to a wide variety of conditions, these particular comments will focus on content from the short but powerfully insightful book, *Race Against the Machine: How the Digital Revolution is Accelerating Innovation, Driving Productivity, and Irreversibly Transforming Employment and the Economy*, by Erik Brynjolfsson and Andrew McAfee.

We have all seen technology improve and dramatically alter our work environments. Some have had their jobs threatened by technology. But did you know that the best chess player in the world right now is not a person or a computer, but "a team of humans using computers?" It turns out, in the words of Brynjolfsson and McAfee, "Weak human + machine + better process was superior to a strong computer alone and, more remarkably, superior to a strong human + machine + inferior process." In short, the thoughtful combination of human skills, technology, and process are pointing the way to ever-higher levels of performance and productivity.

One of the reasons why people often get intimidated by technology is because the exponential trajectory of its advance quickly outdistances simple linear development. This trend is well captured by Moore's Law which has accurately forecast the doubling of transistors on integrated circuits every 18 to 24 months.

While this is true, it is also true that "Combinatorial explosion is one of the few mathematical functions that outgrows an exponential trend." This ends up being terrific news for us non-machines: "Because the process of innovation often relies heavily on the combining and recombining of previous innovations, the broader and deeper the pool of accessible ideas and individuals, the more opportunities there are for innovation." The authors conclude that "combinatorial innovation is the best way for human ingenuity to stay in the race with Moore's Law."

Finally, it is useful to step back and view technology in the context of history. Economist Paul Romer described in the book: "Every generation has perceived the limits to growth that finite resources and undesirable side effects would pose if no new … ideas were discovered. And every generation has underestimated the potential for finding new … ideas. We consistently fail to grasp how many ideas remain to be discovered … Possibilities do not merely add up; they multiply."

Romer also makes the point that "perhaps the most important ideas of all are meta-ideas—ideas about how to support the production and transmission of other ideas." Indeed, "The digital frontier is just such a meta-idea—it generates more ideas and shares them better than anything else we've ever come up with." Not only do ideas multiply, but we seem to be right on the threshold of enjoying technologies that enable more and better multiplication.

"Every generation has perceived the limits to growth that finite resources and undesirable side effects would pose if no new … ideas were discovered. And every generation has underestimated the potential for finding new … ideas. We consistently fail to grasp how many ideas remain to be discovered."

None of this is to say that we human beings can just ride this wave and have our needs taken care of. We will need to actively participate, invent, and adapt ourselves to avoid obsolescence. For those who are up to this challenge, however, the world of tomorrow is quite likely to be far better than that of today.

Best regards,

David Robertson, CFA
CEO, Portfolio Manager

Insights

Let's say there is a game in which you repeatedly ante up some money and – BAM! -- you lose it; it's gone. Every once in a while you win a big pile, but over time you always lose more than you win. This may seem like a gamble and not a sensible thing to do with money and you'd be right: it is essentially the model for slot machines.

It's a bad game in that regular play will always induce losses. Most people who are serious about investing can't think of anything less enticing than throwing their money away like this. They may also harbor similar sentiments about the stock market and to some degree they would be right given the investment landscape today.

Consider an analysis of the landscape from John Hussman in his recent weekly letter: "When overbullish conditions have been in place [in combination with favorable trends and overvaluation – as they are today], the overvalued, overbullish conditions have dominated, producing a negative excess return averaging -3.3%." In other words, investing in the market in conditions that persist today is likely to produce negative returns over an intermediate time horizon. You are essentially throwing money away. Although the payoff structure is different, current market conditions make the proposition of investing in equity indexes something similar to playing slots.

Framed this way, index investing seems almost ludicrous. Yet in reality it often feels like an extremely difficult choice: If I'm not investing in stocks, where can I go?

As with many challenges, it often helps to return to first principles. Hussman also writes, "The core structure of nearly all optimal portfolio allocation models is that investment exposure should be relatively proportional to the excess return that can be expected per unit of risk." In other words, what we're really trying to do is determine where and when to take risks.

So in one sense, the question of where to go is easily answered: if expected excess return is negative for some period, investment exposure should, at best, be zero. You always have a choice and if one alternative is a bad one, you can always refuse to play.

The fact that the "just say no" option is not strikingly obvious speaks volumes about today's investment landscape. One factor that explains the willing acceptance of a poor risk/reward tradeoff is the enduring effect of the "equity culture." The strong returns on stocks from 1982 through 2000 still live happily in the memories of many of today's investors. As a result, strong equity returns are considered "normal" by many and an entitlement by some. Positive emotions about stocks can serve to soften or even completely obstruct the perception of risks.

