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ARETE INSIGHTS

Welcome

One of the great things about living in the times we do is that it is so cheap and easy to get information. For an admitted "lover of wisdom" and data geek like me, these conditions could hardly be more favorable; it's like a playground. For more "normal" people, however, the flurry of information can seem like a blizzard that often obscures important issues.

Realizing this, I have begun testing a new tool to help people navigate a clearer path through the investment landscape. I mentioned this in the last *Arete Quarterly* when I mentioned "a knowledge database constructed out of the pieces of information I gather on a regular basis." I am happy to report that I am making significant progress on this initiative and look forward to getting comments and feedback to make it as useful as possible for investors. If all goes well, I will plan on offering it as a subscription service.

The database takes the form of a wiki and is designed to be an amalgamation of information, insights, and knowledge. It is also designed to help investors gain perspective and to better address a wide variety of common investment issues. It is easiest to think of it as a digital extension of the files and information I already manage on a regular basis.

The wiki project originated out of a desire to be able to serve investors who are facing a number of challenges but have limited resources with which to meet them. Since so many investment services are "sold", investors often only hear one side of a story, and generally a very biased one at that. This situation further exacerbates the challenges wrought by a difficult investment environment that demands more attention. A common theme I hear is that people would like to be better able to get their arms around things so they can get more confident in their investing.

This project is also an attempt to address what I perceive are some important bottlenecks in the investment services industry. Given the vast number of financial services employees and offerings there is a lot of noise and it can be hard to tell the bad stuff from the good. Even among the higher quality organizations and advisors, investors are often disappointed with how little of the expertise trickles down to them in the form of material benefit.

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In other words, there seems to be a problem with either the delivery of investment expertise, or with the conversion of expertise into realized benefits. For a number of reasons, I sense there is an opportunity to more effectively provide useful and objective insights and I hope the AreteResearch wiki can address some of the challenges investors face.

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There is no doubt that I have fun doing investment research and that I truly enjoy sharing insights, both of which make a project like this easier. If you have an interest in taking a look, please let me know; I'd love to hear your feedback. If there are simple things I can do to make it more useful, it will help everybody. Hopefully, together, we can keep making this challenge called investing better!

Best regards,

David Robertson, CFA
CEO, Portfolio Manager

Insights

Turn on the TV and you're likely to hear "Stocks are cheap!" mainly from equity managers and "Beware deflation!" mainly from bond managers. How can you tell who's telling the truth? Importantly, what does it suggest as to what you should do?

Our qualified assessment is that stocks are decent long-term investments, but a great deal of selectivity should be exercised. This assessment belies a great deal of nuance which can provide useful context for investors, however.

One part of the analysis is clear: At current yields, bonds are terrible long-term investments. Jim Grant, the thoughtful and widely respected editor of *Grant's Interest Rate Observer* dubbed Treasurys as "return free risk." While there may be some opportunities outside of the US, by and large, we do believe that stocks are far more attractive than bonds.

That makes stocks *relatively* attractive, but it does not necessarily make them attractive on an *absolute* basis. This is an important distinction too often glossed over in television soundbites. More specifically, just because stocks are better long-term investment propositions than bonds right now doesn't mean one should back up the truck either.

The real question, and the crux of fiduciary duty, is to determine which assets have favorable risk/return tradeoffs and therefore make attractive investments. The unfortunate truth, which we have mentioned several times over the past couple of years, is that there are significant risks to owning stocks and some of these risks are rising. These risks serve to mitigate the attractiveness of stocks on an absolute basis.

One risk is that a set of long-term valuation measures that have proven very effective in the past point to stocks being very expensive right now. While many pundits and practitioners bandy about metrics that corroborate their views, far too often these metrics fail to withstand the test of efficacy (i.e. they don't work; they are not useful in framing future performance).

Another risk is that corporate profitability is exceptionally high now which flatters already expensive valuations. Since a stock is a long lived asset, an appropriate valuation should normalize profitability over the life of the asset. The current market, to the contrary, appears to be discounting the indefinite continuation of record profitability. Receding profitability levels and valuations are both likely to likely to impede future stock performance.

