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Volume 6, Issue 1

THE ARETE QUARTERLY

Inside This Issue

Welcome

There is a saying that generals always fight the last war, which holds especially true if they've won it. Back in the middle of the twentieth century, America's industrial prowess was an incredibly important factor in the victory by allied forces in World War II. There was no doubt that the massive quantities of ships, aircraft and armaments that American industry produced were critical to prevailling in a war spanning multiple fronts across three continents.

As with many things, however, the nature of armed conflict has changed dramatically over the past several decades. This change was foreshadowed in Vietnam and was clearly evident in the 9/11 attacks on the World Trade Center towers. It has also been demonstrated in a wide variety of other incidents across the globe since. The spectacle of collossal clashes has been supplanted by surgical strikes.

As the nature of attacks has evolved, so too have the responses. This was neatly demonstrated in the recent movie, *Zero Dark Thirty*. Notably, the effective effort of tracking down the intelligent and highly elusive target of Osama Bin Laden was not due to masses of people and machinery. Instead, what worked was basically a single, dedicated CIA agent and a Navy Seal team.

These lessons from warfare have application to the investment management business. Many investment firms that were created in more fruitful economic times and in more tranquil capital markets built massive distribution networks and research departments. In the context of high and persistent returns and new money inflows, the high costs of building and maintaining such mammoth structures were outweighed by the benefits of simply providing exposure to such broad opportunities.

In today's world of low real returns and sketchy economic prospects, however, many incumbent investment firms seem poorly suited to win today's investment battles. Spending lots of money to amass piles of information does a lot less towards making investors better off than does thoughtfully and efficiently piecing it together and adroitly acting on opportunity. Nonetheless, many investors continue to be impressed by the grand profiles large firms present in fighting the last war.

Arete is different from many of its competitors in that it is not big nor does it aspire to be. It is purpose-built to find attractive stock picks and is dedicated to doing this well. It is also driven by the mission of ensuring that clients benefit from its efforts and end up better off. In these respects, Arete is not fighting past investment wars like so many others, but rather is fighting current wars and constantly adapting for future ones.

Business Update

There are many different stories about why people start their own investment firms. Some always wanted to be entrepreneurs. Some wanted to make bucket-loads of money. Some just wanted a nice, comfortable lifestyle in which they could call the shots.

For me, it was always about being a great investor. This wasn't just a nice idea; it was an economic imperative. Starting with a pile of student loans instead of a wad of family money, I knew the best thing I could do to materially improve my lot in life was to save and invest well. As a result, investing takes on a special place in my psyche. I see it not just as an academic exercise but as a means of realizing a better life.

Interestingly, as my investment knowledge and expertise increased over the years, my belief in the value of most of the investment products I encountered decreased. I certainly didn't find many that I felt comfortable putting much of my own money in.

It wasn't that there weren't talented people out there. There were plenty. I think it is more accurate to say that what I found (and still find) were services that were compelling in one dimension, but not in other important ones. For example, hedge funds were very performance-oriented, but tended to be expensive, illiquid and inaccessible. Mutual funds were liquid and accessible, but had low active share which significantly diminished performance opportunities. Institutional separate accounts were more secure, but only available to the largest institutions.

Since I didn't find any options that met my high standards, I started investing in stocks myself. Mainly I wanted to further benefit from what I believed to be the fairly strong set of investment skills I was developing, other than just by receiving compensation for my job. I also thought it would be a good lesson to learn what it felt like to have my own money on the line.

Although I started in early 2000 at perhaps one of the worst times to enter equity markets, my valuation work successfully directed me away from technology stocks and towards energy stocks (I didn't have the money to invest earlier because I was paying off student loans). As a result, I managed to substantially increase my personal holdings during a time in which the S&P 500 was flat to down. This experience was extremely beneficial to me because it ultimately gave me both the funds and the confidence to found Arete.

As I consider business development efforts today, I am sharing with other investors the course of action I am taking myself. In short, I continue turning over a lot of rocks to find great stock ideas, but the fact remains that there aren't a lot given the huge run-up in prices. As a consequence, I still have quite a bit of cash ready to deploy as great opportunities emerge.

One of the negative consequences of low real rates of return is that investing in financial assets under these conditions does not make you significantly better off. In many cases, the risks taken are outweighed by the meager benefits. It may end up preserving some wealth that otherwise would be lost to inflation or other means, but it does not leave you in a better place.

While it is fair to say I am pretty intensely dissatisfied with this situation, it is also fair to say I don't intend to accept it passively. Given limited opportunities with financial assets right now, it makes sense to consider other forms of wealth, of which knowledge can be considered one in a very broad sense. Indeed, at these low interest rates we have a unique situation in which there is essentially no opportunity cost for acquiring knowledge.

