Second quarter 2011
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THE ARETE QUARTERLY

Welcome

Summer is a great time to get away and to explore new places. A remote trail with beautiful scenery, an underappreciated historic site, and a new restaurant with an interesting menu are but a few of the new experiences that can be sought.

While our process of uncovering new stock ideas extends throughout the year, the quest for unique, new ideas is very similar. In order to guide our way, we pay special attention to tidbits of information that suggest interesting and overlooked phenomena in the market.

One recent tidbit, in particular, is that there have been more corporate spin-offs than usual over the past several months. Helen Thomas also noticed this developlment in a recent article for the *Financial Times*. She reports, "Divestitures have risen to a record share of global mergers and acquisitions activity so far this year, according to Dealogic data. In the US, [spin-off] activity is up more than 40 per cent on the first half ot 2010."

In identifying the rationale for this activity, Thomas quotes Mark McMaster, vice-chairman of US investment banking at Lazard. According to McMaster, "There is a trend right now in the public markets towards purity, focus and specialization." He continues, "The impetus for separation is usually a meaningful and persistent undervaluation of a portfolio business."

Inside This Issue

The notion that value can be created through spin-offs has been documented and is not new. In fact, we highlighted spin-offs as one of many factors that make the mid cap universe so robust and dynamic in our 2007 white paper, *The Case for Mid Cap Stocks*.

The increasing *incidence* of spin-offs, however, is interesting for a couple of reasons. One reason is that the recent trend to become smaller is occuring in direct contradiction to forces that naturally compel organizations to grow ever-larger, a phenomenon Warren Buffett has labelled the "institutional imperative."

Buffett illustrates, "Just as work expands to fill available time, corporate projects or acquisitions will materialize to soak up available funds . . . any business craving of the leader, however foolish, will be quickly supported by detailed rate-of-return and strategic studies prepared by his troops." It shouldn't be surprising that executive compensation also tends to grow as companies swell with these projects and acquisitions.

Another reason why the increasing incidence of spin-offs is interesting is because the trend also runs counter to the advice of many financial advisers who are recommending large cap stocks. While the majority of large cap stocks do not spin-off business units, the trend does suggest a something of a disconnect between large cap advocates and the executives that prefer to subdivide their companies.

Consider what it means for a CEO of a large company to pursue a spin-off. First, he or she must engage in an active effort to effect a spin-off; it is far easier to do nothing and to remain large. Further, the CEO will likely relinquish a certain amount of power and compensation attendant with a larger organization. Also, by engaging in a spin-off, the CEO rejects a preference of many investors for size. Clearly, a CEO must require overwhelming evidence regarding the net benefits of a spin-off to overcome so many hurdles.

Spin-offs often happen because they allow for more efficient capital allocation by deliberately constraining company size. Indeed, the rationale of resolving "meaningful and persistent undervaluation" by pursuing "purity, focus, and specialization" through spin-offs sends a powerful signal: Many businesses can be much more effective as mid cap companies rather than as divisions of very large corporations.

Arete began its existence by focusing on mid cap stocks because we thought this was an extremely exciting area that lent itself to terrific opportunities for stock selection. Large companies often become too large to be efficient through the "institutional imperative." When executives choose to get smaller through spin-offs, it often provides interesting new mid cap stocks for us to investigate. For us, new ideas are always in season!

Business Update

The more I think about how Arete creates value, the more I see connections to my education at Grinnell College. This shouldn't be too surprising since Grinnell had such a powerful influence on my thinking. Indeed, the name Arete comes from Greek philosophy which I first read in my studies there.

I can still remember vividly how excited I was to attend Grinnell. I was anxious to learn — about everything. While I enjoyed math, science, and economics, I also really enjoyed literature, history, and sociology. When I took my first philosophy class, I felt like my mind was stretched in all kinds of unfamiliar, but good ways. I was hooked.

I found my studies, as those in any good liberal arts program, to provide me with a rich source of ideas and metaphors from which to better understand the world. Because my studies were so diverse, I found it difficult to become overly dogmatic. Whenever I may have been tempted to relax intellectually, I was always exposed to a swarm of models and paradigms which begged for my consideration. By de-emphasizing structure, Grinnell's culture really nurtured independent thinking. It was a wonderful learning experience and continues to influence my approach to learning today.

