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# The Arete Quarterly

Inside This Issue



## Welcome

As a continued reminder, the text content of this and future editions will be considerably shorter than in past letters. This change will allow the *Arete Quarterly* to be more focused on portfolio analysis and will also facilitate much more regular publication of general commentary through the Arete blog. If you haven't visited www.areteam.com/blog yet, please take a look when you get a chance.

## Business Update

The biggest issue for Arete in terms of business happenings has been the continuation of challenging conditions for the asset management business. The Fed's persistence in continuing an aggressively loose monetary policy has created a market addicted to short term gains at the expense of longer term sustainability. In doing so it has created conditions which are distinctly antithetical to long term investment. Unfortunately it has also served to push back much needed reform for investment services.

Investors got a close-up look at the industry's many flaws during the depths of the financial crisis 2008/9 and were incensed by the problems. Most of these had existed for many years but big losses crystallized discontent. The rapid recovery in stock prices, however, allowed pressure for more meaningful and sustainable reform to dissipate. Investors want better ways to invest, but not so much when markets are strong. As a result, the hard reality is that the Fed policies have materially altered the timing of Arete's business opportunity.

One positive development for the investment community (and Arete), however, has been the emergence of some high profile leaders that are promoting many of the same investment values and practices as Arete. John Authers at the *Financial Times*, for example, has done an excellent job of highlighting the many ways in which the industry is not "fit for purpose" and suggesting alternatives. Paul Woolley, a former practitioner, established the Centre for the Study of Capital Market Dysfunctionality in association with the London School of Economics to study structural flaws in the industry and to recommend better practices.

While I absolutely applaud these efforts, I wanted to go even one step further by founding Arete; I wanted to do something about making the industry more "fit for purpose" by putting these ideas to work. Although the business prospects for this have been delayed, they are still very real and growing. In the meantime, I will

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continue to work with the types of individuals, organizations, and family offices that recognize the need to do better now.

Although the environment for investing has remained challenging, the environment for leveraging technology has remained exceptional. Indeed, one of the biggest successes of the last year was the launching of the Arete blog last summer. While the content remains very similar to what I posted in the newsletters previously, the blog creates an extremely flexible platform for distribution.

In addition to being posted on Arete's website and going out to the regular email distribution list, blog posts now appear in Seeking Alpha, *Advisor Perspectives*, LinkedIn *Pulse*, Twitter, and StumbleUpon. Exposure to these audiences has substantially increased readership and expanded Arete's following. This success also reaffirms my belief that there are a lot of people that are looking for knowledgeable and *unconflicted* sources of investment insight which is, of course, Arete's bailiwick.

On the subject of technology, I am surrounded by it at Betamore and these experiences have suggested some useful actions. For example, an overarching goal of most of the firms and freelancers is positive "user experience". In other words, messages should be easy to understand and websites should be easy to navigate. Since Arete is all about quality, user experience has always been an important priority, although admittedly, this has tended to focus more on content and research (function) than on polished presentation (form).

As a result, I will be working on updating many aspects of the website and you will already notice some important changes. The website started primarily as a repository of useful information and it will retain that functionality. The changes will focus both on design, to make it more visually compelling, and on performance, to make it more responsive to visitors. Further, I have added a discussion forum to the "Reading list" section (and may add more) with the intent of facilitating a deeper and more meaningful way to engage with investors. If you have other suggestions for the website, please let me know! If you have investment questions or comments, please join the discussion!

I also wanted to provide an update on the personal CIO service that was launched last quarter. The good news is that there has been a great deal of interest and most people I talk to agree that there is a lot of unmet demand out there. The less good news is that most people feel that they and their organizations are in good shape but believe there are many less fortunate investors who could benefit.

While it may certainly be true that a number of these people and organizations are truly in good shape for whatever may happen in the market, I also strongly suspect this is less the case than many imagine. This sense comes from seeing all too clearly the inner workings of large, medium, and small investment management organizations and all of the things that happen that just don't help investors. While some of these things are well documented, many are not.