As a result, I have been making extra efforts to step up my learning experiences. Much of this I have been accumulating in the AreteResearch site, but I have also been preparing presentations on topics I believe can be especially helpful for investors. Some of this can help create context for the investment environment, some of it can help combat misinformation, and some of it can present useful courses of action for various investors.

Because I believe there are so many potential uses of the insights gleaned from my efforts, and because this is a great time to pursue them, I am renewing efforts to talk to investors, to share this knowledge, and to build new relationships. I am still leery as to the intermediate term opportunity for stocks given current valuations, and don't plan on chasing the market. But this is a very good time to learn and prepare and I recommend other investors do the same. At very least, it is also a great opportunity to learn more about what Arete is and how it works.

If you, someone you know, or some group with which you are familiar, may be interested in hearing more about Arete or any of several different general subjects about investing, please let me know and we can work something 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.

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 outperformance. 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 (3/31/13)

	Arete MCC*	Midcap Index**
Size		
Average Market Cap ($ mil.)	7,515	6,648
Median Market Cap ($ mil.)	5,774	4,956
Minimum Market Cap ($ mil.)	82	321
Maximum Market Cap ($ mil.)	29,473	30,374
Number of holdings	39	796
Valuation		
P/E current year	22.8	19.3
P/E forecast Y1	18.9	19.1
P/B	2.1	3.4
P/S	1.0	1.6
Yield (%)	1.4	2.4
Valuation drivers		
ROE (%)***	12.8	22.5
LT eps growth forecast (%)	10.2	11.9

Source: The Applied Finance Group™
**Note:* Excludes positions which are less than 0.1% weights.
***Note*: Arete currently does not subscribe to the Russell Indexes and therefore the statistics presented here represent approximations of the Russell Midcap® Index.

Portfolio characteristics for the quarter continue to confirm that the equity portion of AMCC is a very representative mid cap portfolio. Market caps for AMCC are extremely similar to the mid cap index and with the exceptions of yield and current-year P/E, AMCC is cheaper. ROE is noticeably lower, but is subject to many distortions and has not been especially reliable.

Sector exposures were all below benchmarket weights due to the high cash position, but still within our general guidelines of 50% - 150% of benchmark weights. Three sectors are currently very close to benchmark weights including Utilities, Health Care, and Materials & Processing. Notably, Heinz is the sole holding in Consumer Staples and therefore a replacement or two will need to found when its acquisition is consummated. While we always target best ideas in our research process, we will also be sensitive to these underweights as we deploy cash in upcoming quarters.

Sector exposure (percent of assets on 3/31/13)

Economic sector	Arete MCC*	Midcap Index**	Percentage Comparison
Consumer Discretionary	10.9	17.4	62.7%
Consumer Staples	3.7	6.2	59.9%
Energy	5.0	7.6	65.8%
Financial Services	13.6	21.5	63.2%
Health Care	8.5	9.1	93.5%
Materials & Processing	6.4	6.8	93.8%
Producer Durables	10.0	13.3	75.0%
Technology	7.5	11.3	66.1%
Utilities	6.8	6.8	100.5%
Equity exposure	72.4	100.0	
Cash and equivalent	27.6	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.

Transactions review – Arete Mid Cap Core

After several quarters with virtually no transactions, there were several this quarter.

There was only one new purchase and that was Yamana Gold (AUY). While there is always a great deal of controversy around the role of gold in a portfolio, gold mining stocks are extremely cheap relative to the underlying price of gold. Further, Yamana compares extremely well in terms of cost management, profitability, and cash flow generation. Finally, the stock serves as a nice hedge to some of the deeper value names that can be sensitive to concerns about the financial system.

Significant additions were made to each of Exelon (EXC), NII Holdings (NIHD), and Dex One (DEXO). The portfolio originally inherited a position in EXC due to the acquisition of Constellation Energy. The stub position underperformed due to the continuation of low gas prices and concern about a dividend cut, which eventually did happen. This created an unusual chance to increase the holding to a full 2% position at a very attractive price.

NIHD suffered terrible performance in 2012 as network expansions were botched and competitive threats mishandled. The stock price was crushed despite substantial underlying asset values in spectrum and towers. The announcement in December of Steve Shindler as interim CEO provided strong encouragement that recent missteps would be corrected. In the event they are, the stock price could rise by many multiples.

In a similar vein, the DEXO position was increased again based on the plan to merge with Supermedia and refinance debt and the likelihood of that plan going through. The reach for yield in the markets is helping in this case as it has significantly increased the chances of refinancing.

While DEXO is certainly a more speculative position, like with NIHD, there is an opportunity for the stock to rise by many multiples. Also like with NIHD, DEXO seems to be especially attractively priced because it does not fit the mold of what the rest of the market is chasing.

As a brief note, a small number of shares of Chicago Bridge and Iron (CBI) were received through its acquisition of Shaw Group (SHAW). The vast majority of the transaction value was paid in cash and it is unlikely CBI will be a permanent position.

