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ARETE INSIGHTS

Welcome

"Greece Schmeece" I can almost hear people say as they roll their eyes. "What does it matter to us?"

I certainly empathize with this view. Sometimes the news coming out of Europe seems like a soap opera that never ends. While it can certainly be tiresome and tempting to dismiss, it really is important for us to watch.

The reason Europe matters so much (and Asia too, but let's stay on one topic at a time) is because so many parts of its financial system and economy are interconnected with those in the US. Just like a group of mountain climbers that are tied together by a rope, if one climber falls, the adjoining climbers will certainly feel the pressure of the additional weight.

In normal conditions, this may be just fine. The fallen climber can be supported temporarily by his fellow climbers until he regains his hold. In adverse conditions, however, the fellow climbers may not be able to maintain support. They also may eventually succumb to the additional weight and lose their grip. When they fall, it can precipitate a cascade whereby everyone falls.

The technical term for this type of situation is "tight coupling." When components have close causal relationships and propogate shocks very quickly to other components, a system is tightly coupled. The mountain climbers are tied together so as soon as one falls, the adjacent climbers feel the effect immediately. There are a lot of other examples of tight coupling such as just-in-time (JIT) manufacturing, and the global financial system.

In very broad terms then, Greece is the fallen climber. They will not be able to repay all of their government debt. Since many banks across Europe hold Greek debt, they will need to write it down. Since many of these banks are undercapitalized, they will need to find a way to raise capital in a very difficult environment. In many cases this will likely lead to reduced lending. Since banks provide a much larger share of funding in Europe than in the US, this is likely to create a significant impediment to growth there. Lower growth will mean yet more bad loans for banks to absorb. US companies that do business in Europe or that borrow from European banks will be affected. In short, this all matters to US markets.

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It shouldn't be any surprise that tight coupling is a situation to be managed very carefully. Rick Bookstaber, author of *Demons of our own Design*, goes so far as to attribute one of the primary causes of the 2008 financial crisis to tight coupling. Tight coupling contributed because there were close causal relationships between many components of the financial system. This was exacerbated by complexity because the vast array of interconnections were too numerous and diverse to manage or control.

An extremely important step in any risk management effort is recognizing when you are dealing with a complex, tightly coupled system. When these conditions exist, which they unfortunately still do, the system remains especially vulnerable to significant disruption. In other words, things have the potential to get bad quickly.

Bookstaber describes a common mistake, “It might be reasonable to consider crises as hundred year flood events if we mistakenly treated them as being drawn from the same distribution as those normal market days. But they are not.” In other words, it is appropriate to treat crises as conditional probabilities. They don’t happen that often, but they are far more likely when certain, identifiable conditions exist.

Another important step in risk management is simply to avoid areas of heightened risk. An important aspect of avoidance is nothing more than having the will to do so. In his blog article, “Common Sense Crisis Risk Management,” Bookstaber acknowledges the challenge for managers: “It is not hard to take steps to protect against a crisis . . . [but] it is exactly the opposite of what makes money as the market is building into a crisis.”

One of the things that drives me crazy is when I hear investment advisors who are dismissive of risk. I don’t particularly care if they don’t know, don’t see it, are not even bothering to look, or see it but lie about it. The end result is that investors can get hurt. I don’t expect anyone to be perfect, but I do expect them to try to provide a clear assessment of the investment landscape.

Anyone who knows me knows that I don’t have any aversion to adverse conditions. I am perfectly happy to gear up and walk through rain, wind, snow, whatever. I have even been accused of enjoying it. Where I draw the line though is when conditions present a real danger to safety. Whether it is a lightning storm in the Grand Tetons or a white-out in a snow-bound pass in Glacier National Park, when I see dangerous conditions, I turn around.

I take the same approach to managing risk in the Arete Mid Cap Core strategy. I spend a lot of time to scan the investment environment and to identify relevant risks. Arete is very well positioned to provide “weather forecasts” and to communicate closely with investors in ways that they are extremely unlikely to find at larger competitors. If you have questions or would like to follow up with anything I address, please always feel free to call or email.

Best regards,

David Robertson, CFA
CEO, Portfolio Manager

Insights

The world of investing is largely a segregated one with the big institutional investors generally having access to better managers and lower fees than individual investors do. Individual investors have the same wants and needs from their investment services, but generally do not have the same resources to verify the quality of their services providers. Instead, individuals often resign themselves to selecting among whichever services are sold to them.

One of the most important characteristics that many large, well-managed institutional funds look for in money managers is a focus on "best ideas". Large funds want the benefit of the pure expertise of their managers. When they hire active managers, they don't want to pay up for a number of holdings that can be acquired cheaply through index funds.

A study from researchers Martijn Cremers and Antti Petajisto of the Yale School of Management corroborates the efficacy of this approach. After reviewing the performance of over two thousand mutual funds over a twenty-three year period, they found that a measure called Active Share was useful in predicting fund performance.

Active Share is defined as the "percentage of stock holdings in a manager's portfolio that differ from the benchmark index" (Investopedia). The study concluded that funds with Active Share of 80% or higher beat their benchmark indexes by about 1.5% after fees.

In an important sense, this shouldn't be surprising. After all, how can a fund significantly *outperform* an index unless it is significantly *different* from an index? Many skeptics point to the fact that most funds underperform their benchmarks as evidence that active management is a foolish endeavor.

