First quarter 2011
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THE ARETE QUARTERLY

Welcome

Warm winds breezed through Baltimore last week and with them came scents of spring and thoughts of vacations and beach trips. Of course such trips often involve a great deal of planning — for food, activities, and traffic. But what a great time we'll have!

Not unlike retirement in many respects. We work hard and then look forward to taking it easy and having fun. We take pleasure in anticipating just rewards. We may face some challenges and detours, but we fully expect to arrive at our destination. But what if we run out of gas along the way? What if we don't have enough money saved to retire?

In her *Financial Times* article, "Americans have not yet learnt how to share pain fairly" Gillian Tett offers an interesting insight. "In a country built by pioneers, where resources seemed abundant and growth eternal, no one has worried about how to divide up the pie — after all, everyone assumed the pie would swell."

This aspect of American character pervades many aspects of our lives, and we believe retirement planning is one of them. Financial advisors plug in long-term return assumptions for stocks in the high single digits, extrapolate several years ahead, and voila, an image of a couple comfortably retired on a beach front.

What if the assumptions of "growth eternal" are no longer correct though?

Inside This Issue

Given the market's powerful pattern of reverting to mean valuations over time, we believe there is very good evidence to suggest S&P 500 returns over the next seven to ten years will be a lot closer to zero than high single digits. How do retirement plans look under these assumptions?

This is what we call the "investment challenge." If equity returns are near zero for the next seven to ten years, retirement portfolios, excepting regular contributions, will be no larger than they are today. Worse, once financial planning fees are trimmed off, there is a very good possibility portfolios in this scenario will *shrink*. Talk about running out of gas!

A big part of the reason Arete was formed was to present a constructive solution to this challenge. Essentially what we do is make people's money work harder for them — so they have a better chance of reaching their retirement destination. Of course, there are no guarantees, but there are absolutely opportunities to do this. It's not magic, but it is hard work — and it beats the heck out of hitchhiking.

Business Update

I normally run across one show on TV each year that I really enjoy and make it point to watch. This year the show is “The Good Wife.” I enjoy the way the show captures much of the strategizing and maneuvering that is required to succeed in many important encounters. I also enjoy the way the show eschews black and white depictions and rather embraces the all-too-real “gray” areas with which we are all familiar. Somehow, the main character manages to navigate the landscape and remain “good”.

What does this have to do with Arete? As assets under management officially eclipsed $1 million at the end of the quarter, I had occasion to reflect on the business and how it has grown. It has grown by patiently finding and working with “good” clients.

From the start, I made a deliberate effort to avoid growing assets just for the sake of increasing revenues. While it is easy to see the allure of making more money short-term, longer term the result is almost always the same: Managers end up with “fickle” clients that leave at the first sign of volatility, and clients are eventually disappointed that the managers fail to meet expectations.

So I wanted to do something different with Arete. I wanted to focus on “good” clients rather just any clients. I wanted to build relationships rather than distribution channels. And I wanted to offer terrific investment value to people who appreciate it as such.

What constitutes a “good” client for Arete? A good client in many ways is someone who shares our views as to what constitutes a successful approach to investing. A long-term investment horizon, a preference for low turnover, and an appreciation of a valuation-based approach are all aspects of this. Good clients also share our skepticism of conflicts of interest and seek simple business models that avoid conflicts. In addition, good clients are also very sensitive to costs, preferring to pay a reasonable price for a robust research process, but foregoing the costs of elaborate sales efforts.

The single best indication of a good individual prospect for Arete, however, is when someone has an isolated lump of money. Perhaps the individual left a job and has a stranded 401(k) plan. Or a person may have sold an asset. In either case, a person has some money that is not currently being “managed” that he or she would like to be more productive.

Arete’s mission is functional excellence in money management — which really means helping people’s money work harder for them. Stranded or isolated assets are great situations for Arete because it allows us to focus on what we do best.

If you happen to know of someone who has a stranded 401(k) or another lump of money he or she may want to put to work, please let me know. I am looking to add a couple new individual clients this year and always appreciate the opportunity to help out.

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.

Portfolio Characteristics (3/31/11)

	Arete MCC*	Midcap Index**
Size		
Average Market Cap ($ mil.)	6,730	5,954
Median Market Cap ($ mil.)	4,943	4,537
Minimum Market Cap ($ mil.)	120	209
Maximum Market Cap ($ mil.)	21,113	63,094
Number of holdings	49	778
Valuation		
P/E current year	20.1	21.7
P/E forecast Y1	19.8	19.1
P/B	2.6	3.1
P/S	1.1	1.6
Yield (%)	1.4	2.3
Valuation drivers		
ROE (%)	10.4	16.8
LT eps growth forecast (%)	11.5	11.9

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.

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.

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 continue to confirm 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.

Sector exposure (percent of assets on 3/31/11)

Economic sector	Arete MCC*	Midcap Index**	Percentage Comparison
Consumer Discretionary	18.6	15.9	116.7%
Consumer Staples	3.1	5.3	58.5%
Energy	7.3	9.6	75.7%
Financial Services	18.5	20.3	91.0%
Health Care	9.8	8.6	113.7%
Materials & Processing	11.4	6.6	173.4%
Producer Durables	9.8	14.1	69.3%
Technology	6.9	11.6	59.4%
Utilities	5.9	7.8	75.4%
Equity exposure	91.3	100.0	
Cash and equivalent	8.7	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.

Sector exposures changed a bit as a result of the transactions, but for the most part remain well within our general guidelines of 50% - 150% of benchmark sector weights. Consumer Discretionary is now very near the index weight and the Materials and Processing sector is the only sector outside of guidline boundries.

