Second quarter 2010
Volume 3, Issue 2

THE ARETE QUARTERLY

Welcome

A Manifesto for Giant (and tiny?) Funds

When we look at mutual funds, hedge funds, and most of the money management industry we see an awful lot of offerings that do not present good value to end investors. Legendary investor Warren Buffett provided a similar, and characteristically folksy, assessment of the industry: "There is so much that's false and nutty in modern investing practice . . . If you just reduced the nonsense, that's a goal you should reasonably hope for."

Interestingly, we recently came across a fascinating article in *the Economist* which addressed this very issue of "nonsense." Specifically, the piece described the efforts of Paul Woolley, a former fund manager, to study the dysfunctionality of capital markets. In fact, he set up think tanks at both the London School of Economics and the University of Toulouse to study the issues further.

Woolley presented his findings in a doctrine entitled "A Manifesto for Giant Funds" (http://www.lse.ac.uk/collections/paulWoolleyCentre/). Woolley lists several tenets of a reasonable investment program in his manifesto which include long-term orientation, avoidance of performance fees, and avoidance of alternative assets such as hedge funds and private equity.

His argument is that since very large funds such as pensions, endowments, and others, in aggregate, represent such a large share

Inside This Issue

Welcome	1
Business Update	2
Portfolio Characteristics	3
Transactions Review	5
Market Overview	5
Performance Review	6
Investment Philosophy	8
Arete Mid Cap Core Composite	10

of global wealth that they are engaged in a zero-sum game for outperformance. As a group, by definition, they cannot outperform the market. To the extent that large plans dole out performance incentives to certain managers to try, these fees simply represent economic rents that accrue to the finance industry at the expense of investment plan beneficiaries.

Some elements of Woolley's thesis are no doubt controversial, but its main thrust is not: Investment fiduciaries should exercise great care to preserve the wealth of beneficiaries by scrutinizing the fees and costs of their investment management vendors. Anything short of such an effort means wealth is being transferred from beneficiaries to the financial services industry.

Two things strike us about Woolley's manifesto. First, it provides an eminently sensible foundation for any investment policy — for institutions *and* individuals. Having a long-term investment horizon, maintaining low turnover, demanding fair fees from managers, and eschewing "alternative" investment vehicles are all actions that can go a long way towards "reducing the nonsense."

The second thing that strikes us is that the prescriptions Woolley makes are nearly identical to Arete's value proposition. This is no coincidence. We have no desire to use our knowledge and experience of investing to redistribute others' wealth to ourselves. If we did, we would have had no need to create Arete; plenty of other shops are quite efficient at redistribution. Rather, we try to provide an honest, valuable service for a fair price — which should fit in very neatly with a lot of well-reasoned investment plans.

Business Update

Before I founded Arete, I used to marvel at how many mutual funds, hedge funds, and other investment vehicles there were for investors to choose from. I used to marvel even more at how few offered a good value to their investors. I measured value in simple ways. Was it something I would want to invest in? Would I feel comfortable recommending it to a friend or family member?

I still feel the same way, enough so to make the enormous commitment of founding Arete. Arete's value proposition is to offer a sound investment philosophy and process which can really outperform, to avoid conflicts of interest, to be very transparent in disclosures and communication, and to offer it all at a very fair price. I am very happy to report that this proposition seems to resonate deeply with people who have done their research and who understand the business well.

I believe this proposition is becoming ever more valuable to investors of all types. The reason it is becoming more valuable is because the investment landscape has changed over the last several years and in the process, has changed the relative value of the proposition.

In order to appreciate the change, let's look at some history. Following the bear market bottom in 1982, equity investing was a land of plenty. Valuations were excessively low and the specter of inflation was high. Over time, globalization provided large pools of cheap labor which kept prices down, concerns about inflation receded, and we entered "the Great Moderation."

During that time, consistent outsized equity returns rapidly built wealth for many people. Those outsized returns also covered a lot of mistakes, though, and smoothed over a lot of expensive money management fees.

The next seven to ten years looks to be considerably different in what Mohammed El Erian has described as the "New Normal." This landscape looks to provide very little if any stock market appreciation and will be further complicated by more "bumps in the road" than we are accustomed to.

