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ARETE INSIGHTS

Welcome

The money management industry is undergoing what may be its most fundamental change since I've been in the business. Nowhere is this more apparent than with the enormous outflows from actively managed mutual funds.

While there are surely several reasons for this mass migration, there is no doubt that one big impetus is dissatisfaction with the poor value proposition that many mutual funds offer. Costs to manage funds have come down substantially, but management fees have remained stubbornly high. And this doesn't even begin to address performance and service issues.

A good deal of money is flowing into passive equity funds because they are cheaper. Money is also flowing into bond funds because they are perceived to be safer. These are certainly reasonable responses, but I also strongly suspect that these actions more accurately represent the beginning of a fruitful journey rather than a destination.

> "Most market indexes represent a systematic implantation of valuation errors."

The recent activity especially highlights the debate between active and passive management. While I very much believe in the value of passive investing in providing cheap and easy access to market exposures, index funds and ETFs are not perfect and will not solve all investment challenges. Further, as an ever-higher proportion of equities are held by passive funds, the tradeoffs between active and passive management will become increasingly important.

One of the most intuitive and effective ways to appreciate the value of active management is simply by observing the universe of 1500 mid cap stocks. These stocks vary in market cap from $1 billion to $20 billion, span all economic sectors, range from young companies to those over a hundred years old, and have growth rates and returns on capital that span the spectrum. It defies all reason and experience to expect all of these extremely diverse stocks would be anything but substantially differentiated in attractiveness as investments.

Given the countless ways in which differentiated performance permeates our lives (the Olympics is a great example!), it never ceases to amaze me how strongly some people feel that it can't happen with investing. I founded Arete partly because I believe it makes sense to profit from these disparities and partly because I see active management as one of the best ways to invest my own money.

In contrasting active and passive management, it is also useful to look closely at the way index funds work. An important and often overlooked aspect of most indexes is that they are weighted by market caps. This has the deleterious effect of overweighting overvalued stocks on one hand and underweighting undervalued stocks on the other. As such,

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most market indexes represent a systematic implementation of valuation errors. When market participants buy certain stocks simply because they are going up (momentum investing), it compounds the valuation errors inherent to market cap weighted indexes. This is an important risk with index funds.

Another important difference between active and passive investing regards corporate governance. Some activist investors use the combined levers of stock ownership (or sales of stock) and corporate governance to agitate for change at poorly performing companies. While passive fund managers can send a message to management teams through the proxy process, they are completely powerless to reinforce the message with action. I am quite sure that corporate boards and managers are well aware of how much pushback they may or may not get from investors when formulating executive compensation and other policies. Active investing is necessary to hold managers to task for upholding their responsibilities to shareholders.

Finally, for the sake of argument, let's imagine a world in which everyone owns index funds. No-one owns stocks directly or through active funds. When a company launches a new product, or makes an important discovery, or adds a huge new client, who would be there to adjust the price to reflect the change in underlying value? If all investors were passive index investors, these fundamental changes would never get reflected in the stock price.

Now let's assume a less extreme situation. Let's assume there are just a handful of active investors and everyone else is passive. This would produce enormous profit opportunities for a small number of investors at the expense of everyone else. The lesson is that active investors are essential to doing the bidding in order to keep markets reasonably efficient. Too many of them and there will be too few opportunities to support them. Too few, and prices will become wildly inefficient. At the end of the day, just like in any other system, there needs to be a balance.

Philosophically, I see important benefits to both active and passive methods. I don't at all dispute that many active funds provide poor value and that many index funds provide useful and cheap access to market exposures. I think it is extremely important though, for investors to be aware that there are tradeoffs and therefore no easy rules-of-thumb.

It will be important for investors to appreciate that simply having exposure to markets may not provide enough return for them to meet their financial goals. It is also important to understand that in an environment of low expected returns and significant risks, it will be ever-more important to seek out the opportunities that do emerge. If you or someone you know is interested in learning more about the opportunities for active management, I'd be happy to discuss how Arete might be able to help out.

Best regards,

David Robertson, CFA
CEO, Portfolio Manager

Insights

The value investment philosophy has proven to be extremely successful over long periods of time and across many different markets. While there are many strategies that can work at various times, valuation has proven to be an extremely robust way of making money.

As happens periodically, however, the excellent historic record of valuation-based strategies has been noticeably challenged recently. For the two years since July 2010, the Russell Midcap Growth index has outperformed its value counterpart by over 2% per year. While such periods of performance differentials are not uncommon, this particular one foots suspiciously well to the initiation of quantitative easing by the Federal Reserve beginning in the latter half of 2010.

It is clear that the Fed has engaged in such actions with the intent of keeping the economy humming along by staving off deflationary forces. Despite these extraordinary efforts, however, the US has experienced one of the weakest economic recoveries in its history, unemployment remains extremely high, and recent data points to further slowing from already anemic levels.

We believe the continued economic limbo, and underperformance of valuation strategies, can be at least partly explained by a behavioral response to changes in the business landscape. Specifically, Gillian Tett discussed the role of investors' assumptions about risk in a recent *Financial Times* article.

Citing the research of anthropologist Michael Thompson, Tett describes two important dimensions of assumptions about risk. For one, power can be concentrated vertically in an organization or government at one extreme, or broadly distributed across a crowd horizontally at the other extreme. High levels of government intervention in the market since 2007 have "trumped the power of the crowd in ways that feel alien to investors."

A second important assumption about risk regards the way in which power is exercised. Societies can operate anywhere on a spectrum between a benign, accountable manner and a capricious and harmful one. As power gets exercised in more capricious ways, people become more fatalistic, and adapt their risk management strategies accordingly. The two assumptions are captured by the questions, "Do we assume anybody is in charge, and is the power structure benign?"

