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The Areté Quarterly

Welcome

The investment landscape is changing and so are the needs of investors — and Areté is here to help however we can. While we do actively manage stocks in our mid cap core strategy, we have also introduced a Personal CIO Service [here] in order to help investors who want access to our expertise on a more modular basis. In these services and any future ones, Areté will always focus on conducting good research, thinking independently, and putting our clients' interests first.

In order to stay apprised of our latest thinking on the investment landscape, please take a look at our blog [here]. Finally, please always feel free to contact us with questions or comments.

Business Update

Easy go, easy come. As rapidly as concerns about the market accumulated in the fourth quarter, they dissipated just as quickly in the first quarter. I mentioned last quarter that I expected "dramatic swings", and did we ever get one!

The more interesting takeaway from the sharp turnaround in performance, however, is how unsettled the market seems. The massive "V" shaped move was a far cry from the record low volatility of 2017.

The turmoil in the market also forebodes turmoil in the landscape for investment services. Broadly, there are two different directions the industry can take over the next several years. One is that central banks can continue attempts to support asset prices and succeed for some period of time. Another is that the effort to support asset prices can fail in the relatively near future. There are consequences to both.

Inside This Issue

In the event support for asset prices fails, investors will be confronted with a landscape very different from the one they have experienced the last ten years. Valuation-based strategies will make a powerful come-back and investors who have cash on hand will be able to acquire assets at low enough prices to provide a high probability of realizing attractive long term returns.

However, this path may prove bumpy. Belief in growth stories is so fervent and disdain for useful accounting metrics is so high that any stock declines are likely to be met with enthusiastic and repeated efforts to recapture momentum, as was the case in the fourth quarter. It could take some time and lots of zigs and zags before the full weight of economic reality decisively takes its toll on stock prices.

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In the event support for asset prices continues to succeed for some period of time, there will be a different set of consequences. Investors with intermediate to long term investment horizons can either hope to make their returns while the market is rising, but at risk of realizing a substantial setback that may be hard to recover from, or they can abstain from overvalued markets, but at risk of not realising equity-like returns for a substantial portion of their saving years.

The challenge was illustrated nicely by *Grants Interest Rate Observer* in it's April 5, 2019 edition. In the piece entitled, "Cost of low rates", *Grants* rightly noted that the rising asset values driven by low rates have also been accompanied by the rising cost of associated liabilities. In other words, "As interest rates have fallen, the number of dollars required to produce the same level of income has risen." The burden of such retirement cost inflation is borne disproportionately by younger investors.

So investors face a troubling mixture of ongoing pressues, heightened uncertainty, and existential risks. Unfortunately, many probably won't realize the challenges in time to implement corrective action.

Nonetheless, such challenges also promise that there will be plenty of work for service provides to help investors navigate the difficult landscape; the only question is to determine the best way(s) of accomplishing that.

That is no mean task, however, because the unusually wide range of investment possibilities requires very different models that in turn, require very different resources and scale.

For example, if the market crashes in the near future, valuation-based active management is likely to be a winning strategy. If valuations don't materially correct for a long time, active management is unlikely to be especially rewarding. While valuations will not remain high forever, they can do so long enough to compromise most business models, and in many cases already have.

In order to account for such possibilities and also to regularly explore the best ways to serve investors, I have been making an extra effort to reach out to like-minded people in the industry to see if there are ways in which we can help one another. Part of this is just fun for me but part of it involves a serious effort to explore new ways to efficiently share investment expertise.

I continue to believe that there are a lot of things that should be improved in the investment services industry and I also believe that there is a better chance of accomplishing some of those things by working together. More specifically, I am especially interested in finding ways to expand the reach of my valuation work, market insights and research development that are independent of market direction. If you have any ideas of people I should talk to, I would very much appreciate hearing about it.

Thanks for your interest and take care!

David Robertson, CFA
CEO, Portfolio Manager

Portfolio Characteristics – Areté Mid Cap Core

A key proposition for Areté'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 (3/31/19)

	Arete MCC*	Midcap Index**
Size		
Average Market Cap ($ mil.)	9,806	10,479
Median Market Cap ($ mil.)	7,104	7,811
Minimum Market Cap ($ mil.)	535	16
Maximum Market Cap ($ mil.)***	48,535	103,177
Number of holdings	16	784
Valuation		
P/E current year	23.7	22.1
P/B	2.4	4.9
P/S	1.4	2.6
Yield (%) ****	4.2	2.7
Valuation drivers		
ROE (%)****	7.2	12.2

Source: Calcbench
**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.
****Note*: Stocks with low floats are excluded
*****Note*: The measure of ROE was changed from the average to the median as of 3/31/14.
*****Note:* Average of available yields

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.

Sector exposure (percent of assets on 3/31/19)

Economic sector***	Arete MCC*	Midcap Index**	Percentage Comparison
Consumer Discretionary	0.3	11.9	2.5%
Consumer Staples	0.0	4.2	0.0%
Energy	0.0	4.1	0.0%
Financials	3.1	12.6	24.6%
Health Care	3.8	10.3	37.0%
Industrials	0.0	13.6	0.0%
Information Technology	1.9	19.2	9.9%
Materials	5.2	4.9	105.8%
Real Estate	6.5	9.3	69.5%
Communication	0.0	3.4	0.0%
Utilities	4.8	6.6	73.0%
Equity exposure	25.6	100.0	
Cash and equivalent	74.4	0.0	

Source: Calcbench
**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.
****Note*: Economic sector classifications were changed from Russell to GICS beginning Q414.

For example, many fund managers attempt to beat their benchmark by timing the market and/or migrating style. These tactics rarely generate sustainable 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.