Insofar as this outlook is reasonable, and I believe it is, it has at least two very serious implications for investors of all types. I don't believe either of these is fully appreciated.

First, plans which are underfunded, and many are, will not be able to rely on the market to bail them out. They will need to increase contributions, reduce liabilities, or both. If the effort is not made to match assets with liabilities, the plans will fail to provide adequately for beneficiaries and therefore fail their only mission.

Second, just as most of us do when our budget gets squeezed, investors will need to increase scrutiny of costs. Can some investment activities be done more cheaply in-house? Are we getting a good value from our vendors? How much are we even spending? These costs — for management fees, consultants, brokers, financial planners, etc. can easily surpass 2% of assets under management (AUM) and can be even higher for individuals.

The trouble is, if market returns are near zero over the next ten years, and costs are 2% (for sake of argument), all of this "help" is going to eclipse returns and whittle away at assets. Investors will be left worse off than they are now.

This is a key point. As the investment landscape has changed from a "land of plenty" to a "bumpy road", the importance of the value proposition of investment service providers has increased from a modest curiosity to an economic necessity. I very much appreciate the difficult decisions investors face — so much so, in fact, that I built Arete to help investors navigate the difficult investment terrain.

If you or someone you know is not satisfied with the investment options you are finding, please let me know. I would love to see if Arete can help.

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 out-performance. To us, such activities usually just serve to obfuscate the underlying inability of the manager to add value through a coherent and disciplined investment process.

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

Portfolio Characteristics (6/30/10)

	Arete MCC*	Midcap Index**
Size		
Average Market Cap ($ mil.)	5,112	4,308
Median Market Cap ($ mil.)	4,363	3,263
Minimum Market Cap ($ mil.)	188	684
Maximum Market Cap ($ mil.)	14,603	13,731
Number of holdings	49	792
Valuation		
P/E current year	19.9	22.2
P/E forecast Y1	13.5	16.7
P/B	2.8	2.9
P/S	1.0	1.4
Yield (%)	0.9	2.6
Valuation drivers		
ROE (%)	9.7	14.8
LT eps growth forecast (%)	10.5	11.6

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.

While market caps of AMCC stocks remained very similar to those in the benchmark, the gap between the two has increased over the past year. At the end of the second quarter in 2009, the median AMCC stock was $3,072M which was just slightly greater than the median of $2,696M for the benchmark. Now, the median AMCC stock has risen to $4,363M while the benchmark is just at $3,262M. Since there have been few transactions in the AMCC portfolio, most of the change can be attributed to the recent rebalancing of the benchmark with larger components migrating to the Russell Top 200 Index.

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

Sector exposure (percent of assets on 6/30/10)

Economic sector	Arete MCC*	Midcap Index**	Percentage Comparison
Consumer Discretionary	20.9	15.5	134.5%
Consumer Staples	3.6	6.0	60.3%
Energy	6.8	8.2	83.4%
Financial Services	18.5	20.5	90.1%
Health Care	12.1	9.3	130.6%
Materials & Processing	11.0	6.7	164.2%
Producer Durables	12.6	13.3	94.7%
Technology	7.3	11.9	61.1%
Utilities	6.3	8.6	73.3%
Equity exposure	99.1	100.0	
Cash and equivalent	0.9	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.

Since our portfolio construction is driven by bottom-up research, sector considerations do not play a primary role. That said, our sector guidelines do serve the purpose of providing an important degree of diversification in the portfolio. In addition, when a sector exposure reaches or surpasses the extremes of our guidelines, it serves as a useful challenge to the thesis for holding each of the individual stocks in that sector.

As a result, we often do more stock work in sectors with larger exposures relative to the benchmark. While it is not uncommon for no transactions to emerge from the effort, that does not mean work is not being done or that value is not being added. First, every time we come across an attractive company that does not meet our high criteria for purchase, we continue to track it in our "bullpen." In this way we leverage our ongoing research efforts and significantly improve our ability to act quickly as opportunities arise. Second, when additional research does not uncover stocks that are more attractive than what we already own, the effort still further improves our knowledge and awareness of the overall universe of mid cap stocks.