> "When the rules are clear, the referees are fair, and the goalposts can't be moved, the game is known and dynamic competition can ensue."

We believe an unintended consequence of "extraordinary" action (as relates to the Fed and other government policies) is the perception of ever-greater capriciousness. This is particularly harmful to the economy and markets in a couple of ways. First, an important part of the valuation-based investor's credo is to include a margin of safety in one's assessment of value. In a world of capriciousness and whimsy, this is excessively difficult to do. The downside is almost always in the ballpark of zero if you just don't know what law might be created

to render your business uneconomic or which policy might unfairly advantage your fiercest competitor. Investors and entrepreneurs don't avoid risk, they avoid bad risks.

Second, value investors are the "sheriffs" of the market in an important sense. In a chaotic and desolate landscape (picture the Wild West, for example), there is virtually no limit to human behavior. In the market, the floor to valuations is normally provided by value investors who, in their own self-interest, see significant opportunities for profit. In doing so, they act out of principle rather than following the herd and these actions establish downside limits to valuation. In the absence of such investors, however, there are virtually no downside limits.

This is often intuitive for entrepreneurs, business managers, and anyone tasked with allocating scarce resources to risky projects. When the rules are clear, the referees are fair, and the goalposts can't be moved, the game is known and dynamic competition can ensue. When these conditions do not apply, however, it makes little sense to accept unknown risk for unknown reward. The consequence is that many participants withdraw.

This behavioral dynamic is useful in more than just explaining our economic limbo. This understanding also informs us as to how the situation can improve. In the context of too much debt and weak economic growth, and assumptions of increased capriciousness in policy-making, it will be incredibly beneficial to have a clear and credible roadmap for reducing the debt and deficit. An environment of more benign and accountable exercise of power would facilitate much more normal levels of business activity and investment.

Further, despite rich valuations for the market as a whole, there are several cheap stocks and many of the fundamental strengths of the US economy remain in place. Once the reins of capriciousness are released, we expect the drivers of healthy economic growth to return. When that happens, a much more fertile landscape will also be available to valuation-based investment strategies.

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.

In a landscape of uncertainty, it helps to have as many landmarks and signposts as possible in order to navigate successfully. In efficient markets, prices generally serve as good landmarks because they generally represent underlying value fairly accurately. When prices do not serve as very good landmarks for value, however, it is easy to get lost or to head in the wrong direction. As a result, it is extremely useful to be able to judge the quality of available landmarks.

Most of the time, most prices in US markets fairly accurately represent underlying

values. This happens because there is a large and diverse group of active participants, each with the intent of making money. The lively interaction that ensues among participants ensures that information gets discounted in market prices very quickly and efficiently.

Under these conditions, prices can deviate from fair value, but tend to do so only sporadically, over relatively short periods of time and on an idiosyncratic basis. In other words, most landmarks are useful most of the time. As long as you can take an occasional false signal in stride, you should be able to find your way fairly comfortably.

There are times, however, when the market does a poor job of establishing useful landmarks in the form of accurate prices. It is extremely important for investors to recognize when this happens so they can switch to other navigational methods and stay on track.

The conditions which reduce the quality of landmarks are exactly the opposite of those that provide for accurate prices. For example, when money flows out of a market, it tends to reduce activity (lower volume). Also, when certain types of investors opt out of market activity, the market becomes more homogeneous.

The situation that arises out of these conditions is like a boat full of people. A market with a lot of volume is more stable, like a large boat. A market with a broad mix of people is also more stable, like a boat with people distributed fairly evenly across it. When people on a small boat all tend to rush to one side at the same time, however, it creates a dangerous imbalance that can cause the boat to tip over.

It's important to beware that when a small boat like a canoe tips over, it often says more about the clumsiness of the paddler than it does about the turbulence of the water. In the context of the market, this means that under certain conditions, prices and price moves often say more about the market and its participants than it does about underlying value.

This provides a useful background for better understanding some recent market activity. Market volumes have been coming down for some time and are even lower now amid the late summer slowdown (picture the small, unstable canoe).

We also know there are market participants that can act in a uniform fashion. One example of potential homogeneity is algorithmic trading. These are software programs designed to implement trades. Index funds, for example, use algorithms to manage positions when investors buy or sell shares.

At the end of July, Knight Capital Group (a market maker comprising about 10% of market volume) implemented new software. When it did, the program automatically, and inadvertently, started transacting swaths of stocks that were much larger than intended (picture a paddler shifting all of his weight to one side of the canoe). The result was a big imbalance that caused a "splash" in the form of several stock prices being significantly affected. Notably, the mechanisms involved were similar to those in the "flash" crash of May 2010.

When situations like this occur, it is easy to see how prices can be significantly affected by factors wholly unrelated to underlying value. As such, they can produce periods

of wild and seemingly capricious stock moves that can be confusing and disheartening for many investors.

Fortunately, one need not wander aimlessly when markets prices do not provide useful landmarks. If you know a market has low volume and is vulnerable to herding, the first order of business is to be extremely skeptical of prices as accurate landmarks.

The next order of business is to find a way to validate existing signals and/or find a better set of landmarks. This is exactly what makes a valuation-based investment strategy so useful. Valuation provides an analytical basis for determining what things are worth. As such, it is insulated from the market conditions that can periodically distort price signals.

Since most of us have not arrived at our retirement destination, we will be continuing a journey to reach our investment goals. When it's hard to navigate by traditional landmarks, inaction is not a useful option; it will only guarantee you won't reach your destination. Arete's valuation process can help show the way.

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.