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# ARETE INSIGHTS

## Welcome

It is not uncommon knowledge that many of the best investors tend to be contrarians — often taking positions that are at odds with conventional wisdom. While contrarian tendencies have tended to serve me well as an investor, they often complicate the process of communicating Arete's message.

The complication arises from the gap between my views and interpretations of things as a contrarian investor, and the views and interpretations of people who have devoted themselves to pursuits other than investing. My goal is to share some of the insights I have gained from working within the business for so long and to highlight some of the practices that can work against investors' interests.

The first topic in this edition concerns fiduciary duty, which is the responsibility to act in a client's best interest. Unfortunately for investors, there is an incredibly wide array of interpretations of fiduciary duty and worse, the standard does not apply in any legal sense to vast swaths of the business.

The second topic involves some of the key elements of Arete's approach to stock research. When I talk to people about stocks what strikes me more than anything else are the number of assumptions and mental models people use that I think are completely inappropriate for long-term investment success. This is my effort to help bridge the gap.

I always enjoy talking about the money management business in general and about Arete in particular. If you are going to be in downtown Baltimore, please let me know, I'd love to get together. I enjoy sharing the ideas I have and it also helps me to hear what investors are most concerned about.

Thanks and take care!

David Robertson, CFA
CEO, Portfolio Manager

## Insights

*You say tomato* . . .

Variety is the spice of life and we enjoy it as much as anyone. In fact, if it were not for differences in opinion, our job of picking stocks would not exist — a point that is never lost on us. Different people have different perspectives and viewpoints and that is part of what makes life so colorful.

Sometimes though, we say the same thing, but mean something very, very different. Often this happens when people have different value systems or mental models from which they make sense of how the world works. This phenomenon is especially evident in the investment management business and its importance is often underappreciated.

How many times have we heard, "We are here to serve our clients"? What does it really mean? It clearly means something different for Goldman Sachs than it does for some of their CDO (collateralized debt obligation) clients. One of the ways variety gets manifested in investment services is through the vast array of approaches and attitudes toward client relationships.

Many of the standards for service in the investment industry are prescribed at least in part by regulation. Registered representatives (brokers), for example, are held only to the standard of selling securities that are "suitable" for their clients. Once suitability is determined, the operative standard is *caveat emptor* (buyer beware).

The suitability standard is far different, however, and considerably lower, than the standard of serving in a client's best interest. Indeed, only registered investment advisors (RIAs) are formally bound to the standard of fiduciary duty. Although many other industry players may perform similar *functions*, they are not held to the same service *standards*. We believe this is a critically underappreciated aspect of the business.

In order to capture the difference in standards, imagine if brokers had to issue a disclaimer before engaging in any stock transaction. The warning might read something like: "I have no obligation to act in your best interest; my obligation is to serve my employer. I am not required to have formal training in investments. I get paid on the basis of initiating transactions which creates an incentive to maximize transactions and may very well serve to reduce your wealth."

All of this is not to say there aren't very good brokers with a great deal of integrity — clearly there are. Instead, it is intended to delineate exactly where professional obligations end, and trust needs to take over.

That there are differences in standards is only part of the problem. Quite clearly there is also enormous "variety" within the RIA community regarding what constitutes fiduciary duty.

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The concept of fiduciary duty is normally applied to investment securities and portfolio construction, but it is hard to understand why it should stop there. Importantly, virtually all asset managers charge on the basis of assets under management which, by definition, detracts from returns. As such, it is difficult for us to see how charging excessive fees can fulfill an obligation to act in a client's best interest.

Some recent research into industry compensation reveals the magnitude of this problem. John Plender recently reported in the *Financial Times:* "Academics Thomas Phillipon and Ariell Reshef estimate that 30 – 50 per cent of the wage differential between the US financial sector and the rest of the private sector comes from rent-seeking — the economist's euphemism for ripping off customers in opaque and inadequately competitive markets."

