Second quarter 2016
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The Areté Quarterly

Inside This Issue

Welcome

Please remember that the *Areté Quarterly* now contains primarily a quantitative description of the Arete Mid Cap Composite. For our overview of the market for the second quarter, please check out the Areté blog [here].

Business Update

I founded Areté based on the belief that the investment landscape would become increasingly difficult and would require professional help for most investors. I also believed that exceptionally few investment services provided outstanding value to investors. I concluded that things would have to change as economic necessity forced investors to demand better value.

Thus far I have been wrong. While I was right that investors sought change after the financial crisis in 2008 and 2009, the nature of that change was more one dimensional and short term oriented than I anticipated. Of the two big trends that did emerge, both involve leaving traditional active managers and both seem to involve some spurious reasoning.

One push was to just leave active management altogether and go with cheap index funds and exchange traded funds (ETFs). This trend has been clearly evidenced by money flows. Another push was to "double-down" on the market and essentially become more active by increasing allocations to hedge funds and alternative investments.

In both cases investors sought "better" solutions, but the conception of "better" is overly simplistic. For pension funds, foundations, and other similar funds, "better" means high enough returns to meet existing spending plans or to hit (often unrealizably high) return targets. For many other investors, fees are the single biggest problem and the cheaper the better.

The argument for hedge funds has historically been that you get the "cream of the crop" in terms of expertise, capabilities, and ultimately returns, but you have to pay up for it. In too many cases, however, the benefits fail to outweigh the costs. This situation is being made progressively worse by an environment of exceptionally low interest rates.

Increasingly, hedge fund investors are beginning to speak out against the poor value these services offer. For example, New York City Employees' Retirement System liquidated all of its hedge fund investments. Letitia James, the city's public advocate, complained in the *Financial Times* [here], "Hedge funds …

believe they can do no wrong, even as they are losing money". She continued, "If they truly cared about New York's pensioners, 'they would never charge large fees for failing to deliver on their promises'."

On the other end of the spectrum, a wide swath of investors has been migrating to the "everyday low prices" of index funds. While these funds often (but not always) offer much lower prices than actively managed funds, just like at Walmart, you don't always get great stuff and you certainly don't get much, if any, service to help you out. For very basic stuff this can be fine. For more complicated or high-value stuff it can end up costing more in the long run.

In an investment landscape dominated by monetary policy, investing can seem like pretty "simple stuff". You just put money in the market and it goes up. Easy. One of the great disservices of such extreme policy, however, is that it artificially suppresses volatility and artificially inflates asset prices. In other words, it makes investing look a lot easier than it is, at least for a period of time. And that can effect the decision of where you shop.

Ben Hunt addressed this issue [here] when he stated: "Specifically, extraordinary monetary policy has obliterated the focal points of price discovery. When you no longer have Common Knowledge regarding the price of money, you don't have Common Knowledge regarding the price of anything."

This assessment, with which I agree, dispels any notion that the "market always knows best" or that investing is an easy, one dimensional decision. Those who believe that their wealth is better represented by numbers on their month end statements than by the value of the stream of cash flows represented by the underlying ownwership positions are setting up for a pretty big disappointment.

Nonetheless, the clear shortcomings of the hedge fund and passive approaches begs the question of why there hasn't been a stronger movement to find better and more efficient versions of the active management model. After all, the flaws of active management that were revealed in the financial crisis had already been fairly clear for some time. Further, none of these flaws are inherent to the practice of active management, but rather reflect the business choices that many, but not all, active managers make.

Across many parts of the economy consumers are leveraging information and connectedness to become better consumers. As they become better informed, they are also demanding better value. While the field of investment services has been rather immune to these trends, it is ripe for change. Sooner or later, investors are going to demand better overall value from providers and Areté is here to provide just that.

Thanks for your interest and take care!