Transactions review – Arete Mid Cap Core

During the second quarter we had no transaction activity in composite portfolios. The dearth of transaction activity though, belied the high level of activity in implementing the investment process and deserves a brief description here.

Without a doubt, we had a handful of stocks that demonstrated substantial price swings over the past couple of quarters. These huge swings beg the question of why we didn't sell them when they peaked in May, harvest our gains, and avoid subsequent underperformance.

The short answer is that in our regular reviews of the portfolio, none of the stocks met our criteria for sale. Specifically none exceeded long-term price targets, experienced material increases in risk, or were outclassed by any of the slew of new stocks we examined.

It is useful to note that our sell criteria are based on a long-term investment horizon of three to five or more years. We also tend to single out stocks for which a lot of things can go right. Both factors cause us to be patient in selling stocks in order to realize their full potential.

It is also useful to note that our investment process revolves around the premise that we are very good at assessing intrinsic value over time and not at all good at determining market sentiment or daily price action. We may miss some "trading" opportunities, but we also avoid getting caught off guard. Many investors sold out of stocks in early 2009 for fear of declining prices. For their efforts, they missed a 15%+ return for the Russell Midcap Index in April and much of the subsequent rally throughout the year.

Finally, while large price fluctuations do not drive our long-term strategy, they do provide some opportunities. For new clients and for existing clients that increase their allocation to us, price volatility gives us a great opportunity to buy stocks we like at extremely attractive prices.

Market Overview

Last quarter we noted that, "While conditions are improving in the US, we are concerned about the complacency the market has exhibited toward a rather large number of risks." This quarter a number of those risks became more evident to the market and got discounted fairly quickly and severely.

In the US, housing starts sank after tax breaks expired and job growth remained anemic. Regulation continued to be on top of investors' minds, but this time the target was financial services rather than healthcare. Investors barely got a breather from one set of uncertainty before having to transition to another.

In Europe, sovereign debt issues captured the attention of investors along with the implications for slower growth. As events unfolded, weaknesses in the governance and structure of the European Union were exposed which also increased uncertainty. Further east, China's economy slowed which oddly may have been the only condition scarier than that of China's economy overheating.

As if there weren't enough cross-currents to make investors a bit seasick, trading volumes drifted downward as we entered the summer months. Amid lower volume, many price movements were exaggerated far beyond underlying long-term fundamentals. If nothing else, it is clear that the market is still being driven by "narratives" with the dominant narrative currently being deflation.

Due to low volumes and high volatility, there has been a lot of noise in the market and not a lot of real information content. In that context, one of the most useful insights we have heard came from distinguished value investor, Seth Klarman, at the CFA Annual Conference in May. He described the markets as "Hostess Twinkie markets" based on the key factor that there is such a high level of government intervention in so many critical areas of the economy right now. In his view, the markets are currently comprised almost entirely of artificial ingredients and as such, nobody really knows what things will look like when the intervention ceases.

We believe Mr. Klarman's comments suggest an appropriate course of action as well as any: Don't read much into short-term volatility and be sure to plan through the various scenarios of returning to a normal economic "diet".

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.

The market continued its nice run in April and then in May performed a rapid about-face. Arete's Mid Cap Core (AMCC) strategy returned -16.32% (net of fees) for the quarter which pretty significantly underperformed the Russell Midcap Index (RMC) return of -9.88% (see pages 9 – 11 for performance and related disclosures). Relative performance was negative in May and accelerated in June as the market declined further.

Stock performance* (3/31/10 - 6/30/10)

Best performers

Company	Return in quarter (%)
Discovery Holdings	5.7
NRG Energy	1.5
Dresser Rand	0.4
Annaly Capital	-0.2
Shaw Group	-0.6

Worst performers

Company	Return in quarter (%)
The Saint Joe Company	-28.4
Seagate Technology	-28.6
Genworth	-28.7
Sears Holdings	-40.4
Energy Conversion Devices	-47.6

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

Interestingly, individual stock performance did not provide much insight into Arete's relative return this quarter. The benchmark declined nearly 10% so it's not surprising the best performers were unimpressive.