One thing I have experienced firsthand, for example, is the institutional bias towards growing assets at the expense of investment performance. I was a technology analyst during the internet boom and got beaten up almost every day for refusing to add to absurdly overvalued technology positions. The crazier valuations got, the more I got beaten up. My rational arguments about valuation and business prospects simply did not hold weight to the institutional demands to "go with the flow". Did the company have a ton of resources? Yes. Were there a lot of very smart people? Yes. Did investors, avoidably, lose a ton of money when the tech boom crashed? Unfortunately, yes.

Jim Ware, author of *High Performing Investment Teams*, identified a broader challenge in a 2010 article [here]. In addressing the industry's need for "strong ethical leaders," he asks the question outright, "So why do firms often engage in practices that betray their own principles (and best interests)?" Through anonymous polling of industry participants he found that the vast majority believe "investment firms routinely commit these [ethical] breaches" and that most agreed that, "Yes, those breaches occur at our firm." His conclusion is that as long as people believe that most industry participants will take the low road, "The smart response, according to game theory, is to do likewise."

I could provide plenty more examples to complete the mosaic, but suffice it to say, there is a great deal of investment expertise that never reaches investors. In my opinion, the most important source of such "friction" is a dearth of quality leadership. In the absence of leaders demanding to take the high road, we end up with complex and conflicted organizations that simply don't serve investors well. I think the CFA program has done a lot to improve the situation, but it is nowhere near enough. Arete and a handful of other firms are trying to create something better.

So, yes, I do suspect that there are many investment clients who are not getting advice that is as high in quality as they might think. What I fear might happen, and I hope doesn't happen, is that many investors will feel reasonably assured that they are positioned fairly well until we get another big market disruption. And, just like the last time, it will reveal a lot of ugliness that was overlooked in better times. Then I will get a million calls to explain what went wrong, but only after it's too late to prevent major damage.

I do think it is a great time to get very clear on investment strategy, expectations for the future, and various risk scenarios. This doesn't necessarily imply any huge changes; it can start with just getting a "second opinion". If you know of anyone who might be interested in talking, please let me know. I think the personal CIO is an outstanding offer and it is absolutely free to try out.

Thanks for your interest 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 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 cheaper in the future.

Portfolio characteristics for the quarter continue to confirm that the equity portion of AMCC is a very representative mid cap portfolio. Market caps for AMCC are fairly similar to the mid cap index although the median is now considerably smaller. AMCC is considerably cheaper on the bases of Price-book and Price-sales which tend to be more stable metrics. Notably, Price-book still compares well despite a substantial rise from the inclusion of an anomalously high figure from GLPI.

**Portfolio Characteristics** (6/30/15)

| | Arete MCC* | Midcap Index** |
|---|---|---|
| Size | | |
| Average Market Cap ($ mil.) | 7,821 | 8,497 |
| Median Market Cap ($ mil.) | 4,067 | 6,572 |
| Minimum Market Cap ($ mil.) | 13 | 1,350 |
| Maximum Market Cap ($ mil.)*** | 33,217 | 28,083 |
| Number of holdings | 26 | 828 |
| Valuation | | |
| P/E current year | 25.1 | 24.5 |
| P/E forecast Y1 | 19.1 | 21.0 |
| P/B | 2.7 | 4.9 |
| P/S | 1.4 | 2.1 |
| Yield (%) | 1.9 | 2.6 |
| Valuation drivers | | |
| ROE (%)**** | 9.6 | 12.9 |
| LT eps growth forecast (%) | 10.2 | 11.6 |

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

As a note, we changed the calculation of ROE from an average to a median some time ago. As it was, this particular measure was volatile and provided little information content. Indeed, as the markets have run up under the Fed's policy of quantiative easing, the benchmark's average ROE has become increasingly biased by a relatively small number of extremely high returns.

Sector exposures are all below benchmark weights due to the high cash position. As we have continued to raise cash, partly through sales of overvalued positions, and partly by not redeploying cash from acquisitions, several sectors are now below our normal guidelines of 50% - 150% of benchmark weights.