Finally, the Mohawk Industries (MHK) position was reduced significantly to 1%. The stock has had a great run but has become fairly expensive. In addition, risk has increased because of its cyclicality: There is significant potential for revenue growth to slow or reverse and for economic margins to plateau or even decline. MHK is a great company, though, and we'll be happy to add again at cheaper prices.

Market Overview

Hope springs eternal and especially so as springtime approaches it seems. Notably, the return of the Russell Midcap Index® for each of the last four first quarters (Q113: 12.96%, Q112: 12.94%, Q111: 7.63%, Q110: 8.67%) was significantly better than would normally be expected for an entire year.

Indeed, for each of the three complete years 2010 – 2012, the first quarter's return comprised a significantly disproportionate share of the year's return. The first quarter in 2012, for example, comprised nearly three-quarters of the annual return and in 2011 the return was negative for the year.

The Fed, through its easy money policy, is clearly trying to arm-twist any remaining risk-averse (we would say "prudent") investors into capitulation. This has created a great deal of temptation worth addressing.

While we are contrarian by nature, we are far from the only ones reluctant to completely give in to that pressure. The evidence of increasing disparities between weak economic fundamentals and high market valuations has been far too great to ignore. A useful characterization of this paradox was coined by noted economist, Gary Shilling, as the "Grand Disconnect."

One of the research pieces we came across recently that illustrates the "Grand Disconnect" especially well was posted on the [ZeroHedge.com] website and is displayed below (though there are a huge number of graphs portraying similar stories). It shows the relationship between employment (which is a good proxy for economic health) and the S&P 500 index over the last ten years. The graph depicts clearly that what is happening in the real economy is completely different from what is happening in the market.

Source: ZeroHedge.com

Of course this has happened in the past as also shown in the graph. In late 2006, the S&P 500 continued its run upward while employment flattened and eventually dropped significantly. Eventually the two patterns converged when the S&P 500 fell precipitously to "reconnect" with employment trends.

Recent comments by a couple of excellent investors on CNBC and reported by ZeroHedge.com illustrate what this means for investors. Sam Zell said, "The current stock market feels like the housing market of 2006. Everybody can't afford to miss it." He continued, "Every single day it [the market] goes up. What were the headlines in 2006 - housing prices going up every day. What are you talking about every day now - new high in stocks every day!" David Rosenberg of Gluskin Sheff also provided his perspective: "You could have fought the Fed in 2000 and 2009 and done quite well… [thanks to the Fed] the market will tend to drift up - **until something breaks**."

This encapsulates well the challenges for investors. Your two main choices are feeling like you "can't afford to miss it" and jumping on the bandwagon, or waiting "until something breaks," and suffering negative real rates of return on cash during the interim. Given that our normal policy is to be fully invested, let's examine the logic required to justify such a position now.

In order to go all-in with stocks, you would first need to have confidence that the current ride is going to last long enough to make it worth your while. Second, you would want to make sure you could get out before the market reversed. Finally, you would need to have a good idea of the things could go wrong and the magnitude of losses if they did.

While it probably is fair to assume that the Fed will continue its program of quantitative easing for some time, it is far less clear whether this will lead to further gains in the market. For one, earnings do matter and have been under pressure despite record high margins. Also, it may become evident to the market, and perhaps even to the Fed itself, that its policies are either ineffective or counterproductive in helping employment growth. In addition, there remain a great many exogenous risks across the world that could rapidly quell risk-taking at any time irrespective of central bank policy.

Underlying all of these conditions is a credit market significantly comprised of shadow banking activities. These forms of credit differ materially from credit created through the fractional reserve banking system in that there is no reserve. They work as long as asset prices keep going up, but they collapse when asset prices fall (i.e., when “something breaks”). Noted economist, Hyman Minsky, called such systems, “Ponzi finance” to capture their salient features.

As a reminder, the financial crisis of 2008-2009 was precipitated by problems in the shadow banking sector. This is why problems that started with the relatively small subprime housing sector became much, much bigger. Unfortunately the structure of the credit market has not changed a great deal and there are many signs of resurgence in shadow banking.

What this means for investors is that the system is still quite fragile. When things do go down, they can go down a lot, and quickly. Forced sellers jam the exit doors because they must get out at any price. This is exacerbated by the vast interconnectedness global financial institutions which enables problems to cascade quickly from almost anywhere in the world.

The main point of outlining this is to highlight the logical flaws of undue exuberance for stocks right now. It doesn’t change the fact that bonds look even riskier over long investment horizons.

