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ARETE INSIGHTS

Welcome

As an equity analyst, I normally prefer to focus the vast majority of my efforts on company-specific valuation and fundamental analyses because that is typically what delivers the best results for clients. When things aren't normal, though, I adapt to whatever activities will produce the best returns for clients. Given Arete's long-term investment horizon, it is hard for me to conclude right now that anything is more important than understanding the credit system and the nature of money.

This may seem like more than a modest digression for a person trained in equities research, but there are some fundamentally sound reasons why it is less of a stretch than it first appears. First and foremost, I consider myself a steward of capital before any particular brand of analyst. As a result, I'm always going to be on the lookout for things that can especially help, or hurt, Arete's clients.

In addition, I believe credit is poorly understood as a driver of stock prices. Stocks, like anything else, are driven by supply and demand. When more money and more credit are available, prices go up. This was especially true of housing in 2006 and is especially true of equities now.

"The gentle but persistent effect of credit growth is much like a trailing wind when you are riding a bike. You don't even really notice it when it is at your back."

The gentle but persistent effect of credit growth is much like a trailing wind when you are riding a bike. You don't even really notice it when it is at your back. It just seems fun because it's not very hard and you are going a little faster than usual. When you turn around, though, you get a surprise as to exactly how much help you were getting. If you aren't careful, it can be really hard to get back with all of the extra energy you need to ride into the wind.

I've noted in the past that credit has provided a strong "trailing wind" for equities. More specifically, total credit in the U.S. (from the Fed's Z.1 release) grew at 9.5% per year from 1964 to 2007. During the same period, income (nominal GDP) only grew a little over 7% per year. When we turn around, it's going to feel a lot different than it has for the last few decades.

This basic message is illustrated much more comprehensively by Chris Martenson in his "Crash course" webcast series at www.peakprosperity.com. According to Martenson, the accumulation of debt at a much faster pace than income over the last 30 years is unsustainable and will lead to a major "reset" in the financial system.

This reset will create an environment extremely different from our recent past. As government debt increases well beyond levels that are serviceable, it is quite likely that significant inflation will be used as a policy mechanism to reduce the real value of that debt. As this happens, massive

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amounts of wealth will be transferred from those who save cash to those who own real assets. Martenson sums up his outlook with the assessment that "the next twenty years are going to be very different than the last twenty years".

Radical positions like Martenson's can often be easily dismissed as the ramblings of a crank or a crackpot. In the case of Martenson, however, he makes such a spectacularly lucid and reasoned case, it is hard to dismiss without serious consideration. Perhaps because of his academic training as a Ph.D. in toxicology, he intuitively understands how excessive debt can poison the financial system.

At very least, a future that is very different from our past will require very different planning. Certainly real assets will need to be considered as part of that plan and equities will likely play an important role too. *Preserving* wealth will be imperative.

As such, calibrating exposure to stocks is likely to be an ongoing challenge. While it would be easy and probably more profitable, at least in the short-term, to keep my head down by just researching stocks and ignoring the implications of a major credit disruption, I can't in good conscience say this is the best thing for Arete's clients. The stock market has been riding a long time with the wind at it's back. Arete continues to serve as an antidote to the silliness that pretends otherwise.

Best regards,

David Robertson, CFA
CEO, Portfolio Manager

Insider's View

For better and worse, the remarkable growth of most asset prices over the past thirty years has also had a powerful influence on investment service providers. Driven by demographics, rapid credit growth, and strong asset returns, each part of the services eco-system has adapted business models, services offerings, and revenue structures that thrive in this environment.

A natural consequence has been that many providers are essentially designed to ride the "wave" of capital markets growth. One manifestation of this condition is that an unusually large proportion of providers base revenues on assets under management (in order to benefit disproportionately from attractive equity returns) regardless of economic logic for doing so. Another manifestation is that there are lots of undifferentiated offerings. Indeed, offerings that are truly different can stand out in an awkwardly undesirable way.

"The established firm more often responds by using its market and political power to resist change."