The worst performing stocks tell a slightly more interesting story, but just slightly. ENER continued to get pressured by its large contingent of short sellers betting that company will need to dilute existing shareholders with an equity offering. JOE got hit especially hard as the prospect of oil balls from BP's Macondo well washing up on its pristine beaches dimmed any views of an imminent real estate recovery.

By far the most important factor for each of the five worst performers though, is that they have all been treated as high beta proxies for economic recovery. Each, with the exception of ENER, performed quite well last year and through early May of this year. In May, it was as if the market flipped on the "deflation switch" and each got clobbered.

This analysis is also corroborated by what we saw in the broader markets. As market participants rapidly switched from being concerned about inflation to being concerned about deflation, conventional signals for risk aversion sounded loud and clear. The two year Treasury yield, for example, hit a low last set at the end of 2008.

Although the broad market swing was an important part of the performance story for the quarter, another part was what happened within the benchmark. Reviewing second quarter and year-to-date performance for Russell Midcap Index stocks revealed some key developments which contributed to our relative underperformance.

One development was that M&A activity increased in the first half of the year which had a very significant effect on the energy and biotech industries in particular. This activity had deleterious effects on AMCC performance due to the magnitude and breadth of appreciation of stocks in these industries. Underperformance was exacerbated by the underrepresentation of energy and biotech stocks in the AMCC portfolio.

Another development that contributed to our relative underperformance was the strong performance in the quarter of a number of high growth stocks. While Arete's investment strategy distinctly provides for inclusion of high growth companies, our review of the significant outperformers in the benchmark index revealed that many of the best performers seemed to be driven by momentum despite extremely high valuations.

In summary, while we never enjoy underperforming, we found little evidence we had "missed" anything. Instead, we came away feeling much more confident that much of what transpired in the quarter represented investors somewhat desperately chasing growth and momentum. These situations rarely turn out well for those trying to tip-toe through the valuation mine field. Nonetheless, they do happen and we do our best to manage through them thoughtfully.

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 - June 30, 2010

Period	Gross-of-Fees Return (percent)	Net-of-Fees Return (percent)	Russell Midcap® Index Return (percent)	Number of Portfolios***	Internal Dispersion (percent)	Total Composite Assets ($)***	Composite Assets With Bundled Fees ($)	Percentage of Composite Assets With Bundled Fees	Total Firm Assets ($)
2008**	-37.97	-38.16	-35.01	3	NA	207,031	207,031	100%	207,031
2009	48.63	47.83	40.48	3	NA	471,867	471,867	100%	673,806
2010									
January	-0.19	-0.19	-3.34	3	NA	470,985	470,985	100%	673,872
February	2.94	2.69	5.00	3	NA	483,663	483,663	100%	689,224
March	7.68	7.68	7.07	3	NA	520,819	520,819	100%	738,658
April	3.36	3.13	3.76	3	NA	537,099	537,099	100%	759,343
May	-9.66	-9.66	-7.35	3	NA	485,200	485,200	100%	790,766
June	-10.18	-10.18	-6.25	3	NA	435,813	435,813	100%	725,087
Q1	10.64	10.37	8.67	3	NA	520,819	520,819	100%	738,658
Q2	-16.13	-16.32	-9.88	3	NA	435,813	435,813	100%	725,087
YTD	-7.21	-7.64	-2.06	3	NA	435,813	435,813	100%	725,087

**Note*: Composite returns for September 2008 have been corrected for an error that occurred in the calculation of accrued income. The new, new, corrected performance is higher by 10 basis points, which equals our threshold for materiality. The error occurred due to an ex-post post adjustment made by our reporting software. We have identified the source of the problem and have created procedures designed to avoid recurrence.
***Note*: Peformance through 12/31/08 is from inception of composite on 7/31/08.
****Note*: One new and one existing account contributed additional funds which were not at least 90% invested by the end of June. 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.

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. For purposes of composite construction, "fully invested" is defined as having greater than 90% of portfolio assets invested in equity securities. Every new portfolio is added to the composite in the first complete calendar month that it is "fully invested". A complete list and description of firm composites is available upon request.

Fee schedule

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

Minimum account size

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

Dispersion

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

Arete Asset Management Mid Cap Core performance composite disclosures continued:

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

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