While this learning environment worked extremely well for a lot of students, there was a potential weakness. With few real constraints or objectives, it was not hard to get "lost in learning." The experience could certainly become addictive and self-serving. As much as I enjoyed learning, I realized learning alone wasn't enough for me. As I approached graduation, I had to find a way to put my learning and knowledge to good use.

With this context, I believe it is much easier to articulate what I have tried to do by founding Arete. The essence of Arete is a platform to leverage curiosity to learn, to develop unique insights and knowledge through independent thinking, and to apply that knowledge so as to increase well-being.

As much as I enjoy these activities intrinsically, I created Arete so they could also be delivered in the form of a valuable service. While Arete explicitly strives to increase well-being through long-term portfolio performance (and that has certainly been my personal experience), it is not all.

Because I spend so much time reading, researching, modeling, analyzing, meeting management teams, and assimilating information, I develop all sorts of knowledge that can be useful beyond portfolio performance. I share some of these insights through Arete's newsletters. I also enjoy volunteering in my community. Importantly, however, I really enjoy sharing insights with clients so they can better understand market activity and risks — and enjoy the greater sense of empowerment that provides.

An interesting footnote to my college experience is that I never could have afforded Grinnell if it were not for the school's need-blind admission policy. Although I worked several jobs there, received scholarships, and took on several loans, Grinnell still granted me a huge portion of the tuition.

Grinnell was able to make such a large and meaningful contribution due to the strength of its endowment — which is the second highest per student behind Harvard University. The endowment was managed extremely well for years under Joe Rosenfield, but also received valuable input from Warren Buffett, who has served on the Board of Trustees since 1968.

The learning experience at Grinnell — that made my life immeasurably better — serves as a powerful reminder to me of the good that great money management can produce.

Exceptional money management also serves as Arete's mission. I created the organization in order to improve well-being, not least of which is through helping people's money work harder for them. If you know of someone interested in talking to such a devoted manager, please let me know.

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.

Portfolio Characteristics (6/30/11)

	Arete MCC*	Midcap Index**
Size		
Average Market Cap ($ mil.)	6,992	5,844
Median Market Cap ($ mil.)	5,867	4,500
Minimum Market Cap ($ mil.)	63	661
Maximum Market Cap ($ mil.)	23,662	17,896
Number of holdings	49	788
Valuation		
P/E current year	21.1	21.9
P/E forecast Y1	17.8	19.8
P/B	2.6	3.2
P/S	1.1	1.6
Yield (%)	1.0	2.3
Valuation drivers		
ROE (%)	10.2	16.9
LT eps growth forecast (%)	10.7	12.2

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.

For example, many fund managers attempt to beat their benchmark by timing the market and/or migrating style. These tactics rarely generate sustainble out-performance. To us, such activities usually just serve to obfuscate the underlying inability of the manager to add value through a coherent and disciplined investment process.

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

Sector exposure (percent of assets on 6/30/11)

Economic sector	Arete MCC*	Midcap Index**	Percentage Comparison
Consumer Discretionary	19.3	16.2	118.8%
Consumer Staples	3.5	5.6	62.9%
Energy	6.9	8.5	81.6%
Financial Services	16.9	20.4	82.9%
Health Care	10.4	9.5	109.2%
Materials & Processing	11.1	7.5	148.9%
Producer Durables	8.9	13.6	65.6%
Technology	7.9	11.4	69.4%
Utilities	6.2	7.4	83.8%
Equity exposure	91.1	100.0	
Cash and equivalent	8.9	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.

Sector exposures were within our general guidelines of 50% - 150% of benchmark weights for each sector this quarter. The Materials and Processing sector is still overweight, but less so due to an increase in the benchmark sector weight which occurred when the Russell Midcap Index® was rebalanced at the end of June. The greatest change in exposures occurred in the financial sector as underperformance in the AMCC portfolio led to a smaller weight in that sector.