**Sector exposure** (percent of assets on 6/30/15)

| Economic sector*** | Arete MCC* | Midcap Index** | Percentage Comparison |
|---|---|---|---|
| Consumer Discretionary | 2.3 | 16.5 | 14.0% |
| Consumer Staples | 0.0 | 5.6 | 0.0% |
| Energy | 0.1 | 5.8 | 1.7% |
| Financials | 18.9 | 21.4 | 88.2% |
| Health Care | 6.4 | 10.5 | 60.8% |
| Industrials | 5.5 | 12.8 | 42.9% |
| Information Technology | 3.8 | 14.9 | 25.6% |
| Materials | 3.7 | 6.1 | 60.6% |
| Telecommunications | 0.0 | 1.0 | 0.0% |
| Utilities | 2.9 | 5.5 | 52.9% |
| Equity exposure | 43.6 | 100.0 | |
| Cash and equivalent | 56.6 | 0.0 | |

*Source*: The Applied Finance Group™
**Note*: Arete Mid Cap Core is represented by the aggregate of all assets in the composite at the given date.
***Note*: Arete currently does not subscribe to the Russell Indexes and therefore the sector weights presented here represent approximations of the Russell Midcap® Index.
****Note*: Economic sector classifications were changed from Russell to GICS beginning Q414.

**Active share*** (6/30/15)

| Period | Percent** |
|---|---|
| Q215 | 93.0 |
| Q115 | 94.2 |
| Q414 | 93.5 |
| Q314 | 93.1 |
| Q214 | 94.1 |

**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. Arete's Mid Cap Core portfolio consistently exhibits active share well above the 80% level considered to be very active.

## Transactions review – Arete Mid Cap Core

Through the quarter we continued the process of pruning positions that had become quite large and/or expensive. We cut the position in MYL about in half after an incredibly strong run since inception in July 2008. It is not incredibly expensive, but the easy gains for generics companies have been made and we've never been incredibly comfortable with MYL's aggressive management or its high levels of debt. It was easy to reduce exposure after recent gains.

We also sold out of the position in DOX during the quarter. DOX has also been a terrific stock for us as it has parlayed cash flows from its strong competitive position into attractive dividends and stock repurchases for the benefit of shareholders. A high valuation coupled with increasingly risky exposure to emerging markets caused us to exit the position. We also sold the small portion of SEARF as we decided not to increase the holdings to a full position.

Finally, we also purchased RGLD this quarter. We have been working on increasing exposure to gold stocks and took advantage of the continued attractive pricing. RGLD is a royalty company that benefits from increasing gold prices, but does not have the operational risks that mining companies do. Further, when efforts to increase gold supply increase to meet demand, which we believe is inevitable, RGLD will be extremely well positioned to help finance those ventures.

## 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. 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 -2.40% (net of fees) for the quarter versus -1.54% for the Russell Midcap Index® (RMC) (see pages 9 – 11 for performance and related disclosures). True to form, the strategy outperformed when the index was down in April and failed to keep up in May when the index strongly rebounded. Disappointingly, it lost ground in June even as the index declined. The monthly relative performance reveals both the strategy's unique characteristics and exactly how strong herding is around some key macro themes.

**Stock performance*** (3/31/15 - 6/30/15)

**Best performers**

| Company | Return in quarter (%) |
|---|---|
| Mylan Inc. | 14.3 |
| Synovus | 10.0 |
| Spirit Aerosystems | 5.6 |
| Genworth Financial | 3.6 |
| Pacwest Bancorp | -0.3 |

**Worst performers**

| Company | Return in quarter (%) |
|---|---|
| Dex Media | -82.6 |
| Peabody Energy | -55.5 |
| Sears Holdings | -35.5 |
| Lands End | -30.8 |
| Investment Technology Group | -18.2 |

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

The top performers were an anticlimactic group as performance ranged only as high as the mid teens for the quarter. There was very little to take from individual company performance except for the fact that they avoided the strongly negative sentiment that swept across a number of other industries.