David Robertson, CFA
CEO, Portfolio Manager

Portfolio Characteristics – Areté Mid Cap Core

A key proposition for Areté's Mid Cap Core strategy is that it is a truly representative mid cap portfolio. In general, this suggests that over time, you can expect to see the aggregate characteristics and sector exposures of the strategy migrate to those of the Russell Midcap Index®. During intervening periods, however, sector exposures and other characteristics will reflect the opportunities we find in the market at that point in time.

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.

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 (06/30/16)

	Arete MCC*	Midcap Index**
<u>Size</u>		
Average Market Cap ($ mil.)	8,137	8,081
Median Market Cap ($ mil.)	4,704	6,166
Minimum Market Cap ($ mil.)	525	1,166
Maximum Market Cap ($ mil.)***	33,524	28,578
Number of holdings	20	800
<u>Valuation</u>		
P/E current year	18.0	23.5
P/E forecast Y1	24.6	20.1
P/B	2.1	4.5
P/S	1.0	2.1
Yield (%)	2.2	2.6
<u>Valuation drivers</u>		
ROE (%)****	9.6	12.4
LT eps growth forecast (%)	8.8	10.5

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.

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.

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 exposure (percent of assets on 6/30/16)

Economic sector***	Arete MCC*	Midcap Index**	Percentage Comparison
Consumer Discretionary	1.2	15.5	7.7%
Consumer Staples	0.0	5.6	0.0%
Energy	0.0	6.1	0.0%
Financials	14.8	22.4	66.1%
Health Care	5.8	9.8	59.0%
Industrials	2.5	12.5	19.9%
Information Technology	1.0	14.0	7.1%
Materials	4.9	5.6	87.7%
Telecommunications	0.0	1.0	0.0%
Utilities	2.8	7.4	37.7%
Equity exposure	33.0	100.0	
Cash and equivalent	67.0	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.

Sector exposures are all below benchmark weights due to the high cash position. Cash has remained at fairly high but stable levels over the last several quarters.

Active share* (6/30/16)

Period	Percent**
Q216	96.1
Q116	96.2
Q415	96.6
Q315	92.3
Q215	93.0

**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 two small transactions in the quarter - we sold the remaining holdings of DXMM and BTU. Both companies entered bankruptcy proceedings and as such, deserve some elaboration.

We purchased BTU when Areté was founded in 2008. The thesis at the time was that oil was overpriced at well over $100 per barrel and that cheaper forms of energy would eventually become economic necessities. We believed that BTU well positioned as a low cost producer of a large and undervalued energy source.

Although we were right in assessing BTU's competitive position and oil as being overpriced, that was not enough to overcome an unusual confluence of negative developments. Ultimately, an abrupt change in China's purchases of coal beginning in 2013, management missteps, an exceedingly hostile regulatory and public relations environment, and a sustained period of exceptionally low natural gas prices served to undermine our thesis in BTU.

The thesis on DXMM was similarly based on valuation. Once a darling of the investment community for its steady streams of cash flows, DXMM and predecessors increasingly felt the same pressures from digital advertising as newspapers did. When the company restructured its debt in 2010, however, we felt that bought them enough time to fully leverage their deep and wide relationships with small business people through new offerings of their own.

In hindsight, management was too slow to fully embrace new digital offerings and at the same time the broader economic trends of unusually slow growth and increasing pressures on small businesses combined to prevent DXMM from realizing the potential of the business.

Both of these cases provide useful insights into our investment philosophy and the investment landscape. For one, our overarching goal is to buy stocks that are undervalued knowing that this is the key to long term performance. While it is always nice to find companies with terrific business models and great management teams that are cheap, it doesn't happen often, and in this market those stocks are almost ludicrously expensive.

This reality has led us to search, on the margin, for what opportunities do exist and BTU and DXMM represent a couple of those less than ideal, but attractively cheap prospects. The logic is that not every situation will work out, but the ones that do will perform well enough to more than cover the costs of those that don't. In other words, they have asymmetric reward/risk tradeoffs. This was absolutely the case with URI and STX, for example, which were multi baggers off of their lows in 2009.