Gillian Tett and Kate Burgess, also reporting for the *Financial Times,* capture some of the mechanisms at work in the industry*:* "While in much of the western business world the trend has been to remove middlemen, investing has gone in the opposite direction. Not only did the sector expand at a startling rate in recent decades but the 'investment chain' that links those supplying capital with the people who ultimately use it has become fiendishly complex, riddled with agents creaming off fees along the way."

To us, the standard of acting in the best interest of our clients is not hard to articulate. Indeed, is not really any different than: "Do unto others as you would have them do unto you." By this standard, we believe reasonable fees are an essential component of fiduciary duty. We don't want our investment returns slashed every year by excessive fees so we don't inflict them on our clients either.

Much of this discussion of service standards may be considered little more than a frivolous nicety. We argue that a service standard can represent far more than a standard for interaction, it can represent a critical component of risk management.

We think of the nature of client/vendor relationships as being a bit like insurance. When times are good, it is easy to rationalize skipping premiums on an insurance policy by working with people you may not completely trust. When times are tough though, the lack of an insurance policy, in the form of an advisor truly acting in your best interest, can be potentially devastating. This holds true for individuals and institutions alike.

In conclusion then, the same expression can mean very different things to different people. Within the investment management business, serving clients can mean very different things. While the phrase *caveat emptor* has historically guided much of the business, there seems to be an opportunity for much of the business to graduate to a higher standard. Arete was built on the principle of applying a higher standard to fiduciary duty and we look forward to showing you exactly what we mean by it.

## Insider's View

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

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

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

When we talk to people about stocks, many often have questions about our process of doing research. Several have asked us specifically to provide more insight into how we go about selecting stocks so we thought this would be an appropriate place to do exactly that.

First, and importantly, this exercise will not be a tutorial on how to pick stocks. It is simply not possible to easily and quickly capture all of the education, experience, and insights of a career in the business.

That said, the exercise need not be mysterious and arcane either. We are always skeptical of processes or explanations we cannot understand. We normally find that when explanations are obtuse, they are either intended to mislead, or are reflective of lack of understanding. Our approach is designed to be clear and understandable. If it is not, please let us know.

With so many things to talk about, we will begin with a bit of philosophy. When we consider the nature of stock picking deeply, we believe it is essentially, and in a very general way, an exercise in attaining knowledge. As such, it makes sense to think about what knowledge is and how people arrive at a state of being knowledgeable.

The way we illustrate our working model of knowledge attainment is through an analogy to manufacturing. The model involves three primary components. The first is data and information which are the "raw materials". The second component consists of the models and analytical frameworks which are the fabricated "parts" of knowledge. The third component is "assembly" which pulls all of the pieces together, connecting them into one cohesive unit. Combined, we have what we call knowledge.

Applying this model should make it a bit easier to understand what goes into our process for stock research. We start with gathering information and data on various companies. We use that information to feed various models and analytical processes in order to generate incremental insights. We then evaluate multiple hypotheses and potential future scenarios, and confirm and disconfirm evidence for each. When we pull everything together, it constitutes our "knowledge" of an investment and can be compared to what the market is discounting.

"Our research efforts focus on uniquely adapting various models and synthesizing insights gained from various thought experiments."

This model of knowledge attainment sheds light on two aspects of our research process. First, the model is a very general one that is by no means proprietary to stock selection or money management. In an important sense, what we do is no mystery; it is what any professionals do in their areas of expertise. As a result, most anyone should be able to apply the model to their area of expertise and quickly identify where they have advantages over less experienced players.

The second aspect highlighted by the model is the chain of value in the research process. We often get asked about our data sources, screening methodologies, and so on. As the model suggests, however, these items are raw materials, are normally commoditized, and as such, do not contribute much value to the end product.

The most valuable components of Arete's research process involve the fabricated "parts" and "assembly". Specifically, our research efforts focus on uniquely adapting various models and synthesizing insights gained from various thought experiments.

While this is a very high level view of the research process, hopefully it lays a strong foundation for understanding how we look at stocks. In future issues we will delve into more detail about the components of 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.

**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."

**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