Transactions review – Arete Mid Cap Core

During the second quarter we did not execute any transactions. This lack of explicit portfolio activity, however, belies the considerable efforts exerted to protect and enhance the portfolio. Since we don't have transactions to discuss, this is a good opportunity to review those efforts.

We have been discussing various market risks for several quarters, and while they have not been significantly discounted by the market yet, that doesn't mean they don't exist. As a result, much of our work has largely revolved around various forms of insurance.

One form of insurance has been through portfolio construction. With an investment horizon of three to five or more years, we look beyond short-term fluctuations and try to capture broader trends and insights. In that regard, we strongly believe consumers in the U.S. have too much debt and that they will need to curb spending over the next several years. Conversely, the global middle class continues to grow and will need vast amounts of infrastructure to accommodate that growth. As a result, the portfolio is tilted toward these long-term global growth opportunities.

Another form of insurance is financial stability. We prefer companies with significant cash stockpiles to weather a liquidity crisis. Also, while we like companies that pay dividends, we primarily look for strong cash flows. We absolutely don't mind conceding a lower dividend yield in a company that instead can redeploy its cash with profitable growth opportunities. Either way, while stock prices will fluctuate, there is strong protection against permanent impairments of capital due to significant intrinsic value.

Also, and a bit counter-intuitively, we always look for stocks with very big upside opportunities. Certainly we prefer to find such options for free, but we are also willing to pay for them if they are cheap enough. Often they are cheap enough because they involve controversy that many analysts prefer to avoid. Recommending a stock that has some chance of failure is a very difficult career risk for many analysts to take. On the other hand, a portfolio does not need too many three or four baggers to really drive performance.

In addition, we also try to insure the portfolio by finding stocks that have cash flow streams that are uncorrelated with the market. These may be asset-based or event based situations, or may simply have idiosyncratic revenue streams that are completely independent of macroeconomic performance. Because these stocks are different, they are often under-followed, under-appreciated and under-valued, but they can also serve as solid ballast against economic upheavals.

We tend to make use of all of these strategies in the normal course of portfolio construction. Given the increasing risks we have identified in the market the past several quarters, we have also implemented one additional measure to protect the portfolio. We have raised cash to levels well above the normal one to three percent we deem appropriate for operations. The rationale is that in the event of a liquidity crisis or other market disruption, ALL stocks get hit. The only way to take advantage is to have some dry powder. While we normally prefer to be fully invested, the cash position fairly indicates our assessment of how abnormal market risks and valuations currently are.

Market Overview

The character of the market has remained much the same over the last several quarters. The strong cyclical recovery unleashed in March 2009 reversed quickly beginning in April 2010. Fears regarding European sovereign debt and slowing economic growth emerged simultaneously which pulled the market down, but had an especially harsh effect on more cyclical stocks.

Late last summer, the Fed outlined its plan for quantitative easing which helped the market significantly, but not uniformly. Cyclicals continued to lag while companies producing short-term earnings improvements experienced huge price appreciation. This environment tended to favor many technology and biotech companies.

The Russell style returns also bear this out in a more general way. Returns of the Russell Midcap Growth® Index, for example, outpaced those of the Russsell Midcap Value Index® by almost 800 basis points for the latest twelve months. The style effect was even greater for small cap stocks. In short, relative performance over the past year depended meaningfully on style.

During this period, however, we have also seen increasingly violent market reactions to individual company performance, which has often been exacerbated by low trading volumes. Many of the earnings shortfalls and subsequent price-bashing have occurred with manufacturing companies that have not been able to pass through pricing as fast as raw material costs have increased. For strong companies, this is normally just a timing issue and does not reflect a permanent condition.

The good news in this is that many of the stocks we like are very cheap. The bad news is that in this unforgiving environment for short-term earnings misses, the stocks can continue to get even cheaper. While we constantly evaluate opportunities, we are also extremely aware of how fragile the market environment is right now.

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 -2.34% (net of fees) for the quarter which trailed the Russell Midcap Index® (RMC) return of 0.42% (see pages 9 – 11 for performance and related disclosures).