A final point is that we believe the downfall of both BTU and DXMM reveals some important insights about the market that are relevant to portfolio strategy. Namely, the critical factor affecting these companies was that recovery of economic growth to any kind of "normal" level was forestalled for too long a period for them to make it to the other end. We believe the continuation of using extraordinary monetary policy measures instead of real, constructive economic policy, is harmful to all business and therefore, ultimately, to stocks as a whole.

Performance review – Areté Mid Cap Core

The Areté Mid Cap Core product is designed with the flexibility to invest in the most attractive mid cap stocks, regardless of any particular "style" designation. With that context, the primary criterion for selecting a stock in the Mid Cap Core strategy is that market value is significantly less than our estimate of intrinsic value. In other words, we try to find situations in which our research generates expectations for a company's growth and profitability that justify substantially greater valuations than what the market discounts.

Our investment process is designed to discover, analyze, and assemble stocks into a diversified portfolio that consistently outperforms its benchmark over time. Specifically, our investment objective is to outperform the benchmark Russell Midcap® Index by 200-400 basis points per year, net of fees, over the course of a market cycle.

Our target of 200-400 basis points of outperformance is based upon our experience with the strategy and upon our judgment of value creation. Our goal is to outperform by a large enough margin relative to risk to clearly merit the cost in time and resources to evaluate investing with us.

Areté's Mid Cap Core (AMCC) strategy returned 1.20% (net of fees) for the quarter versus 3.18% for the Russell Midcap Index® (RMC) (see pages 8 – 10 for performance and related disclosures). AMCC continues to outperform in down or modestly up markets and underperform when the market races higher. This record of relative performance largely reflects the high cash holdings and defensive positioning of the strategy.

Stock performance* (3/31/16 - 6/30/16)

Best performers

Company	Return in quarter (%)
Yamana Gold	71.1
Royal Gold	40.4
Oshkosh Corp	16.7
NRG Energy	15.2
Owens Illinois	12.8

Worst performers

Company	Return in quarter (%)
Lands End	-35.6
Seagate Technology	-29.3
Investment Technology Group	-24.3
Sears Holdings	-11.1
TD Ameritrade	-9.7

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

Top performers did not reveal a great deal of insight into the quarter other than the fact that the market is increasingly becoming concerned about the ability of central banks to maintain control of inflation and the economy. As a result, precious metals performed extremely well, again, and we saw this in the performance of AUY and RGLD. OSK, NRG, and OI all performed well but reflected little other than rebounds after having suffered severely in the selloff earlier in the year.

The list of underperformers said a lot more about general themes and narratives in the market than they did about individual company performance. Among those themes were concerns about consumer spending and high levels of debt in the context of poor economic growth.

In addition, the continuation of low rates and the expectation that those low rates may continue for quite some time longer is starting to get expressed in the discounting of business models that depend on reasonably positive rates. These include insurance companies, banks, investment management companies and in the AMCC portfolio include stocks such as AMTD and ITG.

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 - June 30, 2016

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									
January	-3.21	-3.46	-6.55	4	NA	887,219	887,219	100%	1,172,245
February	1.48	1.48	1.13	4	NA	900,330	900,330	100%	1,188,694
March	3.60	3.60	8.19	4	NA	932,773	932,773	100%	1,223,729
April	1.43	1.18	1.06	4	NA	943,800	943,800	100%	1,238,672
May	-0.57	-0.57	1.64	4	NA	938,449	938,449	100%	1,230,777
June	0.59	0.59	0.46	4	NA	944,009	944,009	100%	1,238,757
Q1	1.76	1.49	2.24	4	NA	932,773	932,773	100%	1,223,729
Q2	1.46	1.20	3.18	4	NA	944,009	944,009	100%	1,238,757
YTD	3.24	2.72	5.50	4	NA	944,009	944,009	100%	1,238,757

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

Areté Asset Management Mid Cap Core performance composite disclosures follow:

Compliance statement

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

Definition of the firm

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

Areté Asset Management Mid Cap Core performance composite disclosures continued:

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.

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.

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