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ARETE INSIGHTS

Welcome

I'm just returning from the CFA Annual Conference in Scotland so what better subject to discuss than golf! It's not that I'm a particularly avid golfer, and certainly not a very good one. However, I do enjoy playing once in a while and have played enough to appreciate how fiendishly challenging it can be at any level.

I can also appreciate how phenomenally good the pros are. They have shots for every condition and every situation. They can shape their shots to the fairway. They are remarkably strong and flexible. On top of it all, they are incredibly consistent. When a novice makes a mistake, he or she whiffs and misses the ball completely. When I make a mistake, I slice my drive 80 yards into the trees. When pros make a mistake, their 300+ yard drive gently rolls into the rough.

We all understand such exceptionalism intuitively. We watch professional sports to see the very best athletes. We read books written by the smartest and most creative writers. We watch great actors create scenes on TV that are so realistic as to engage our attention and emotions.

Most people also easily understand excellence relative to their own areas of expertise. What have you done in terms of education and practice and commitment to get really good at what you do? Is it easy for "non-professionals" to replicate your skills? Can amateurs match your success by just getting lucky? Could they sustain that success over a long period of time? For most people, the answer clearly is, "No!"

Despite the natural tendencies to admire and seek out exceptionalism in most parts of our lives, I am always surprised by how many people seem to reject or avoid exceptionalism when it comes to investing. Some have even worked pretty hard to "prove" that skill is irrelevant to investing. They believe skill cannot meaningfully differentiate returns.

There are a couple of reasons why people treat investing differently than almost every other part of their lives. The first reason is that when you watch exceptional athletic performances, the results are obvious and immediate. When someone chips out of a bunker and holes it, you know it's a great shot.

With investing, however, things are far less obvious. It can be months or years before great analysis is finally realized. Even then, because of time lags and indeterminate future events, great analysis is not always realized in the form of outperformance. Sometimes the value of quality analysis reveals itself more in loss avoidance, risk management, or robust portfolio construction. Regardless, it is very difficult to accurately infer skill from performance with investing, especially over short time periods.

The second reason why people treat investing differently is that the field is wide open. Most competitions are closed to amateurs and novices. Not so with investing. Virtually anyone can play as long as they disclose what they do. This makes for a very crowded field with participants spanning the entire spectrum of talent levels.

This "open" format for investing further adds to the difficulty of judging skill. Given the incredibly large number of competitors, it is virtually impossible to fully evaluate all of them. As a result, about the best one can do is to watch a relatively small number of participants for long enough to make an assessment. This takes time and effort itself, and many find it easier to avoid the evaluation process altogether.

This is unfortunate, because exceptionalism exists in investing, just as it does in every other human endeavor. Think of it this way: What if you found someone who invests the way you would if investing was the one thing you devoted your entire career to getting exceptionally good at?

I founded Arete to be a great investing partner. If this sounds like an interesting proposition to you, please let me know. Perhaps Arete could be a good fit with your investment needs.

Best regards,

David Robertson, CFA
CEO, Portfolio Manager

Insights

Have you ever been in a position when you paid more for something than it was probably worth, but the convenience was important to you? Perhaps you needed milk and the 7-11 was much closer than the grocery store. Or maybe you were travelling and it was just easier to pay $20 for a burger at the hotel restaurant. In both cases, time and location are important variables.

This business arrangement is common in many industries. It involves adding intermediaries, often known as "middlemen", to a supply chain in order to improve distribution. In other words, it makes it easier for people to get things. The tradeoff, however, is that it costs more to get those things. It is common to find such arrangements for relatively low cost, short-lived products for which convenience is imperative.

The last place one would expect to find such arrangements is with relatively expensive items that have long lives. Because these items involve more money, we would expect buyers to do more research to get a good deal. Also, since these items are intended to be long-term, convenience provides very little benefit. For example, all else equal, why would you pay 50% more for a house in order to buy it quickly?

Oddly enough though, this is exactly what happens with a lot of investment products. According to a draft IBM report noted in the *Financial Times*, "An army of consultants, advisers and distributors has emerged to act as middlemen in recent decades, distancing the global asset management industry from its ultimate customers." In the process of distancing asset managers from customers, "increasingly powerful distributors [are] taking a greater share of the spoils, at the expense of asset managers."

The bottom line is that the industry is "paid too much for the value it delivers."

While there is plenty of blame to go around, there is no doubt that more and more powerful middlemen are extracting significant sums from investors. In the face of the headwinds of lower economic growth, and lower discretionary income for many people, investors continue to pay a premium for convenience by shopping at the "7-11" for investment products.

An alternative course of action is to accept less convenience in return for lower costs by avoiding intermediaries. The technical term for this practice is called "disintermediation" and was one of the theses behind the internet boom. Just like it is cheaper for people to buy books on Amazon than at a Barnes and Noble, so too it is cheaper to buy many investments directly through a money manager than through a broker or adviser.

Importantly, many investors may value the services of a broker or adviser, just like they may find it useful to actually visit a bookstore. The main point, though, is that when you are on a budget, it is important to pay only for what you really need. This is doubly important with investing because any fees avoided can also be invested.

Arete was built on the idea being able to offer an extremely affordable, actively managed portfolio by keeping marketing costs as low as possible. We don't like paying up for things we don't need so that is what we also offer to our clients. We provide a great deal of information on our website at www.areteam.com so you can evaluate our offering in a very cost-effective way. Further, we are always available by email and phone if you have questions. Please let us know if you are interested!

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. Due to several requests from readers, we have created a new section to expand upon the scope of our "Insider's View." "Lessons from the Trenches" will highlight 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.

The Baltimore CFA Society (BCFAS) recently hosted an educational luncheon featuring Jim Valentine, author of *Best Practices for Equity Research* Analysts and founder of AnalystSolutions. This type of event is a great example of the value BCFAS provides its members, but is also a great example of how BCFAS makes investment-related insights available to the broader community.

Having been a top-rated Wall Street analyst for several years, and having served as Director of Training for Morgan Stanley's global research department, Valentine has strong credentials in equity analysis. One might have expected him to come out talking about esoteric modeling tools and the like. Instead, he offered a much more philosophical approach, which in many ways amounted to lessons for knowledge management. Three of the key lessons he shared apply equally to individual investors as to professional analysts.

The first lesson is that investment calls need to differ materially from consensus. This is often difficult for individual investors to fully appreciate. If you hear an idea on CNBC or read it in the paper, the chances are millions of others are doing the same. As a result, the idea gets discounted very quickly and efficiently yielding no special benefit.

One way to gauge the uniqueness of an investment idea is to consider exactly how it differs from consensus. Do you have a much more accurate financial forecast? A better valuation approach? Or do you understand sentiment around the stock better? If you don't, you don't stand much chance of beating the market.

Another lesson is to be selective with information. In a world where information is cheap and prevalent, the analyst's job is to efficiently filter out the stuff that is just background noise, so he/she can focus on the things that really matter. We simply do not have the time to do everything and need to choose wisely. What are the two to four critical factors that really drive the stock? If you don't know, you may be focusing on the wrong things.

Finally, it is important to have some edge or competitive advantage. Lots of very smart people are all doing the same thing trying to make money. What makes you special? Do you have an especially effective valuation methodology? Do you have proprietary information resources? Whatever it is, you need something to stand out from all of the others.

At Arete, our research effort is absolutely core to the mission of delivering functional excellence in money management. These are the things we do every day.

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