First quarter 2010
Volume 3, Issue 1

# The Arete Quarterly

## Welcome

"Who is Atticus Finch?"

In this time of deep-seated distrust of institutions, the question reflects back to when things were perhaps simpler, when human interaction was perhaps more meaningful, but when there was also tremendous uncertainty and potential for conflict.

The character of Atticus Finch is the father in Harper Lee's novel, "To Kill a Mockingbird" which was famously played by Gregory Peck in the 1962 movie. Despite numerous challenges through the story, Atticus consistently steps up to do what is right, often despite imminent danger. The character of Atticus serves as such a powerful image of ethics and fiduciary duty that we seriously considered naming the company Atticus in order to represent one of our most important ideals.

The character of Atticus illustrates so clearly what it means to be a fiduciary. Part of being a fiduciary is that there is no one thing or act that is sufficient. Rather, it requires a guiding ethic, a personal disposition, to serve the interests of others.

Fiduciary duty is about far more than following a law. It is about standing up for those you represent when times are tough. It is about fighting the right fights on behalf of a client. It is about exercising expertise for the benefit of others. We hope the investment community has not forgotten about Atticus Finch.

### Inside This Issue



The question, "Who is Atticus Finch?" is also a reference to another literary character — that of John Galt, the main character in Ayn Rand's epic novel, *Atlas Shrugged*. The novel is largely a celebration of individual achievement, but also serves as a manifesto of enlightened self-interest. While Rand's themes and imagery are dramatic, she raises fair questions.

The novel contrasts the "good" of individual ability with the "evil" of societal exploitation of that ability. In the story, John Galt and an elite subset of high achievers eventually tire of being repeatedly penalized for their accomplishments. In response, they go on "strike" by disappearing from society altogether and creating an independent community guided by the code of enlightened self-interest. The new arrangement produces a culture which is fairer, more productive, and more ethical.

Just as the question, "Who is John Galt?" represents the mysterious disappearance the ablest members of society, the question, "Who is Atticus Finch?"

represents a similar risk to those who exercise the highest ethical standards. If the Atticus Finches of the world, the paragons of stewardship, aren't only not appreciated by society, but often punished by it, they too may gradually choose to "disappear" some day. We do have concerns that the proliferation of moral hazard increases the risk of a widespread "strike".

All the things we do at Arete are aimed at providing the highest standards of stewardship. We present performance based on the institutional GIPS standards, we vote our own proxies in order to voice our concerns to directors and to enhance our research process, we offer separate accounts to ensure the security and transparency of investors' funds, and we use independent custodians and brokers to structurally eliminate conflicts of interest.

We do all of this in addition to running a sound investment process that is designed to create value by outperforming its benchmark. We enjoy doing it, and sincerely hope you appreciate the effort.

## Business Update

Spring has sprung, market sentiment is thawing and we are all looking forward to sunnier days. There is no doubt that with signs of a healthier market, I have seen increased interest in Arete's services. While the market has helped, Arete now has twenty months and a full calendar year of composite performance. This track record also includes strong performance by mid cap stocks and outperformance of the Russell Midcap Index by Arete's mid cap core composite (See the performance presentation on p. 9).

While the recession and market downturn certainly had the obvious impact of reducing wealth for many, I believe the more subtle, but more important effect, was the fundamental re-evaluation of investment programs by individuals and institutions alike.

At the top of the priority list was ensuring adequate liquidity which many addressed last year. Next on the list was an evaluation of risk. Most of us have not experienced the widespread breakdown of financial markets and confidence that we saw in 2008-2009. Many relied on personal experience to frame their expectations for the markets and had no even remotely similar experience. Even those of us who have studied the equity markets in depth, and knew cognitively that big declines were possible, were shocked by the firsthand experience.

When I look across the market of institutional investors, I have to admit that I am fascinated by the extreme reactions to the downturn. One approach for some plans has been to take a step back to assess the goal of the plan — which is to meet liabilities, and to narrowly focus on that objective. As such, I have seen an increase in asset-liability matching which may not be not be as exciting, but absolutely fulfills the mission.

