First quarter 2020
Volume 13, Issue 1

THE ARETÉ QUARTERLY

Welcome

As it becomes progressively more apparent that the investment landscape presents unique challenges, it is also becoming progressively more apparent that conventional investment approaches are not sufficient for meeting those challenges.

Areté is a unique organization for unique times. With an orientation to active management, research and analysis are primary activities and are applied for the purpose of solving problems and helping investors do the best they can. Each investment decision and communication is made with the mindset of having skin in the game.

If you are interested in getting more (or different) investment insights, please take a look at our blog [here]. Content for the posts is selected and created on the basis of being important, relevant, and useful. In addition, these posts provide excellent exposure to our thinking.

Also, in addition to managing a mid cap core equity strategy, Areté now also provides insights and expertise on a personal basis through the Personal CIO Service. If you would like to learn more, please take a look on the website [here]. Finally, please always feel free to contact us with questions or comments.

Business Update

An eventful quarter in the markets also shifted the perspective of the business landscape. Just last quarter I complained that monetary policy had served to "almost eradicate any perception of risk in markets."

Inside This Issue

After the turbulence in the quarter, I'm not worried about lack of risk perception any more! The severe selloff in March re-acquainted many investors with what it feels like to have their portfolio down on the order of 30%. Many felt the kind of pain that can serve as an impetus to do things a different way.

For better and worse, many people do not appreciate risk until it hits. Insurance is always much more costly just after a hurricane than just before and it is no different with investments.

The good news, then, is that in a space of just a few weeks the types of "insurance" that are endemic to Areté's business mission – like research, risk management and strategic perspective - have become more valuable and have acquired a broader audience.

The explicit recognition of risk is a necessary, but not a sufficient, condition for success, however. What I have observed in stock prices and market action in the first several days of April is that the selloff served as a good wake up call for investors, but not a loud call to action. It seems investors are being slow to fully incorporate the depth and breadth of economic harm that is being caused.

My base expectation is that investors have become fairly complacent after more than ten years of rising markets, with only periodic and transient episodes of adversity. The public policy playbook has been to come riding to the rescue any time it looks like there might be a serious problem and prices could fall a lot.

Some investors will be stuck on autopilot and continue assuming the Fed is both willing and able to "protect" the prices of risk assets. I think they will be in for a very rude awakening, but if they are absolutely determined to maintain this belief, there really isn't anything I can do about it; it's a matter of faith.

A number of other investors are increasingly becoming concerned that something doesn't seem right, however. Whether it is a nagging feeling, a specific concern about something like asset allocation, or a question about things that don't make sense, some of those investors will be looking for answers.

While it is certainly natural to feel uneasy in a time of great uncertainty, and I certainly don't pretend to have all the answers, I can provide a great deal of context for better understanding the investment landscape.

Since my primary goal is helping investors and not selling products, I am able to approach challenges in a way that is distinctly different from what most brokers, advisors, and research platforms do.

For example, when stocks go through a period of selling off, investors often receive notes from organizations that have anything to do with their investments. The notes typically caution them to not overreact and implore them to stay focused on the long-term. I receive those notes too.

While these messages are not wrong, per se, they aren't especially helpful either. They rarely explain what is going on or what the implications are. I have yet to see one that provides any substance. Such messages are designed to retain assets and that's it.

This is exactly where my approach with Areté can be so helpful. Since my approach to investing involves constant research in an effort to understand the landscape as best as possible, not only can I answer questions and provide context, but I am available to do so on a personal basis. By establishing a robust strategic perspective, investors don't need to be so concerned with day-to-day events and can instead focus on a few key priorities.

Also, while investment research comprises a great deal of what I do with Areté, so too does decision making. All the great ideas in the world don't matter if they don't get implemented with actual portfolio actions.

This is no trivial factor either. When you are inundated with information, especially conflicting reports, it can be hard to rise to the threshold of acting. It is all too common to fall down a "rabbit hole" of research topics or to simply put off important actions until things “clear up”. Either way, failure to act can be extremely costly.