Once again the bottom performers seemed to be driven more by macro trends and momentum than by company specific developments. Each of DXM, BTU, and LE retained prominent positions as worst performers. While each of these companies has their own issues, weaker than expected GDP growth reported for the first quarter made it very difficult for new investors to step up. These are all very small positions.

SHLD got hit hard after some fairly decent performance recently. The announcement to form a REIT with some of its real estate holdings was originally viewed positively as a way to monetize these valuable assets. Nonetheless, given its fairly low float, SHLD shares can bounce around a lot and they often trade down with GDP expectations. Ultimately we believe these ups and downs are more indicative of attractive purchase points than anything fundamentally meaningful.

Finally, ITG lost some ground in the quarter, but it was due to cool off a bit after doubling since last fall.

## 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, 2015**

| 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 | | | | | | | | | |
| January | -2.61 | -2.61 | -1.56 | 4 | NA | 977,504 | 977,504 | 100% | 1,171,544 |
| February | 3.22 | 2.98 | 5.54 | 4 | NA | 1,006,595 | 1,006,595 | 100% | 1,202,192 |
| March | 0.25 | 0.25 | 0.06 | 4 | NA | 1,009,091 | 1,009,091 | 100% | 1,307,160 |
| April | 0.52 | 0.28 | -0.91 | 4 | NA | 1,011,891 | 1,011,891 | 100% | 1,310,162 |
| May | -0.10 | -0.10 | 1.46 | 4 | NA | 1,010,876 | 1,010,876 | 100% | 1,308,576 |
| June | -2.81 | -2.81 | -2.07 | 4 | NA | 982,483 | 982,483 | 100% | 1,276,571 |
| | | | | | | | | | |
| Q1 | 0.78 | 0.53 | 3.95 | 4 | NA | 1,009,091 | 1,009,091 | 100% | 1,307,160 |
| Q2 | -2.40 | -2.64 | -1.54 | 4 | NA | 982,483 | 982,483 | 100% | 1,276,571 |
| | | | | | | | | | |
| YTD | -1.65 | -2.12 | 2.35 | 4 | NA | 982,483 | 982,483 | 100% | 1,276,571 |

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

**Arete Asset Management Mid Cap Core performance composite disclosures follow:**

### Compliance statement

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

### Definition of the firm

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

### Benchmark

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

**Arete Asset Management Mid Cap Core performance composite disclosures continued: Calculation methodology**

Portfolio valuations are calculated as of calendar month-end and are computed in U.S. dollars and performance is also reported in U.S. dollars. Time-weighted rates of return are used which adjust for external cash flows. Our smaller, retail accounts contain fee structures in which one flat, per-transaction fee is charged for trading expenses and which embeds an implicit charge for custody. Since trading and custody charges cannot be directly segregated in these cases, they constitute "bundled fees". Gross-of-fees performance returns are presented before management and custodial fees when custodial fees can be segregated from trading, but are presented before management fees and after bundled (trading and custodial) expenses for our retail accounts. Net-of-fees returns are presented after management fees, trading expenses, and custodial expenses are deducted or after management fees and bundled (trading and custodial) fees for retail accounts. There are no instances in which management fees are bundled with trading or custodial fees. Returns are presented net of nonreclaimable withholding taxes when applicable. Arete does not use leverage or derivatives in the management of portfolios. Additional information regarding policies for calculating and reporting returns is available upon request.

**The composite**

This U.S. Equity Mid Cap Core composite was created in August, 2008 and includes all fee-paying, taxable and non-taxable, discretionary, long only, fully invested portfolios benchmarked to the Russell Midcap Index. Every new portfolio is added to the composite in the first complete calendar month that it is "fully invested". For purposes of composite construction, a portfolio is "fully invested" if its equity composition is greater than 90% of the equity composition of the composite. Each portfolio will remain in the composite until its equity composition becomes less than 90% of that of the composite. A complete list and description of firm composites is available upon request.

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

**Fee schedule**

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

**Minimum account size**

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

**Arete Asset Management Mid Cap Core performance composite disclosures continued:**

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

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