Another common response has been what appears to be the exact opposite reaction: ratcheting up risk exposure. I think the logic is that with a certain amount of wealth destroyed by the market downturn, but with liabilities remaining the same, the only way to make ends meet is to go for broke. Interesting, but dangerous.

I have also seen a huge proportion of searches for emerging markets managers and alternative products. There are many potential reasons for such activity, but I fear much of it may be driven by the "go for broke" mentality. Regardless, for the time being, searches right now seem to be heavily weighted on opposite ends of the risk spectrum and noticeably light for traditional, active US managers.

I have shared my views — with almost anyone who will listen — that mid cap stocks are in a "sweet spot" for investing. They are big enough to have survived their growing pains, but small enough to have very meaningful growth opportunities. In addition, I have talked a great deal about the terrific exposure to higher growth international markets many of these companies have. While investors may not be focusing on mid caps today, they won't be able to ignore the opportunities forever.

I believe very strongly in sharing my views — partly as a matter of transparency — and partly as a matter of sharing ideas of value. I always enjoy hearing other views that challenge or complement my own and heartily encourage you to contact me if there is anything you would like to discuss.

Thanks and take care!

David Robertson, CFA
CEO, Portfolio Manager

## Portfolio Characteristics – Arete Mid Cap Core

A key proposition for Arete's Mid Cap Core strategy is that it is a truly representative mid cap portfolio. In general, this suggests that over time, you can expect to see the aggregate characteristics and sector exposures of the strategy migrate to those of the Russell Midcap Index. During intervening periods, however, sector exposures and other characteristics will reflect the opportunities we find in the market at that point in time.

We believe maintaining a truly representative mid cap portfolio is important for two reasons. First, a truly mid cap portfolio faithfully plays its role in a broader asset allocation scheme. Second, it allows for accurate assessment of performance. Without an appropriate benchmark it is difficult if not impossible to judge whether performance differentials are due to skill or luck, and are sustainable or transient.

**Portfolio Characteristics** (3/31/10)

| | Arete MCC* | Midcap Index** |
|---|---|---|
| Size | | |
| Average Market Cap ($ mil.) | 5,871 | 4,756 |
| Median Market Cap ($ mil.) | 4,560 | 3,684 |
| Minimum Market Cap ($ mil.) | 358 | 220 |
| Maximum Market Cap ($ mil.) | 17,952 | 17,952 |
| Number of holdings | 49 | 766 |
| Valuation | | |
| P/E current year | 19.6 | 21.6 |
| P/E forecast Y1 | 16.8 | 19.6 |
| P/B | 2.7 | 2.7 |
| P/S | 1.0 | 1.3 |
| Yield (%) | 0.9 | 2.4 |
| Valuation drivers | | |
| ROE (%) | 10.3 | 16.7 |
| LT eps growth forecast (%) | 10.4 | 11.2 |

*Source*: The Applied Finance Group™
**Note:* Excludes ASCMA allocation resulting from DISCA corporate action.
***Note*: Arete currently does not subscribe to the Russell Indexes and therefore the statistics presented here represent approximations of the Russell Midcap® Index.

For example, many fund managers attempt to beat their benchmark by timing the market and/or migrating style. These tactics rarely generate sustainble out-performance. To us, such activities usually just serve to obfuscate the underlying inability of the manager to add value through a coherent and disciplined investment process.

Portfolio characteristics for the quarter confirm our claim that AMCC is a very representative mid cap portfolio. Market caps remain a little bit higher for AMCC than for the mid cap index and most valuation metrics remain modestly lower.

We thought it interesting that there has been significant volatility in some of the metrics the last couple of quarters. Most notably, our original calculation of return on equity (ROE) for the midcap index produced an average of -19.8%. Upon closer inspection, that average was skewed by a reported ROE of -27,104% for American International Group (AIG). We arbitrarily zeroed out the AIG return which then produced an index average of 16.69%.

We also noticed big increases in current year price/earnings ratio (PE) for both the AMCC and the index. Clearly the meaningfulness of the characteristics data is subject to limitations and as a result, it makes more sense to consider the metrics in aggregate than to focus too narrowly on any one.