Another reason why more investors don't accept the "just say no" alternative is because they feel coerced by the Fed's quantitative easing measures. To be sure, The Fed has continued to strongly support risk assets ever since the financial crisis emergency in 2008. While it may be tempting to ride the Fed's quantitative easing "wave", that wave will crash -- but nobody knows where or when to step off safely. This does not sound like a particularly good proposition for long-term investors to accept either.

"While it may be tempting to ride the Fed's quantitative easing "wave", that wave will crash -- but nobody knows where or when to step off safely."

The differences between weak economic fundamentals and booming equity markets will be reconciled and when they do, it will dramatically change the perceptions of investing and risk. It will also have a huge effect on the investment industry.

Gary Shilling addressed this issue in his latest *Insight* newsletter by predicting that "Low investment returns will discourage do-it-yourself investing and encourage the use of professionals." As people eventually realize that returns are not an entitlement and that investment mistakes can be incredibly costly, we believe Shilling's forecast will prove prescient.

Shilling's forecast for the investment business recognizes important obstacles as well. He describes, "The challenge, however, is for these asset managers to be profitable at fees that don't consume major shares of investment returns." Further, "At the retail level, the trick is for asset managers to make customers feel like individual clients but at low costs."

We are heartened by these comments from such an insightful and successful market participant because they corroborate our thesis for founding Arete. It has always been important to distinguish "bad games" from "good games" when putting money into equities. Our valuation work has been an ongoing effort to differentiate good games from bad ones on a company-specific basis. Now, in the context of extremes of credit consumption and monetary policy, it is also important to actively manage exposure to various risk assets.

While unusually loose Fed monetary policy has masked the value of these features the last few years, they will be gold when market prices and fundamentals reconnect. Much like a well-built house, the quality of construction is its own insurance when the storm hits.

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.

An important part of the job of an analyst is to filter through piles of information efficiently in order to aggregate enough tidbits to generate a unique insight or perspective on a stock. One of the surprisingly robust sources of such tidbits is the proxy statement. Partly because it provides such a rich seam of information and partly because its value is much greater in the context of other analysis, I have integrated proxy reviews with the research process at Arete. While there is usually a lot of legal boilerplate language to wade through, there is also a great deal of information content awaiting the diligent analyst.

Some insights are fairly straightforward. For example, when executive incentive plans list operating targets and rewards for the fiscal year in progress, these numbers can be used to calibrate estimates. More often, operating targets are posted for the past year, but even then they can be reviewed for their degree of difficulty. In other words, you can gauge how high (or low) the bar is for executives to receive their "pay for performance."

Such revelations can say a great deal about how ambitiously the board engages its fiduciary duties. Ultimately, I think this is one of the most important variables in company valuations, even though it is extremely subjective and qualitative. Because it shows the degree to which board members embrace or eschew their responsibility to shareholders, it gives a strong indication of the extent to which shareholders can expect to benefit from the economic functioning of the company.

Some of the other questions I ask when reading proxies include: Does the company operate in an industry which involves a lot of assumptions to determine earnings per share (such as managed care organizations) AND use earnings per share as a metric for incentive compensation? This may point to a conflict of interest. Does the company provide substantial stock options as part of the compensation package? This can encourage risk-taking with a lot more downside for investors than for executives. Does the board seem too "cozy" with several board members serving more than ten years, or having lots of interrelationships, or including many former executives of the company? Any of these factors can suggest less than complete dedication to shareholder interests.

There are also a few items that I take special issue with. For example, I don't believe there is any good reason to maintain a classified board. In this day and age of instant access to information, why would any responsible board want to intentionally delay feedback on board members by only asking for a vote every three years?

In addition, some companies report a relationship with their current auditor lasting decades. Some pay auditors very substantial fees for non-audit activities. Both of these situations suggest a high likelihood of conflict of interest that can forebode problems.

It is important to note that none of these items in isolation necessarily means very much. There are rarely black and white issues regarding the nature of the board, the quality of governance, or the attractiveness of the investment opportunity. In fact many of the better investments involve ambiguous or apparently negative situations.

There are cases, for example, in which a CEO also serves as chairman of the board but runs the business so well that shareholders benefit from that expertise. There are also examples of executive teams that are significantly overpaid but are outstanding operators and stewards of capital in every other respect. There are also poor performing boards overseeing poorly performing businesses that happen to own great assets. These can be very attractive candidates for takeover or for improvement by activists.

The bottom line is that proxies are often replete with information that can provide nuance and texture to quantitative analysis. These insights can lead to a more accurate set of expectations and can also inform better risk management.

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.

Arete Asset Management

Arete Asset Management, LLC, Business address: 729 E. Pratt St., Suite 700, Baltimore, MD 21202
http://www.areteam.com drobertson@areteam.com 410/649-0086 Toll Free: 866/526-6008