

ARETE INSIGHTS

Welcome

One of the most frustrating things many of us encounter in our daily routines is trying to find good service professionals. Is your car making a funny sound? Who do you call? Does your refrigerator just stop refrigerating every few days — and then start again? What do you do? Most of us prefer to find someone we can absolutely trust to both figure out what is wrong and to actually solve the problem for us.

I don't think the situation is any different for investment services. My goal with this newsletter is to share some of the insights I have gained from the day-to-day work of analyzing stocks and managing portfolios over twenty-plus years. Hopefully you will find some of these ideas helpful in navigating the investment landscape.

Personally, when I begin a search for a service professional, I usually start by asking who I know that might have a good contact. I normally prefer to find independent professionals who I feel really want to solve my problem. Many people, however, prefer to employ a large, well-recognized chain. The first section of this letter will discuss the pros and cons of size as it relates to money management firms.

Also, many of you have asked for more details about how I analyze and select stocks. In response, I am introducing a new section to *Arete Insights* entitled "Lessons from the Trenches." This section will highlight Arete's approach to stock research by discussing various tips, tricks,

and analytical tools I have developed that have provided valuable incremental insights.

Finally, if you know of anyone who may be interested in reading this letter, please let me know or ask them to contact me (my contact information is at the bottom of the page) so I can put them on the distribution list. Arete offers a compelling investment value at least partly by shunning large advertising and selling expenses — I appreciate your help in keeping it that way!

Thanks and take care!

David Robertson, CFA
CEO, Portfolio Manager

Insights

... *I say tomato*

Last quarter we began a discussion about concepts that can mean very different things to different people. Quality is one such concept, and also one that is core to Arete's mission. What makes one firm better than another? For many, size of the firm can send strong signals — for better and worse.

The conventional view is that operational risk is greater at small firms. Small firms often do not have sufficient people, systems, and resources to consistently operate their business. They are busy scrambling for assets. Things slip through the cracks. Conversely, large firms tend to

be more fully staffed, better equipped, and can provide more functional expertise.

The alternative view, and one certainly borne by plenty of experience in the money management business, is that operational risk is often greater at large firms. Organizational culture, power structures, and incentives are tightly linked to firm profitability. These interests nearly always win out when in conflict with client interests. Small firms, on the other hand, often exercise far greater care in serving their clients due to personal commitment and reputation. With everything at risk, they have no other choice.

There is also a widely held view that business risk is greater at small firms. The conventional view is that small firms tend to be under-capitalized and may not be able to sustain themselves or to exploit growth opportunities. Large firms, however, often have better access to capital which allows them to slog through business downturns.

Since money management is not a capital intensive business, capital availability is far less important than for most other industries. What matters a great deal are quality organizational governance and prudent budgetary management. In these respects, small firms often fare much better because owners tend to have significant stakes in the business. Without such stakes in the business, employees at large firms tend to have greater incentive to manage their *careers* than to serve *clients*.

These thoughts were captured well by Henry Higdon of Higdon Partners, LLC. He

stated at the conference, *The Changing Face of the Investment Management Industry*, "We see a lot of disillusionment and disenchantment with the big firms. People want to go to smaller firms. They want to work with people they trust and respect, and they want to make a difference, and the big firms don't really provide that."

While it is clear that there are compelling arguments for both sides, perhaps the most important insight resides with the tradeoffs involved. On one hand, large firms have more resources than small ones. On the other, clients mean everything to small firms. Which is more important?

The answer was easier forty years ago. Large firms could deploy more people to gather information and analyze results. Large firms could also afford costly computing resources to crunch the numbers. Large firms then were also tiny compared to the behemoths of today, and were not saddled with the same degree of organizational complexity and conflicts of interest. Today, much of the bias for large firms represents inertia; technology has slashed the costs of computers, telecoms, and trading thereby substantially eliminating the competitive advantages size once conferred.