Sector exposures remained relatively unchanged from last quarter and for the most part, well within our general guidelines of 50% - 150% of benchmark sector weights. The only exception in the quarter was Materials and Processing which (again) finished just slightly above our 150% guideline.

**Sector exposure** (percent of assets on 3/31/10)

| Economic sector | Arete MCC* | Midcap Index** | Percentage Comparison |
|---|---|---|---|
| Consumer Discretionary | 21.2 | 16.4 | 128.9% |
| Consumer Staples | 3.2 | 6.1 | 51.8% |
| Energy | 6.7 | 7.2 | 93.6% |
| Financial Services | 19.1 | 20.6 | 92.5% |
| Health Care | 11.4 | 8.7 | 131.2% |
| Materials & Processing | 11.5 | 7.6 | 151.2% |
| Producer Durables | 12.7 | 13.2 | 96.6% |
| Technology | 7.3 | 12.2 | 60.1% |
| Utilities | 6.1 | 8.0 | 76.0% |
| Equity exposure | 99.2 | 100.0 | |
| Cash and equivalent | 0.8 | 0.0 | |

*Source*: The Applied Finance Group™
**Note*: Arete Mid Cap Core is represented by the aggregate of all assets in the composite at the given date.
***Note*: Arete currently does not subscribe to the Russell Indexes and therefore the sector weights presented here represent approximations of the Russell Midcap® Index.

We mentioned in last quarter's update that part of the rationale for having a larger than normal weight in Materials and Processing was due to our belief in the potential for at least moderate inflation for commodities and raw materials. This is absolutely true, but probably under-emphasizes the truly bottom-up nature of our portfolio construction. When we look across the six names we own in the sector, all but one are owned for primarily company-specific competitive advantages and opportunities.

The two sectors for which macro issues tend to play a larger role in the portfolio construction process are Financial Services and Energy. Given the prospects for an improving global economy, we have been actively reviewing candidates in both sectors.

## Transactions review – Arete Mid Cap Core

We had very little activity in the portfolio in the first quarter as we primarily reaped the rewards of actions taken previously (See Performance review, p. 6).

The only transaction we did implement was the purchase of additional shares of Energy Conversion Devices (ENER). We had a bit of excess cash — about 1% — in client portfolios that we wanted to put to work and did.

The performance of ENER has been abysmal over the past two years with near-term fundamentals being hampered by several factors. First, ENER's primary markets are for large commercial buildings and commercial real estate has been devastated by the credit crisis. In addition, the economic attractiveness of solar power has been significantly undermined by very low prices for natural gas. If that weren't enough, the weak global economy has prevented the company from achieving the scale of business it needs to operate efficiently. Not surprisingly, short sellers have exploited the situation and control about one-third of the shares which constitutes one of the highest short ratios in the market.

As bad as this may sound, none of these issues changes our long-term investment thesis. The company still offers a unique and proprietary product for an important niche. The balance sheet is solid with plenty of cash to sustain it through the downturn. Finally, the stock is selling at less than one-half of book value. That value consists mostly of cash and industrial and semiconductor processing equipment which we believe could be easily sold if worse came to worse. In addition, there are NOLs of just under $400M. In sum, we see ENER as having very little downside, and many multiples of upside.

## Market Overview

Market returns in the first quarter were surprisingly strong, building momentum through the quarter. At the same time, the market's "fear gauge," the VIX indicator of market volatility, took another step down to levels not seen since May 2008 — and levels lower than those when the S&P 500 peaked in October 2007.

Perhaps the most significant event for the market in the quarter was the completion of the health care reform bill. While there continue to be many dissenting voices as to the merits of the bill, at least with its completion, a great deal of uncertainty was eliminated. Now, companies and investors alike can analyze the bill and begin adapting to the new landscape.

In general, the market has been continuing to climb the proverbial "wall of worry" and nowhere has this been more apparent than among the banks. While mid cap banks were the dregs of the investment universe last year, this year they are the star performers. Certainly improving conditions in residential housing have helped as has the Fed's continued commitment to keep rates low. For those banks that don't go out of business, there will be an accommodating yield curve and diminishing competition for the foreseeable future.