Finally, this relatively new risk environment certainly makes a lot of the work I have done over the last several years resonate more deeply with investors. While this is good for Areté, it doesn’t mean very much unless and until it can be applied to help people improve their investment outcomes. If you know of anyone who could benefit from this work please with let me know or invite them to contact me.

Thanks – I appreciate it!

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.

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 (3/31/20)

	Arete MCC*	Midcap Index**
Size		
Average Market Cap ($ mil.)	7,464	8,065
Median Market Cap ($ mil.)	6,368	5,761
Minimum Market Cap ($ mil.)	173	72
Maximum Market Cap ($ mil.)***	35,816	64,508
Number of holdings	16	802
Valuation		
P/E current year	24.6	26.3
P/B	2.2	4.1
P/S	1.9	3.5
Yield (%) ****	5.9	5.6
Valuation drivers		
ROE (%)****	5.6	11.2

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

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.

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.

Sector exposure (percent of assets on 3/31/20)

Economic sector***	Arete MCC*	Midcap Index**	Percentage Comparison
Consumer Discretionary	0.1	9.9	1.0%
Consumer Staples	0.0	4.7	0.0%
Energy	0.0	2.1	0.0%
Financials	2.4	11.3	21.3%
Health Care	4.8	12.0	40.1%
Industrials	0.0	13.8	0.0%
Information Technology	2.0	19.9	10.0%
Materials	6.7	5.2	129.2%
Real Estate	3.9	9.3	42.0%
Communication	0.0	4.1	0.0%
Utilities	3.4	7.7	44.2%
Equity exposure	23.3	100.0	
Cash and equivalent	76.5	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.

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 lower than the mid cap index and the median is slightly higher. 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* (3/31/20)

Period	Percent**
Q120	96.1
Q419	96.6
Q319	96.1
Q219	95.6
Q119	95.5

**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 were no purchases or sales in the quarter but the acquisition of DRGDF by KL was completed. This was a favorable outcome since DRGDF received a premium and KL provides brings a better operating team.

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.

Stock performance* (12/31/19 - 3/31/20)

Best performers

Company	Return in quarter (%)
Davita	1.4
Saint Joe Company	-15.4
Capitol Federal Financial	-15.4
Seagate Technology	-18.0
Exelon Corp	-19.3

Worst performers

Company	Return in quarter (%)
Seritage Growth Properties	-77.3
Lands End	-68.2
Annaly Capital	-46.2
Weyerhaeuser	-43.9
Owens Illinois	-40.4

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

Areté's Mid Cap Core (AMCC) strategy returned -8.08% (net of fees) for the quarter versus -27.07% for the Russell Midcap Index® (RMC) (see pages 7 – 9 for performance and related disclosures). Major indexes fell strongly in reaction to coronavirus lockdowns but AMCC's defensive positioning insulated the portfolio from far more serious losses.

The poor performance of the best performers was an indication of just how brutal the selloff was in the quarter. Only one stock in the strategy (DVA) posted a positive return. Other top performers were notable less for any individually exceptional performance than for generally defensive qualities.

Among the underperformers, debt and economic exposure were the main themes. Three REITs were among worst performers as rapid increases in unemployment immediately increased concerns about undelrying asset values. Substantive public policy responses also created obstacles for these companies. Other companies with debt in economically sensitive sectors such as retail and housing also suffered unusual selloffs.

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, 2020

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	10.73	9.65	30.54	3	NA	1,046,822	1,046,822	100%	1,257,036
2020									
January	0.16	-0.09	-0.80	3	NA	1,045,862	1,045,862	100%	1,255,939
February	-2.92	-2.92	-8.69	3	NA	1,015,294	1,015,294	100%	1,222,241
March	-5.22	-5.22	-19.49	3	NA	962,276	962,276	100%	1,164,373
Q1	-7.85	-8.08	-27.07	3	NA	962,276	962,276	100%	1,164,373
YTD	-7.85	-8.08	-27.07	3	NA	962,276	962,276	100%	1,164,373

**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®).

Areté Asset Management Mid Cap Core performance composite disclosures continued:

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.

*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.

Areté Asset Management Mid Cap Core performance composite disclosures continued:

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.