The Active Share study suggests a more nuanced view: The more important indicator of performance is not *that* a fund is actively managed, but rather *how* a fund is actively managed. Funds that have an enormous overlap with benchmark holdings but have [higher] fees for active management must overcome significant headwinds in order to outperform.

Although portfolios with high Active Share have significant advantages, they also have drawbacks. The main one is that concentrated, "best ideas" portfolios can be volatile in the short-term. Impatient, short-term investors can easily be frustrated by this approach. More sophisticated investors, on the other hand, tend to have a long-term investment horizon and can take short-term volatility in stride. Further, they also understand that what matters most are fundamental underlying values — which can vary from market prices for significant periods of time.

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At the end of the day, sophisticated investors are really just trying to get a good value from the fees they pay their money managers. They understand that Active Share is a good indicator that a manager is playing to win, to outperform. They also understand that there are a lot of other ways to make money in the business which don't provide as much value to investors.

Since Arete's strategy was borne from experiences in the large institutional market, its value proposition reflects the accumulation of knowledge and insight from the toughest critics. One of the highlights of that strategy is a relatively concentrated portfolio of "best ideas" that boasts an extremely high Active Share of 92.5%. These ideas are the product of intense fundamental research and modeling and represent the unique findings of the portfolio manager. We work hard to deliver the kind of value large, sophisticated investors expect.

The difference with Arete is that you get the same kind of service available with a $100,000 account that is normally only available for $10 or $100 million accounts. Wouldn't it be nice to compete on a level playing field for a change?

Insider's View

One of our goals with the *Arete Insights* newsletter is to share our insights into how the investment management business really works. Another is to share with you some of the tips, tricks, and other tools we have incorporated into our work in order to demonstrate how we engage in our craft. In both cases, we hope to provide you some background and understanding so you can better evaluate the many investment services available.

Business involves tradeoffs and this is certainly true for investment management. In virtually any business, there are a number functions such as marketing, finance, and operations which are necessary to deliver the end product or service. In large companies, these departments often become functional silos. In smaller companies, these activities are often outsourced to external firms.

These organizational structures have the potential to provide benefits in the form of functional expertise and cost efficiency. Having good pieces doesn't always make a great machine, however. When the parts are not well coordinated, friction arises, things slow down, and things can fall through the cracks. At worst, differing agendas can lead to internecine warfare. In all cases, quality can suffer.

We can cite many examples of the costs of poor coordination. We often see the benefit of a skilled portfolio manager eroded by high mutual fund marketing fees. Often legal agreements are written with the intent of unilaterally benefitting the lawyer's client, without reference to the goal of a mutually beneficial relationship. Good intentions for stewardship can be undermined if insufficiently managed back office operations fail to provide timely and adequate disclosure.

> "Most investors feel the same way about their investment programs as their computers; they just want them to work."

Conversely, when every aspect of a business is consistent, the overall impact can be transcendent. One of the most illustrative cases is that of Steve Jobs and Apple. Through his vision and innovations, Apple's iconic products have resonated with consumers in many important ways.

One of the hugely influential innovations Jobs brought to commercial products was the graphical user interface (GUI). It was notable in itself that Jobs created a step-function transformation in the way people interacted with computers. It is also notable that the motivation for the endeavor was a vision of what consumers wanted, but had not yet expressed. They didn't know what was possible.

Another unique contribution of Jobs was the holistic vision he had for Apple. From the beginning he made sure that each aspect of a device was integrated with others. Software was integrated with hardware. He wanted devices to be simple to use, robust, and elegant. He even went so far as to ensure physical design, marketing and packaging were all reflective of this. The cumulative effect of this vision produced things that seemed to be of a higher order of quality than anything else.

The distinctive approach Jobs employed through Apple was artfully illustrated in a series of extremely successful commercials featuring Justin Long (personifying Apple) and John Hodgman (personifying PCs). The key point of the commercials was to highlight the differences in user experiences. Any user of PCs could relate to countless annoyances like setting up hardware, having software conflicts, having the computer freeze and having to reset, constantly defending against viruses, etc. It all seemed like work. It was easy to look with envy on Apple which was easy to use, was reliable, and was even fun.

While Arete makes no claim to rival the achievements of Apple, there are important similarities in the approaches to serving customers.

For one, Arete also has a vision of what customers (individual investors) want. In our case, it is not anything as innovative as the GUI, it is simply what the big institutions also want. They want good value from their service providers, they want security and transparency, and they want to know their manager is completely dedicated to working on their behalf. Arete is fairly unique in making all of these attributes available at such a low minimum investment.

Another similarity Arete has with Apple's approach to serving customers is its holistic approach to investing. Arete works hard to ensure all of the elements of the investment business are thoroughly integrated and consistent with the company's mission of functional excellence in money management. For example, while we take the same intense and active approach many hedge funds take to generating performance, we refuse to charge the high fees they do because it detracts from the benefit to our clients.

All of this goes to say that structure matters. There just aren't many "Apples" in the money management world. That's absolutely not to say that there aren't a lot of really good, smart, well-intended people; there are. However, and it is a big however, what any individual advisor can do for you is significantly constrained by the structure and policies and practices of that advisor's employing firm.

At the end of the day, most investors feel the same way about their investment programs as their computers; they just want them to work. If your investment program isn't working, or if it requires too much attention, please let us know. You may be surprised how much value you can get.

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