We continue to watch the market's rise with some wariness. While we do not consider valuations to be incredibly high, they are clearly less compelling than three months ago. More importantly, while conditions are improving in the US, we are concerned about the complacency the market has exhibited toward a rather large number of risks.

Some of the bigger risks to the global economy include the problems with sovereign debt in Greece and the threat it poses to the entire Eurozone, the Fed's termination of MBS purchases, the high level of US debt, the increasing amount of protectionist rhetoric, continued terrorist threats across the globe, unresolved global economic imbalances, an overheating Chinese economy, and uncertain financial regulation.

Despite, or perhaps because of these risks, our affinity to US stocks has not waned. A couple of weeks ago, we had the pleasure of listening to Russell Napier, author of *Anatomy of the Bear* and one of the pre-eminent commentators on global equity markets. Mr. Napier called US stocks, "terrific global assets" and also indicated that several European investment trusts are significantly underweight US stocks, suggesting an important source of future demand. In sum, we are encouraged by Mr. Napier's analysis and especially so given his international perspective.

## Performance review – Arete Mid Cap Core

The Arete Mid Cap Core product is designed with the flexibility to invest in the most attractive mid cap stocks, regardless of any particular "style" designation. With that context, the primary criterion for selecting a stock in the Mid Cap Core strategy is that market value is significantly less than our estimate of intrinsic value. In other words, we try to find situations in which our research generates expectations for a company's growth and profitability that justify substantially greater valuations than what the market discounts.

Our investment process is designed to discover, analyze, and assemble stocks into a diversified portfolio that consistently outperforms its benchmark over time. Specifically, our investment objective is to outperform the benchmark Russell Midcap® Index by 200-400 basis points, net of fees, over the course of a market cycle.

Our target of 200-400 basis points of outperformance is based upon our experience with the strategy and upon our judgment of value creation. The primary metric we use to judge value creation is the information ratio. The information ratio compares a portfolio's excess return to its risk as measured by tracking error. Our goal is to outperform by a large enough margin relative to risk to clearly merit the cost in time and resources to evaluate investing with us.

The market continued its strong perfomance in the fourth quarter with the Russell Midcap Index (RMC) posting a strong return of 8.67%. Arete's Mid Cap Core (AMCC) strategy returned 10.37% (net of fees) which surpassed its benchmark by 170 basis points. Relative performance was uneven in the quarter with strong outperformance in January, notable underperformance in February, and modest outperformance in March.

**Stock performance*** (12/31/09 - 3/31/10)

**Best performers**

| Company | Return in quarter (%) |
|---|---|
| Genworth | 61.6 |
| Synovus | 60.5 |
| Capitalsource | 40.8 |
| Eastman Kodak | 37.2 |
| Liberty Global | 33.1 |

**Worst performers**

| Company | Return in quarter (%) |
|---|---|
| Foster Wheeler | -7.8 |
| NRG Energy | -11.5 |
| Investment Technology Corp. | -15.3 |
| AES Corp. | -17.4 |
| Energy Conversion Devices | -25.9 |

**Note*: Performance includes price changes only, it does not include dividend income in the quarter.

Regarding individual stock performance in the quarter, "It was the best of times, it was the worst of times" in what was a tale of two sectors. Financials began rebounding last year, but really took off in the first quarter. Fundamentally, the worst losses from residential mortgages and construction and development have worked their way through the loan portfolios which paves the way for restored profitability.

Interestingly, four of the five best performers in the quarter have also been on the worst performers list in the last year and a half. We believe this speaks largely to some of the short selling activities that occurred, especially with financials.

We believe it also largely validates our intrinsic value approach. In many cases, the sharp declines in stock prices in late 2008 and early 20009 better reflected market activity than changes in fundamental value. By sticking to our guns on research and valuation, we did experience price declines, but were largely able to avoid permanent impairments of capital.

Among the worst performers, four of the five names were energy companies of one sort or another. While there was certainly plenty of noise regarding these firms, we did not see any particularly worrisome evidence arise. In light of a strong market in the quarter and weak US natural gas prices, there were quite simply better places to go in the short-term.