The performance of individual stocks in the portfolio largely reflected style-related characteristics through the quarter. Two important exceptions were National Semiconductor and Constellation Energy. During the quarter, both companies received takeout offers at premiums which boosted performance. This was rewarding because takeouts are normally an important component of AMCC's performance and because the strategy has experienced relatively low takeout activity lately.

The underperforming stocks comprised a list of familiar names. Stocks that have been out of favor continued to be out of favor. Energy Conversion Devices, Dex One, and Genworth have all appeared on the list several times.

We continue to believe the market has been far too severe in its discount of short-term challenges for these companies. Insofar as we are correct in our assessment of intrinsic value, we merely need to be patient. As an example, of what can happen, we point to the case of Genworth. After being sold down to a low of $0.84 in February 2009 following the financial crisis, it rebounded wildly to a high of $18.96 just over a year later. These things really happen.

Stock performance* (3/31/11 - 6/30/11)

Best performers

Company	Return in quarter (%)
National Semiconductor	71.6
Coach	22.9
Constellation Energy	21.9
NRG Energy	14.1
Seagate Technology	12.2

Worst performers

Company	Return in quarter (%)
Investment Technology Group	-22.9
Genworth	-23.6
United Rentals	-23.7
Dex One	-47.7
Energy Conversion Devices	-47.8

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

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 Mid Cap Core Composite

Arete Asset Management, LLC
Mid Cap Core Composite
July 31, 2008 - June 30, 2011

Period	Gross-of-Fees Return (percent)	Net-of-Fees Return (percent)	Russell Midcap® Index Return (percent)	Number of Portfolios**	Internal Dispersion (percent)	Total Composite Assets ($)**	Composite Assets With Bundled Fees ($)	Percentage of Composite Assets With Bundled Fees	Total Firm Assets ($)
2008*	-37.97	-38.16	-35.01	3	NA	207,031	207,031	100%	207,031
2009	48.63	47.83	40.48	3	NA	471,867	471,867	100%	673,806
2010	16.86	15.78	25.48	3	NA	546,315	546,315	100%	877,368
2011									
January	2.61	2.37	2.13	3	NA	559,270	559,270	100%	895,481
February	1.56	1.56	3.80	3	NA	568,001	568,001	100%	907,094
March	0.53	0.53	1.53	3	NA	571,008	571,008	100%	1,011,132
April	2.16	2.16	2.99	3	NA	583,327	583,327	100%	1,028,436
May	-1.99	-2.23	-0.42	3	NA	570,329	570,329	100%	1,008,298
June	-2.22	-2.22	-2.09	3	NA	557,644	557,644	100%	990,488
Q1	4.77	4.52	7.63	3	NA	571,008	571,008	100%	1,011,132
Q2	-2.10	-2.34	0.42	3	NA	557,644	557,644	100%	990,488
YTD	2.57	2.07	8.08	3	NA	557,644	557,644	100%	990,488

**Note*: Peformance through 12/31/08 is from inception of composite on 7/31/08.
***Note*: One existing and two new accounts contributed additional funds which were not at least 90% invested by the end of 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 follow:

Arete Asset Management Mid Cap Core performance composite disclosures continued:

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

Definition of the firm
Arete Asset Management, LLC (Arete) was established in 2008 and is registered as an investment adviser in the state of Maryland. Arete is defined as an independent investment management firm and is not affiliated with any parent organization. Arete currently manages one strategy, the U.S. equity mid cap core strategy, which it markets to individual and institutional clients.

Benchmark
The benchmark is the Russell Midcap® Index and its performance is reported in U.S. dollars.

Calculation methodology
Portfolio valuations are calculated as of calendar month-end and are computed in U.S. dollars and performance is also reported in U.S. dollars. Time-weighted rates of return are used which adjust for external cash flows. Our smaller, retail accounts contain fee structures in which one flat, per-transaction fee is charged for trading expenses and which embeds an implicit charge for custody. Since trading and custody charges cannot be directly segregated 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.

Arete Asset Management Mid Cap Core performance composite disclosures continued:

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

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

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

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