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# ARETE INSIGHTS

## Welcome

I chose money management as a career over twenty years ago because I enjoyed the intellectual challenge of investing and because it gave me the opportunity to provide an important and valuable service. A big part of the challenge is sorting through all of the news and data to develop meaningful insights.

In this edition, I am going to discuss two topics that I think are timely and useful. The first is an evaluation of emerging markets and the implications for portfolio construction. The second article highlights research from the field of behavioral investing and analyzes the implications for trading.

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.

Thanks and take care!

David Robertson, CFA
CEO, Portfolio Manager

## Insights

We regularly assess the business landscape for money management as part of the process of reviewing and updating our business plan. In the course of doing this over the past several quarters, one of the developments we have been watching closely is the massive interest (and fund flows) in emerging markets.

Our interest is twofold. From an investment standpoint, our US stock strategy may be competitively disadvantaged if the best investments are in emerging markets. From a business standpoint, the interest in emerging markets also represents a potential risk: Fewer investment opportunities in US capital markets would portend lower demand for our services. For the purposes of this discussion, we will focus on longer-term fundamental factors and not on current aspects of the "carry trade".

Interest in emerging markets is being driven by growth opportunities which are hard to deny. Many of the emerging economies are reaching levels of income which provide for discretionary spending. When this happens, cultural mores can change fairly rapidly to embrace values favoring education and reduced fertility. This is the same phenomenon experienced during the Industrial Revolution in the UK and US which significantly enhanced productivity and drove growth.

Growth in emerging economies is also being assisted in many cases by favorable demographic trends. Many emerging economies are experiencing their own versions of "Baby Booms" in which unusually large chunks of the population are reaching the stage of their lives during which they are most productive economically. Such populations enjoy the benefits of rapidly increasing income but

are not yet threatened with the cost burdens of large elderly populations.

While the case for emerging *economies* is strong, the case for emerging *markets* is not so simple. This distinction is under-appreciated.

In fact, the deeper we dig into emerging markets, the more we see evidence which gives us concern. John Plender did an excellent job of indentifying important issues in his recent *Financial Times* article, "Shift of economic power to the East is a complex phenomenon." While his analysis focuses on China, the lessons are broadly applicable to emerging markets.

Plender reports, "For one, many valuations are extremely high. The Shanghai Composite, for example, reached a price/book valuation of seven times last year at its peak. For perspective, that compares to a five times price/book valuation of the Japanese market at its peak in 1989."

Valuation is not the only weakness in the case for emerging markets, however. Plender goes on to review capital allocation in China. In particular, he noted that as of mid-September, the Shanghai Composite produced a compounded annual return of about nine percent over the past fifteen years. While such returns are not poor, they are meager relative to the fifteen percent run rate in nominal GDP growth, and come with a staggering degree of volatility.

In short, there is a poor connection between economic growth and market returns. Importantly, the disparity between growth and returns is evidence of poor allocation of capital. Poor allocation mechanisms serve as a tourniquet by inhibiting the flow of capital to the most productive projects. In addition, the disparity between growth and returns highlights the importance of market structures themselves which can present significant risks to investors in developing countries.

Plender notes that in China, "The family model predominates, which means that in the quoted sector there is a perennial conflict of interest with outside shareholders, who are often short-changed as a result of opaque related party transactions. Accountability is further muddied by the presence of communist party officials who can call the shots from below board level."

Corroborating the risks in the Chinese markets, *The Economist* also recently noted that Chinese leaders "remain preoccupied by simmering discontent at home: there are tens of thousands of protests each year. For all the economic progress, all sorts of tensions—social, cultural, demographic, even religious—haunt the regime and help explain why it resorts to nationalism so often."

To sum up, we have a difficult time justifying such high levels of interest in emerging markets per se. Being wary of the risks of emerging markets and yet appreciating the growth opportunities, we have tried to find a better way. That way involves investing in US stocks that have economic exposure to emerging countries.

Our ultimate goal, after all, is to find attractive investment opportunities, not to chase fads. By investing in US stocks with significant revenue and cash flow exposure to growth opportunities in emerging

economies, we largely get the best of both worlds. We get stocks in a very transparent and liquid capital market and companies that have significant growth opportunities.

Our last words on emerging markets are to suggest it is far too early to count out the US market as an attractive place to invest. In fact, one of the great strengths of the US market over time has been its powerful capacity to adapt to changing conditions through the process of creative destruction. While overall market growth is likely to be relatively modest, we believe the process of change and adaptation will create terrific opportunities right here at home. More on this in our next issue!

## Insider's View

As in any business, the more familiar one gets with the underlying structures, relationships, and incentives at work, the more often one can see disparities between the widespread perception of the business and the underlying reality of the business.

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 and experience in the business to help people better achieve their investment goals. Second, we do this partly 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.

An article in the September/October 2009 edition of the *CFA Magazine* entitled "Effectiveness and Inefficiency" by Stephen Mauzy provides an excellent example of such useful insights into the market. The article addresses the increase in market liquidity over time, but in doing so also provides useful lessons from the field of behavioral investing.

Mauzy notes that for most of the long history of the US stock market, disproportionately high profits for brokerage firms were virtually assured through the payment mechanism of fixed commissions. The Securities Act Amendments of 1975 ended the practice and allowed for the emergence of discount brokers. Mauzy quantifies the impact: Within four years of the Act's passage, commissions fell between 31 and 47 percent.

Commissions have continued to fall since then as have costs for communications and information. Quite arguably, the progressive decline in transaction and information costs has leveled the playing field of investing by making it far more accessible.

But has it? Mauzy describes the work of two prominent researchers in behavioral finance, Brad Barber and Terrance Odean. They analyzed a group of 1,607 investors who switched from phone-based trading to online trading in the 1990s.

With all the benefits of lower costs and faster execution of online trading, these investors actually performed far *worse* on average than they had when they relied on placing trades by phone. Specifically, with phone-based trading, the group beat the market by over two percent per year. After switching online however, the group underperformed the market by more than three percent per year.

The important insight illustrated by this study is that improved access to markets and information triggers a slew of wealth reducing behaviors. Barber and Odean list "overconfidence, augmented by self-attribution bias and the illusions of knowledge and control" as the primary culprits. In other words, it is very easy to believe that one's trading successes are due to ability rather than luck. When this happens, it is a short step to a vicious cycle of wealth reduction through excessive trading.

This research may also help explain why we continue to find very attractive investment ideas. After all, we had expected the markets to become ever-more efficient as the costs of transactions and information came down. As a result, we also fully expected to see the activity of picking stocks get progressively more difficult over time. Over the last few years, however, we have had to seriously consider the possibility that improved market access is not increasing efficiency at all. Rather, perhaps, improved market access is luring progressively more people into the market who fall prey to their own wealth reducing behaviors—to the benefit of more disciplined investors.

## 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 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.

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