Mid-quarter Q3 2014
Volume 6, Issue 3

ARETE INSIGHTS

Welcome

As I mentioned in the last quarterly report, a key competitive advantage for Arete has been the strategic integration and implementation of technology. This serves many higher goals not least of which is to keep expenses down for our clients. In addition, the thoughtful application of technology has also vastly improved nearly every aspect of Arete's operations including increasing the efficiency of various administrative processes, reducing error rates, and improving the entire process of building and manufacturing knowledge.

With this as context, it should be no surprise that we are again in the process of leveraging technology to improve our services. As many of you are aware by now, we have created a blog to share much of our commentary with you.

This move is designed to achieve a couple of things. First and foremost, we have heard from a number of readers that while they enjoy the content, there is just too much to comfortably read in one sitting. Not only will the blog format make the content available in more digestible pieces, but it will also enable us to reach a broader audience on a more regular basis.

In addition, we will be building out the "Learn" section of the website to highlight various lessons and insights that we believe can help investors better navigate the landscape for investing as well as that for evaluating investment services. Hopefully this will also provide some useful background as to how we think through various issues and challenges.

As a consequence of these changes, we are discontinuing publication of *Arete Insights* so this will be the last edition. We will continue to provide all of the content we have normally provided in *Insights*, as well as all of the content categories, but these pieces will now be distributed through blog posts. We will also retain the *Insights* archives on the website as reference material

In addition, *The Arete Quarterly* letter will be significantly abbreviated and will focus much more specifically on numbers and portfolio commentary. Broader commentary about the markets, the investment management business and other content will be shifted to the blog format.

Finally, for everyone who reads our commentary and stays in touch with our work, thanks for your attention, your feedback, and your continued support. We appreciate it!

David Robertson, CFA
CEO, Founder

The "system"

If there is just one message I could shout from the mountaintop as advice regarding how to be a good consumer of investment services, it would be to look outside of the "system". By "system" I mean the eco-system of large banks, brokerage houses, investment firms, mutual fund companies,

advisory services, et al. The key word here is large.

There are important caveats to this sweeping statement to be sure, but the important thing to understand is that the "system" is not well designed to efficiently leverage investment expertise for the benefit of clients. There isn't a dispute about the existence of such expertise; indeed there are a great many smart and talented individuals in the industry.

The bigger questions are: What is the expertise worth? How much do you really benefit from it? Do benefits outweigh the costs? Many firms claim advantages in particular expertise, but they all come with a price tag. While it is very difficult to assess the value of services provided, it is also critical to do so to make sure that you have a fair chance to get ahead with your investing. Unfortunately, the evidence is overwhelming that you don't get good value.

"Every agent takes a cut in the form of a spread or commission. But because financial products are complex or long-term in nature, the client may not realize the worst until it is too late. The finance sector is thus able to earn a high level of 'rent' at the expense of its customers."

For example, one of the most egregious trends in the industry is that towards higher fees. Yes, *higher*. As virtually all of the major costs of managing money have come down dramatically – computing costs, telecom, information and data – the industry as a whole has been raising fees. Charles Ellis provided a nice historical summary in the *Financial Analysts Journal* in "The Rise and Fall of Performance Investing".

One of the cost categories for investing that has deviated from prevailing trends in other industries is that for distribution. In a world where consumers are so much better off due to the successes of companies like Walmart, Amazon, Netflix, and Yelp in *reducing* inefficient and unnecessary distribution costs, such costs in the investment world are actually *increasing*.

Gillian Tett and Kate Burgess describe in the *Financial Times* article, "Costly Cogs, misfiring machine": "Unease is widespread about the very structure of the industry. While in much of the western business world the trend has been to remove middlemen, investing has gone 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."

The Economist picks up on the same phenomenon in "Too big for its Gucci boots": "Every agent takes a cut in the form of a spread or commission. But because financial products are complex or long-term in nature, the client may not realize the worst until it is too late. The finance sector is thus able to earn a high level of 'rent' at the expense of its customers."

While much of the "rent" comes at the expense of investors, some of it also reflects the balance of power within the industry and comes at the expense of other industry participants. This dynamic is described in "Ten trends that will reshape

the fund industry". Robert Huebscher reports, "The distribution channels are demanding more revenue sharing … and in the process they are compressing the earnings that managers make on their funds." He continues, "If you want access, you have to pay for it." In other words large distribution platforms are leveraging their market position to extract disproportionate revenues from fund managers.

While these qualitative descriptions tell a disheartening story about structure of the investment industry (aka, the "system"), Sophia Grene at the *Financial Times* quantifies the costs in the article "BCG predicts 30% wage cut". According to the work of Andy Maguire, a senior partner at BCG, "industry participants [in asset management] have been used to earning 1.7 times what they might have earned in other professions with similar levels of qualification."

In short, investment professionals earn more than they can doing just about anything else and those excess earnings come right out of their client's assets. As such, these excess earnings serve no socially useful purpose but rather serve as a tax which constantly erodes the wealth of their clients.

One might argue that this account is an exaggeration. After all, there is a free market for investment services and people have lots of choices. But this is deceptive and naive. A far more accurate illustration is the one provided by Michael Lewis in *Flash Boys* which I mentioned in *The Arete Quaterly Q114.*

In respect to the exchanges Lewis notes, "The deep problem with the system was a kind of moral inertia. So long as it served the narrow interests of everyone inside it, no one on the inside would ever seek to change it." He adds, "It wasn't easy … to try to effect some practical change without a great deal of fuss, when the change in question was, when you get right down to it, a radical overhaul of a social order." Lewis' conclusion, and one that applies just as well to the financial services industry as a whole, is that the system is rigged.

So what should investors do? To be sure I am not advocating complete avoidance of the industry or of large firms. There are lots of smart and well-intended professionals that provide valuable services. In addition, many commodity services like custody, discount brokerage, and index funds, to name a few, actually do share the cost benefits that accrue to scale with their clients.

Size is far less important, and in many ways detrimental, however, when the nature of the service involves extremely specialized knowledge, good communication, and strong alignment with your goals. In areas such as wealth management and active money management investors would be well served to look outside of the system to smaller and independently owned organizations that have stronger incentives to serve clients than to extract excess fees.

Finally, if a "radical overhaul of the social order" is to take place in investment services, new providers with better value propositions can only do so much. Ultimately, their success or failure will depend on the willingness of investors to look outside of the system for help. Until then, high fees and excess compensation will persist.

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.