Arete was founded with the mission of delivering functional excellence in money management — in other words, quality. Based on changes in technology, changes in the industry, and dynamics observed through our own experiences, we believe it is now far more important for active managers to be independent and to have skin in the game than to have a few more

"It is far more important for the manager to be independent and to have skin in the game than to have a few more resources."

resources. Quality demands that size be managed to complement mission.

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 are creating 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.

One of my most memorable experiences analyzing a company happened in my first job after business school. It also provided one of my most valuable lessons. My job was to analyze and model a small radio broadcasting company with about \$10 million in revenues and to determine what it was worth.

Like a good bottoms-up analyst, I went about the process of analyzing the financial statements, researching the industry, and looking at comparable companies.

When it came to valuation, I used the historical financials as a foundation from which to forecast future results. I used what I believed to be reasonably conservative estimates for revenue growth and margins and ran them out for ten years in a discounted cash flow

"The future is indeterminate. As a result, analysts need to consider different scenarios and explore the implications of each."

model. I calculated a weighted average cost of capital and discounted the cash flows back to present. When all was said and done, the model indicated that the company had negative value!

Not to be sidetracked, I hunkered down and tested all of my assumptions. I determined that the revenue growth rates were too conservative and that the margins, although forecast to be higher than they ever had been, could go higher yet. I still got a negative value! I pushed and pushed every assumption but to no avail.

I finally had a breakthrough when I was talking to a radio professional about the industry. The person mentioned that a radio station has value even if there are no intervening cash flows because FCC licenses have value. This is called "stick" value. The concept is very similar to that of a patent and to a zoned/entitled parcel of land. All of a sudden, things started to make sense and I was easily able to complete the valuation exercise.

This incident taught me a couple of important lessons about analysis and valuation. First, it reinforced the notion that all models are imperfect representations of reality. Each model has strengths and weaknesses depending on the specific situation. While I already knew this, I gained a much greater appreciation for the breadth and variety of special situations I had not yet encountered.

Second, it also taught me that at any point in time, there are several different possible outcomes. The future is indeterminate. As a result, analysts need to consider different

scenarios and explore the implications of each. Analyzing scenarios improves as one gains experience with certain industries and types of situations. In addition, creativity can also prove useful in imagining what *might* happen that can affect a business model.

In my radio broadcaster exercise, my original valuation analysis was based on only one scenario, that of modest incremental improvements. As it turns out, it wasn't even a useful scenario. Once I researched comparable "stick" values, I was able to provide a reasonable downside valuation (with limited supply, it could always be sold). Then, I could look at the more successful broadcasting companies as a guide for establishing an upper bound for profitability and valuation. Finally, I could compare the managers to others in the industry to determine where along the spectrum company profitability might fall.

There are two important takeaways from this example. First, this is exactly the kind of example I use when I work with younger analysts to help them build their skillsets. They still need to do all of the nitty-gritty work of stock analysis such as reading and studying industries, public filings, articles, research reports, financial statements, conference calls, company presentations, etc. Incorporating concepts like "stick" value, however, increase perspective and in so doing, generate incremental improvement in the conversion of analytical resources to portfolio performance.

The second important takeaway is that this exercise highlights the tradeoff between depth and breadth of analysis. Many investors benefit from the breadth of services a financial planner provides in

managing the myriad financial issues associated with a comprehensive investment plan. Managing such a wide array of issues, while useful to many, makes it virtually impossible to conduct the kind of in-depth analysis that provides real insight into individual companies and securities.

This is exactly how Arete differentiates itself with individual investors. By focusing narrowly on our area of expertise, US mid cap stocks, and by continuing to do the rigorous and original analysis we have been trained to do for large institutions, we offer to individuals and small institutions the type of research and access that used to only be available to large institutions. This proposition should especially appeal to those who appreciate the value active management can provide, but want to make sure their manager knows more about it than they do.

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 *Unconventional 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 significant 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.