What does follow fairly naturally from this discussion are a couple of constructive courses of action for investors to consider. First and foremost is to be wary of playing the market as a whole; this has become an especially dangerous game. Conversely, it is a great time to be looking for stocks that don’t necessarily move with the market, but can perform on their own merits. There are always stocks that work and the mid cap universe is especially flush with interesting and dynamic companies. Don’t let some of the headwinds of the market environment overshadow the real opportunities to produce attractive returns.

Another useful pursuit is to manage the fragility in financial markets. Because a lot of different financial assets can be hurt at these prices, it makes sense to avoid significant concentrations. If there is one thing to avoid, it is any notion that anyone has an incredibly clear idea of the ultimate outcome of these conditions.

Finally, it is a good time to seriously consider ways to better manage against inflation if you haven’t already. Inflation is not a big problem today, but the chances are good that it will be over a long investment horizon. It’s hard to conceive today, but the dollar lost half of its value through inflation over four years from 1978 – 1981. Largely because it’s hard to conceive today, though, the costs of protection are fairly attractive.

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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.

Arete's Mid Cap Core (AMCC) strategy returned 8..94% (net of fees) for the quarter versus 12.96% for the Russell Midcap Index® (RMC) (see pages 10 – 12 for performance and related disclosures). The performance of stocks was largely in-line with the index with the shortfall due almost exclusively to the large cash position.

Once again, several (four) of the top performers, Kodak, Oshkosh, Genworth, and CapitalSource were stocks that had been heavily shorted in the past but have rebounded nicely. Kodak is a very small position, but the others significantly contributed to performance. While the companies have performed decently, the stock performance was almost exclusively related to market action as opposed to company-specific developments.

In addition, Heinz got a nice boost with the announcement that it was being acquired by Warren Buffett and another investment group. This continues a nice string of acquisitions of portfolio companies.

Stock performance* (12/31/12 -3/31/13)

Best performers

Company	Return in quarter (%)
Eastman Kodak	67.6
Oshkosh Corp.	43.3
Genworth Financial	33.2
CapitalSource	26.9
Heinz	25.3

Worst performers

Company	Return in quarter (%)
NII Holdings	-39.3
Peabody Energy	-20.5
Dex One Corp.	-17.5
The Saint Joe Company	-7.9
Foster Wheeler	-6.0

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

The worst performers in the quarter had the common threads of not fitting into any of the neatly defined narratives for “attractive” stocks. They all have zero or low weights in common indexes and tend not to have the most stable streams of cash flows. As a result, the performance of these stocks, as with the best performers, seems to be far more descriptive of market action than insightful of company-specific fundamentals.

One important point to make here is that significant consequence of the combined effects of quantitative easing and the proliferation of passive funds has been to magnify the effects of “regimes” on market activity. The most widely recognized are the “risk-on” and “risk-off” regimes.

This phenomenon has two important implications for investors. First, it has meant that more and more financial assets are moving in sync which vastly diminishes the ability to successfully diversify. Second, it has created an enormous divide between stocks that are in major indexes and those that are not.

For managers like Arete that seek to find best ideas and to minimize overlap with indexes (i.e. maintain high active share), this is the short-term price to pay for being different. However, it also suggests that with a different regime, relative performance will also be very different.

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, 2013

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	-8.20	-8.88	-1.55	3	NA	497,767	797,767	100%	897,918
2012	15.20	13.84	17.28	4	NA	798,766	798,766	100%	897,341
2013									
January	5.17	4.92	6.84	4	NA	838,074	838,074	100%	1,036,725
February	0.28	0.28	1.41	4	NA	840,390	840,390	100%	1,038,478
March	3.54	3.54	4.25	4	NA	870,137	870,137	100%	1,069,209
Q1	9.20	8.94	12.96	4	NA	870,137	870,137	100%	1,069,209
YTD	9.20	8.94	12.96	4	NA	870,137	870,137	100%	1,069,209

**Note*: Peformance through 12/31/08 is from inception of composite on 7/31/08.
***Note*: One new account contributed additional funds which were not at least 90% invested by the end of the quarter.
Per our rules for inclusion, this account was excluded from the composite and will be added once the funds are fully invested.

Arete Asset Management Mid Cap Core performance composite disclosures follow:

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.

Arete Asset Management Mid Cap Core performance composite disclosures continued:

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. Every new portfolio is added to the composite in the first complete calendar month that it is "fully invested". For purposes of composite construction, a portfolio is "fully invested" if its equity composition is greater than 90% of the equity composition of the composite. Each portfolio will remain in the composite until its equity composition becomes less than 90% of that of the composite. A complete list and description of firm composites is available upon request.

*As of March 31, 2012, the composite has been redefined in order to clarify policy in light of unusually high cash positions recently. Prior to March 31, 2012, a portfolio was considered to be "fully invested" if greater than 90% of portfolio assets were invested in equity securities which implicitly assumed a nearly 100% equity position in the composite.

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.

Arete Asset Management Mid Cap Core performance composite disclosures continued:

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.

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