Finally, one of the most important lessons to emerge from the financial crisis of 2008-09 is that credit affects valuation. The

more money that is available to buy assets, the higher prices go. Between 1964 and 2007, total credit in the US expanded at a rate of 9.5% per year, far greater than nominal economic growth of 7.35%. The excess went to inflating assets like stocks in 2000 and house prices in the mid 2000s. Now that deleveraging is underway, the process will reverse and less credit will put downward pressure on asset prices.

There are a couple of key lessons from this analysis. One is that favoring stocks over bonds may lead to a *better* investment, but not necessarily to a *good* investment. This doesn't mean things are hopeless, only that one needs to be patient until better opportunities arise. Second, the major stock indexes are not cheap which means there is a high probability that future returns will fail to compensate adequately for bearing the risk. Finally, despite these caveats, there are interesting stock ideas out there. The opportunities to generate distinctive performance through opportunistic stock selection are becoming quite significant.

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 the last edition of *Arete Insights*, we discussed the usefulness of having valuation landmarks in order to navigate a landscape of uncertainty successfully. Another useful skill set for navigating an uncertain environment is a better understanding of oneself. Behavioral economics has gone a long way in explaining why we do a lot of the (sometimes unhelpful) things we do. More recently, research in neuroscience reveals how our physiological reactions to the environment affect both *our perception* and *interpretation* of information around us.

The recent book, *The Hour Between Dog and Wolf: Risk Taking, Gut Feelings, and the Biology of Boom and Bust*, by John Coates, provides wonderful insights from neuroscience and Wall Street trading to show how our bodily responses to stress (and success) affect both what we see and how we think.

Coates describes, "As cortisol levels rise, and our exposure to the hormone becomes chronic, we increasingly recall the events that were stored under its influence. Scott [fictional trader] now finds he recollects mostly disturbing memories. He tends to dwell on nasty events— failing high-school calculus, a locker-room fight, losses during the dot-com crash— rather than pleasant ones, like meeting his girlfriend, vacations in Verbier or trades he got right. Importantly, when assessing a trade, Scott now increasingly draws on negative precedents in determining the risks, and such a selective recall of things going wrong may promote an irrational risk aversion."

Unfortunately this largely automatic response leaves us ill-equipped to deal with the stress of uncertainty. Coates

continues, "Scott needs to think clearly about his position and the market, but oddly, inappropriately, his body has atavistically prepared him to fight with or run away from a bear. The stress response is prehistorically hamfisted in this regard. It does not distinguish very clearly between physical, psychological and social threats, and it triggers much the same bodily response to each one. In this way the stress response, so valuable in the woods, can prove archaic and dysfunctional when displaced onto the trading floor, or for that matter any workplace. We need to think, not run."

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As the body's stress response inhibits our cognitive activity, the thinking we can conjure is often misdirected. "One of the main jobs of consciousness is to keep our life tied together into a coherent story, a self-concept. In other words, we make things up." As a result, when we are pressed and scrambling to make sense of things, we tend to focus more on contriving a positive spin on the situation rather than resolving a challenge.

If these challenges are not enough, we also seem virtually incapable of even knowing whether we are in a state of stress or not. "What I [Coates] found was that their [traders'] opinions on how stressed they were had little if anything to do with reality, nothing to do with the fact that they might be losing money, or that their trading results seemed more than usually uncontrollable, or with market uncertainty as measured by its volatility. In fact, their opinions had little to do with anything I could discern."

While the insights from Coates' work may seem daunting, they provide a very useful lesson to investors. Namely, when people think of factors that generate lasting benefits to investment performance, they often think of things like access to information and analytical skills. Coates' work suggests that we also need to add our physiological responses to the top of the list of factors that can affect investment performance.

It is normal for any of us to experience some degree of stress when confronted with novelty and uncertainty. This isn't necessarily bad when the level of stress is manageable. However, when the risks rise and more is at stake (like our ability to retire or to maintain a standard of living, for example), stress can rise to unhealthy levels. When it does, our physiological responses cloud our vision of any landmarks we may have established.

As can be imagined from the discussion, there are no easy answers. It is possible, however, to increase one's resilience to challenges through training, and this should be considered by anyone who is regularly tasked with making important decisions. That said, it is also important to be aware that extended exposure to stress (or success) can affect our perception of things. This should be considered a risk and a limit to what we can "know".

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.