Such unchecked growth and uniformity has its downside, though. Anything that thrives in one very narrowly defined environment almost by definition is not well suited to a very different environment. Indeed it's not surprising, as John Kay recently noted in the *Financial Times* that, "The established firm more often responds by using its market and political power to resist change."

It's not unfair to hypothesize that in the event of a significant change in the investment environment, most incumbent

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firms will actually be handicapped by their past success. "We are all reluctant bulls now, say fund managers" is a recent *Financial Times* headline that speaks volumes about the resistance of many money management practices to change. According to the article, "Summing up the research, BofA says investors are 'like a bull in the headlights', unable to move from a potentially dangerous situation."

If it is accepted that the investment environment is likely to change materially at some point, long-term investors will care less about whether that change happens over a few years or whether it happens tomorrow. The important thing to know is that almost all the old rules of thumb and old business practices will be wrong.

This presents yet another challenge, and opportunity, for investors. Not only must special consideration be given to one's portfolio construction, but also to one's service providers. Among these, who can handle a major market disruption? Who is working to create new and better solutions as opposed to resisting change? Who can help you navigate the complex investment landscape?

It is hard to understand how a permanently bullish perspective serves clients' long term interests, although it is likely to help grow revenues for many firms. In a competitive landscape muddled by such self-serving and counterproductive blather, it will be useful to search for new and fresher sources of help. The alternative is to wax nostalgic and hope things don't change.

Insights

"It's a tough old world out there, not least for institutional asset owners. Complexity and volatility combined with a low-return environment are forcing asset owners to reconsider their traditional ways of managing investments. It's a situation that has been a long time building." This was the message delivered in the article "Outsourcing hits its stride" from a recent *Pensions & Investments* supplement. As the process of investing is becoming progressively more difficult, more and more organizations are looking for help with some or all of the various functions.

While this message rings true for many individuals and small institutions, those looking for help through outsourcing extend into much large organizations. "More sophisticated, larger clients are looking at outsourcing because the process of managing complex investment portfolios has become much harder," says Russell's Macy. "Markets are volatile and dynamic. Decisions cannot be made at quarterly meetings. It's a real-time job. So even clients with $1 billion or $2 billion portfolios are looking outside for expertise." The challenges are affecting everyone.

"Outsourcing can span a wide array of activities including evaluating vendors, reviewing investment policy, assessing asset allocation, as well as educating and training fiduciaries about the financial markets."

Given the economies of scale in the investment management industry, many of the most sophisticated approaches are only implemented at the very largest funds. The good news for smaller funds, though, is that these approaches offer roadmaps to best practices and improvement. Further,

with rapid and ongoing improvements in both technology and knowledge management, such best practices often don't have to take long to become much more broadly accessible to individuals and small institutions.

The providers that are most naturally positioned to deliver outsourced investment services are investment consultants and money managers because the strengths of both groups overlap naturally with many of the demands for outsourcing. Both groups have weaknesses as well, though.

"Many consultants saw outsourcing as a good business opportunity," says Russell's Macy. "Many have 30 years experience of giving investment advice to asset owners – plan sponsors, endowments – but just three years of implementation experience. This presents huge challenges. Money managers on the other hand are really good at money management, but do they have the experience of mapping out long-term strategic advice for clients? Not a lot of firms are equally strong in both areas."

The question of whether or not one should consider outsourcing depends on a couple of factors. Most fundamentally, owners should ask, "Are our current arrangements fit for purpose in today's financial market environment? And further, can we move fast enough to take advantage of short-term investing opportunities and to stem a tide of losses?" In short, the volatile and fragile nature of today's markets often demands a fresher and more robust approach.

In addition, asset owners should determine which skills and expertise they need most. Outsourcing can span a wide array of activities including evaluating vendors, reviewing investment policy, assessing asset allocation, as well as educating and training fiduciaries about the financial markets.

The really good news in all of this for investors is that outsourcing is one area in which the investment industry seems to be changing for the better – because it focuses on outcomes. Very specific and narrowly defined service offerings are likely to have a shrinking role in a very complicated environment challenged by limited return opportunities. Conversely, service providers that can forgo a narrow focus on returns and actually help investors achieve desirable outcomes are likely to become ever more important.

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.

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