All of that said, our overarching goal is to provide attractive returns to investors on an *absolute* basis. During most times, the stock market provides an attractive vehicle through which to realize those returns. In unique periods of significant overvaluation, however, when our valuation and other analyses suggest attractive returns are less likely, we may allow the cash portion of the portfolio to increase so as to preserve investors' capital and retain the option to buy more cheaply in the future.

General portfolio characteristics for the quarter continue to confirm that the equity portion of AMCC is a representative mid cap portfolio. The average market cap for AMCC is slightly higher than the mid cap index and the median is similar. Although AMCC is much cheaper on the basis of P/S and P/B, it is important to note that valuation metrics have become less informative as the number of holdings has declined to just 16 currently.

Sector exposures are quite different from benchmark weights, in part due to the high cash position but in part due to different exposures. Cash has remained at high but fairly stable levels over the last several quarters.

Active share* (3/31/19)

Period	Percent**
Q119	95.5
Q418	95.8
Q318	96.2
Q218	96.4
Q118	94.9

**Note*: Computed for AMCC composite
***Note*: Active share > 80% is considered "very active"

As a quick reminder, active share highlights the degree to which a portfolio's holdings differ from its benchmark. A portfolio must differ significantly from its benchmark in order to significantly outperform it — and therefore to justify charging active management fees. Areté's Mid Cap Core portfolio consistently exhibits active share well above the 80% level considered to be very active.

Transactions review – Areté Mid Cap Core

There was one transaction in the quarter and that was to liquidate the position in AMTD. AMTD had been lucrative and became one of the biggest positions in the portfolio. AMTD benefited from the growing discount brokerage business, consolidation within the industry, and more recently from higher interest rates. Increasingly, however, these improvements were being offset by risks. Not only is AMTD especially vulnerable to a downturn, but it also receives substantial payments for order flows, a dubious practice and one that is potentially subject to political and regulatory backlash.

Performance review – Areté Mid Cap Core

The Areté 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.

Stock performance* (12/31/18 - 3/31/19)

Best performers

Company	Return in quarter (%)
Seritage Growth Properties	37.5
The Saint Joe Company	25.2
Seagate Technology	24.1
Weyerhaeuser	20.5
Gaming & Leisure Properties	19.4

Worst performers

Company	Return in quarter (%)
Annaly Capital Management	1.7
Mylan Inc.	3.4
Capitol Federal Financial	4.5
Davita	5.5
Royal Gold	6.2

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

Our target of 200-400 basis points of outperformance is based upon our experience with the strategy and upon our judgment of value creation. 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.

Areté's Mid Cap Core (AMCC) strategy returned 3.90% (net of fees) for the quarter versus 16.54% for the Russell Midcap Index® (RMC) (see pages 7 – 9 for performance and related disclosures). The dramatic rebound in the Russell micap index was an almost perfect mirror image of its decline last quarter just like the weak relative performance of the AMCC composite was almost a perfect mirror image of its strong relative performance last quarter. While the rebound certainly defers the opportunity to find a lot of cheap stocks, the volatility indicates trouble is brewing.

Among outperforming stocks in AMCC the clearest theme was interest rate sensitivity. Real estate, whether in the form of housing or REITs, performed especially well given the turnaround in the Fed's rate policy. The other outperformer, STX, rode on the coattails of improving sentiment in technology in general.

The most notable underperformers were DVA and MYL. DVA fell when CVS announced that it was planning on entering the home dialysis market. While the entry is certainly non-trivial, it is unlikely that home dialysis, which is already a well-known option, will significantly disrupt the dialysis market.

MYL was penalized when it reported weak results for 2018 and did not provide guidance for the upcoming year. Poor visibility and weaker margins have not only detracted from management's credibility, but have also raised concerns about the company's substantial debt burden. The underlying causes for most of these issues have been visible for some time which is why the position was cut in half back in 2015.

Other "underperformers" were not especially noteworthy as they only stood out in the context of such a strong move in the overall market.

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.

Areté Mid Cap Core Composite

Arete Asset Management, LLC
Mid Cap Core Composite
July 31, 2008 - March 31, 2019

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	23.18	22.00	34.76	4	NA	974,605	974,605	100%	1,172,496
2014	4.01	2.99	13.22	4	NA	1,003,729	1,003,729	100%	1,200,564
2015	-7.56	-8.44	-2.44	4	NA	919,035	919,035	100%	1,206,652
2016	4.07	3.02	13.80	4	NA	946,825	946,825	100%	1,142,297
2017	5.03	4.00	18.52	4	NA	984,681	984,681	100%	1,181,490
2018	-2.06	-3.03	-9.06	4	NA	954,785	954,785	100%	1,152,786
2019									
January	3.37	3.13	10.79	4	NA	984,623	984,623	100%	1,184,800
February	0.21	0.21	4.30	4	NA	986,645	986,645	100%	1,187,424
March	0.54	0.54	0.86	4	NA	991,993	991,993	100%	1,193,131
Q1	4.15	3.90	16.54	4	NA	991,993	991,993	100%	1,193,131
YTD	4.15	3.90	16.54	4	NA	991,993	991,993	100%	1,193,131

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

Areté Asset Management Mid Cap Core performance composite disclosures follow:

Compliance statement

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

Definition of the firm

Areté Asset Management, LLC (Areté) was established in 2008 and is registered as an investment adviser in the state of Maryland. Areté is defined as an independent investment management firm and is not affiliated with any parent organization. Areté 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 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. Areté 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.

Areté Asset Management Mid Cap Core performance composite disclosures continued:

*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.

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

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

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