## Investment Philosophy

We firmly believe in the critical importance of a cogent investment philosophy for any investment operation. In order to emphasize this point, and to assist you in understanding how we work, we provide an abbreviated version of our investment philosophy here. The text of our investment philosophy is also provided, in its entirety, in our Form ADV, Part II which is available upon request at any time.

**Performance derives from exploiting mispriced securities.**

The key to investment performance is finding and exploiting market inefficiencies in the form of mispriced securities. There are two components to this. One component involves determining the fair price of securities in the form of underlying intrinsic value, which we do primarily through calculating discounted cash flows.

The second component of exploiting mispriced securities is establishing a clear understanding as to the various mechanisms at work that allow mispricing to occur. By understanding the mechanisms and motivations of the marginal buyer and seller, we believe we can more accurately estimate the probabilities and expected values of investment opportunities.

**Nobody has perfect information.**

Competitive pressure and technological development have conspired over the years to make most data and analysis commodities which no longer provide a meaningful competitive advantage. What can provide an advantage, however, is *how* that information is used and *how* it gets interpreted in making investment decisions.

In order to convert the raw material of information into the useful output of a good investment decision, it is necessary to assimilate and synthesize the information into some meaningful form. We believe the most effective way to accomplish this is to thoughtfully deploy resources available according to the nature of the research tasks at hand.

Research culture and research prioritization are also important in relation to analyzing and synthesizing information. We believe that the best way to leverage the collective knowledge and experience of a research team is to encourage active and open dialogue designed to explore multiple perspectives and to challenge individual assumptions, biases, and beliefs. Only by enduring such scrutiny do the best ideas rise to the top. Further, in order to fully leverage these ideas, we believe research efforts must be dynamic and flexible in allocating resources such that ideas receive attention in proportion to the expected benefit to the portfolio.

**Execution is crucial for investment success.**

In order to create value, an investment strategy needs to be implemented continuously and comprehensively. Actions speak louder than words. We believe the most effective efforts focus on a few simple, but key concepts that work to ensure proper execution of a firm's investment strategy.

The first key to execution is structural in nature and involves a firm's independence. By maintaining independent ownership, an investment firm eliminates agency effects which can present a conflict of interest between clients and certain of its ownership groups. Independent ownership ensures that client and manager interests are optimally aligned.

The second key to execution is temperament. The best investors tend to have a temperament that provides them the courage and initiative to act, often going against the grain, when opportunities arise. However, the same temperament provides balance such that decision-making is not simply a risk-taking activity, but a very conscious and targeted effort to engage in propositions with high risk-adjusted expected returns.

Finally, another important element of execution is simply doing what you say you do in your investment process. Too often, perfectly acceptable investment processes fail when actual investment activities bear little resemblance to the process described in the marketing presentation. We call this the “marketing gap;” the difference between what is said and what is done. Execution is optimized when the marketing gap is minimized.

# Arete Mid Cap Core Composite

**Arete Asset Management, LLC**
**Mid Cap Core Composite***
**July 31, 2008 - March 31, 2010**

| Period | Gross-of-Fees Return (percent) | Net-of-Fees Return (percent) | Russell Midcap® Index Return (percent) | Number of Portfolios*** | Internal Dispersion (percent) | Total Composite Assets ($)*** | Composite Assets With Bundled Fees ($) | Percentage of Composite Assets With Bundled Fees | Total Firm Assets ($) |
|---|---|---|---|---|---|---|---|---|---|
| 2008** | -37.97 | -38.16 | -35.01 | 3 | NA | 207,031 | 207,031 | 100% | 207,031 |
| 2009 | 48.63 | 47.83 | 40.48 | 3 | NA | 471,867 | 471,867 | 100% | 673,806 |
| 2010 | | | | | | | | | |
| January | -0.19 | -0.19 | -3.34 | 3 | NA | 470,985 | 470,985 | 100% | 673,872 |
| February | 2.94 | 2.69 | 5.00 | 3 | NA | 483,663 | 483,663 | 100% | 689,224 |
| March | 7.68 | 7.68 | 7.07 | 3 | NA | 520,819 | 520,819 | 100% | 738,658 |
| Q1 | 10.64 | 10.37 | 8.67 | 3 | NA | 520,819 | 520,819 | 100% | 738,658 |
| YTD | 10.64 | 10.37 | 8.67 | 3 | NA | 520,819 | 520,819 | 100% | 738,658 |