Transactions review – Arete Mid Cap Core

During the first quarter we engaged in three sales transactions. We sold approximately half of each of our positions in Carmax, Coach, and United Rentals. In each case, we still really like the long-term investment thesis for the company. However, given the run up in prices, that far exceeded the improvement in fundamentals, the valuation risk also increased. As a result, we trimmed the positions to reduce risk to the portfolio. These transactions are good examples of our sell discipline.

Notably, we did not immediately reinvest the cash generated from the transactions. Combined with the cash we received from the acquisition of Commscope, which closed in January, total cash positions reached levels well beyond our normal guidelines.

While we have absolutely not changed our long-term view towards participation in the market, we are also very sensitive to managing risk and generating positive absolute returns for our clients. Rather than merely being a slave to "relative returns", we try to provide a higher standard. Currently, we believe quantitative easing has artificially inflated the prices of many companies. With this as context, we believe current conditions argue for having some "insurance" in the form of temporarily higher than normal cash levels.

Market Overview

In many important respects, very little has changed in the market from the last two quarters. Price momentum continued to strongly influence returns and high correlations among stocks persisted. In the short-term, these conditions tend to work against our strategy of picking unique, out-of-consensus stock ideas with strong long-term opportunities.

In addition, many of the same risks are still lurking, and some have worsened since our last report. While they have been largely ignored by the market, that does not mean the risks have disappeared.

One of the best ways to capture the dynamics of the market over the last twelve months is to breakdown Russell's size and style returns. Over that period (3/31/10 – 3/31/11), the Russell 2000 Index® (small cap) return of 25.79% trounced the Russell Top 200 Index® (mega cap) return of 13.64%. That only tells part of the story though. Within small caps, the Russell 2000 Growth Index® return of 31.04% trounced the Russell 2000 Value Index® return of 20.63%

In short, the market clearly displayed greater risk appetite with its preference for smaller stocks over larger ones. This occurred despite the plethora of lurking risks. From the perspective of a three to five year investment horizon, we do not believe stocks can continue to rise unabated given the very serious fiscal and debt issues that must be dealt with. In short, the continued underpricing and underappreciation of risk has left us more cautious than we were last quarter.

Our mental model of the landscape is for fairly volatile markets to persist with no sustainable trends for some time. We remain bullish about the fundamental prospects for our companies, but are very sensitive to diminished appreciation opportunities as prices rise. We continue to believe our stocks are largely protected against permanent impairments of capital due to our extensive financial analyses. On the other side, we continue to search for and pursue interesting new mid cap companies to refresh the portfolio. In both efforts, we try to take advantage of volatility by selling high and buying low.

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 per year, 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.

Performance in the first quarter was solid again in absolute terms, but failed to keep up with benchmark returns. Arete's Mid Cap Core (AMCC) strategy returned 4.52% (net of fees) for the quarter but trailed the Russell Midcap Index (RMC) return of 7.63% (see pages 8 – 9 for performance and related disclosures). Relative performance was positive in January, but lagged in both February and March.

The performance of individual stocks in the portfolio very much reflected the high cross correlation of stocks in the overall market. Along with further indications of a recovering economy, cyclical stocks performed well and that was clearly reflected in United Rentals, Weyerhaeuser, Dresser Rand, and Spirit Aerosystems. United Rentals distinguished itself as the single best performing stock in the portfolio for the third consecutive quarter.

The underperformers also reflected the high degree of correlation across stocks.

Stocks that have been out of favor continued to be out of favor. In our case, those stocks included Energy Conversion Devices, Eastman Kodak, Dex One, and Synovus Financial.

Stock performance* (12/31/10 - 3/31/11)

Best performers

Company	Return in quarter (%)
United Rentals	46.3
Weyerhaeuser	30.0
Kinetic Concepts	29.9
Dresser Rand	25.9
Spirit Aerosystems	23.4

Worst performers

Company	Return in quarter (%)
Synovus Financial	-9.1
Nalco Holding	-14.5
Dex One	-35.1
Eastman Kodak	-39.7
Energy Conversion Devices	-50.9

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

In each of these cases, and with Nalco as well, there are clearly issues affecting the companies. But none of that is new news. What matters is how much the issues affect the business and its expected cash flows. In each case, we believe the market has been far too severe in its discount of short-term challenges and far too optimistic in its assessment of sustainable growth from other companies.

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 Asset Management

Arete Mid Cap Core Composite

Arete Asset Management, LLC
Mid Cap Core Composite
July 31, 2008 - March 31, 2011

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	16.86	15.78	25.48	3	NA	546,315	546,315	100%	877,368
2011									
January	2.61	2.37	2.13	3	NA	559,270	559,270	100%	895,481
February	1.56	1.56	3.80	3	NA	568,001	568,001	100%	907,094
March	0.53	0.53	1.53	3	NA	571,008	571,008	100%	1,011,132
Q1	4.77	4.52	7.63	3	NA	571,008	571,008	100%	1,011,132
YTD	4.77	4.52	7.63	3	NA	571,008	571,008	100%	1,011,132

**Note*: Peformance through 12/31/08 is from inception of composite on 7/31/08.
***Note*: One existing and two new accounts contributed additional funds which were not at least 90% invested by the end of December. Per our rules for inclusion, these accounts were excluded from the composite and will be added 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.

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

Arete Asset Management Mid Cap Core performance composite disclosures continued:

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.

Verification

Arete has not been verified by an independent verifier for its compliance with GIPS.

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.