**Note*: Composite returns for September 2008 have been corrected for an error that occurred in the calculation of accrued income. The new, new, corrected performance is higher by 10 basis points, which equals our threshhold for materiality. The error occurred due to an ex-post post adjustment made by our reporting software. We have identified the source of the problem and have created procedures designed to avoid recurrence.

***Note*: Peformance through 12/31/08 is from inception of composite on 7/31/08.

****Note*: One account contributed additional funds in November which were not at least 90% invested by the end of March. Per our rules for inclusion, this account was removed from the composite for these periods and will be returned once the funds are fully invested.

## Arete Asset Management Mid Cap Core performance composite disclosures:

### Compliance statement

Arete Asset Management has prepared and presented this report in compliance with the Global Investment Performance Standards (GIPS®).

### Definition of the firm

Arete Asset Management, LLC (Arete) was established in 2008 and is registered as an investment adviser in the state of Maryland. Arete is defined as an independent investment management firm and is not affiliated with any parent organization. Arete currently manages one strategy, the U.S. equity mid cap core strategy, which it markets to individual and institutional clients.

**Arete Asset Management Mid Cap Core performance composite disclosures continued:**

**Benchmark**
The benchmark is the Russell Midcap® Index and its performance is reported in U.S. dollars.

**Calculation methodology**
Portfolio valuations are calculated as of calendar month-end and are computed in U.S. dollars and performance is also reported in U.S. dollars. Time-weighted rates of return are used which adjust for external cash flows. Our smaller, retail accounts contain fee structures in which one flat, per-transaction fee is charged for trading expenses and which embeds an implicit charge for custody. Since trading and custody charges cannot be directly segregated in these cases, they constitute "bundled fees". Gross-of-fees performance returns are presented before management and custodial fees when custodial fees can be segregated from trading, but are presented before management fees and after bundled (trading and custodial) expenses for our retail accounts. Net-of-fees returns are presented after management fees, trading expenses, and custodial expenses are deducted or after management fees and bundled (trading and custodial) fees for retail accounts. There are no instances in which management fees are bundled with trading or custodial fees. Returns are presented net of nonreclaimable withholding taxes when applicable. Arete does not use leverage or derivatives in the management of portfolios. Additional information regarding policies for calculating and reporting returns is available upon request.

**The composite**
This U.S. Equity Mid Cap Core composite was created in August, 2008 and includes all fee-paying, taxable and non-taxable, discretionary, long only, fully invested portfolios benchmarked to the Russell Midcap Index. For purposes of composite construction, "fully invested" is defined as having greater than 90% of portfolio assets invested in equity securities. Every new portfolio is added to the composite in the first complete calendar month that it is "fully invested". A complete list and description of firm composites is available upon request.

**Fee schedule**
The management fee schedule is as follows: 1% of AUM up to $1 million, 0.75% on AUM greater than $1 million, but less than $5 million, and 0.65% on assets greater than $5 million.

**Minimum account size**
There is no minimum account size for inclusion in the composite. Please note, however, the minimum initial account size accepted is $100,000.

**Dispersion**
Internal dispersion is currently not meaningful as there are five or fewer portfolios included in the composite. In the future, we plan to calculate dispersion using the dollar-weighted standard deviation of all portfolios included in the composite for each performance period.

**Arete Asset Management Mid Cap Core performance composite disclosures continued:**

**Verification**

Arete has not been verified by an independent verifier for its compliance with GIPS. Please note that the initial minimum period for which verification can be performed is one year.

To receive a copy of the firm's Form ADV Part II, please contact David Robertson at 410/649-0086 x710, by email at droberston@areteam.com, or by mail at the address listed below.