Second quarter 2017
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THE ARETÉ QUARTERLY

Welcome

The investment landscape is changing and so are the needs of investors – and Areté is here to help however we can. While we do actively manage stocks in our mid cap core strategy, we have also introduced a Personal CIO Service [here] in order to make our expertise more accessible to a broader audience. In these services and any future ones, Areté will always focus on conducting good research, independent thinking, and putting our clients' interests first.

In order to stay apprised of our latest thinking on the investment landscape, please take a look at our blog [here]. Finally, please always feel free to contact us with questions or comments.

Business Update

Nearly ten years of extraordinarily accommodative monetary policy has clearly affected markets and asset prices. In combination with a strong trend to passive investing it has also had a bruising effect on the business of active money management. While many managers have lost funds due to high fees or poor value propositions, a huge headwind for the industry has been that increased trend following and reduced volatility have broadly suppressed the opportunities on which the active management business lives and breathes.

Ben Hunt captured the situation for active managers well in his recent report [here]. As he describes, dealing with these market conditions "… is a miserable experience for discretionary stock pickers (and the same is true for any security selectors, whether it's bonds or commodities or currencies or whatever …"

Inside This Issue

Hunt goes on to expound on the difficult tradeoffs money managers are confronted with in these circumstances: "By far the most common coping mechanism for a market we don't like and we don't trust and we don't understand — but a one-way up market for all that — is to become smaller in spirit even as we become larger in scale. To become transactional. To collaborate with the forces that turn markets into utilities. To become positioners rather than investors. To become model followers rather than idea generators. **To hedge out our most pronounced career risk — which is not a large portfolio loss, because so many others will be in the same boat, but is rather a small portfolio loss from independent decision-making while others are making non-independent, collective gains**."

He concludes by describing how most of the industry accomplishes the hedge against career risk: "By eliminating independent risk-taking and embracing collective risk-taking, that's how." What this means for most money managers who focus on security selection, is that "they have to give up their reason for being" in order to stay in business.

What this means for the markets is that the mainstay of active management, idiosyncratic risk, has migrated to systemic risk. In other words, relatively short term inefficiencies in individual securities prices have been substituted for longer term market inefficiencies. This is corroborated by zerohedge [here]: "Which brings us to BofA's striking punchline: between central banks, quants, and ETFs, the market is becoming increasingly inefficient."

More specifically, the report notes, "... ironically, what should be an increasingly efficient market has shown signs of becoming less efficient over the long term ..."

These reports are articulate expressions of what I have been seeing as well. Fortunately, since Areté's marketing strategy focuses on investors with very long time horizons, our business has not experienced the same short term pressures that have forced many other active managers to "change their stripes". Nonetheless, the adverse conditions for stock picking have caused me to re-evaluate where research efforts are best directed. As a result, I have temporarily re-allocated some resources from current stock research to two other activities that I think will provide a greater benefit to investors in the future.

One of those activities is developing and incorporating better signals for systemic risk. If, as it appears to me and both Hunt and BofA suggest, the greater risk for *investors* is not incremental stock losses but that of a "large portfolio loss", then that ought to be a high priority.

As a result, I have been spending more time on evaluating metrics and mental models that help identify and gauge market risks. For example, Andrew Lo's book, *Adaptive Markets: Financial Evolution at the Speed of Thought*, provides a great foundation for this endeavor and *Everybody Lies: Big Data, New Data, and What the Internet Can Tell Us About Who We Really Are*, by Seth Stevens-Davidowitz, provides important insights on using big data.

Notably, in the context of firms pushing harder and harder to accumulate more and more information, Steven-Davidowitz provides a useful reality check. In particular, he notes, "You don't always need a ton of data to find important insights. You need the right data." Further, he says, "In fact, the smartest Big Data companies are often cutting down their data. At Google, major decisions are based on only a tiny sampling of all their data." The really good news is that these insights play right into Areté's strengths of thoughtful technology adoption and independent thinking.

A second activity that I have been investing more time in is a valuation model that I have been building and adapting for Areté's purposes. My thinking here is that an extremely overvalued market is unsustainable and that when it turns, it will be hugely beneficial to have the best valuation tools available to take advantage of the new opportunities. This has been a big project but is finally coming into service.

In sum, I have been frustrated with the dearth of investment opportunities and I know investors have been too. But if stocks are expensive and there simply aren't good opportunities, it doesn't help to "just do something". In light of these temporary challenges, I've been trying to allocate resources in ways that I think best serve client interests under the existing conditions and will continue to do so. A big part of what keeps me going is the belief that there will be significant investment opportunities to be had for those patient enough to wait and big business opportunities for active managers capable of doing so.

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 more cheaply in the future.

General portfolio characteristics for the quarter continue to confirm that the equity portion of AMCC is a representative mid cap portfolio. The average market cap for AMCC is a little higher than the mid cap index and the median is a little lower. Of particular note, however, the valuation metrics have become considerably less informative as the number of holdings has declined to just 18 currently.

Portfolio Characteristics (06/30/17)

	Arete MCC*	Midcap Index**
Size		
Average Market Cap ($ mil.)	9,443	9,283
Median Market Cap ($ mil.)	5,269	7,171
Minimum Market Cap ($ mil.)	477	421
Maximum Market Cap ($ mil.)***	33,404	47,177
Number of holdings	18	791
Valuation		
P/E current year	30.5	27.6
P/B	2.9	5.3
P/S	1.9	2.5
Yield (%) ****	3.6	2.6
Valuation drivers		
ROE (%)****	5.9	10.5

Source: Calcbench
**Note:* Excludes positions which are less than 0.1% weights.
***Note*: Arete currently does not subscribe to the Russell Indexes and therefore the statistics presented here represent approximations of the Russell Midcap® Index.
****Note*: Stocks with low floats are excluded
*****Note*: The measure of ROE was changed from the average to the median as of 3/31/14.
*****Note:* Average of available yields

As a note, we recently started using financial data provided by Calcbench. Historically we used data from our valuation vendor, Applied Finance Group. As a result, there may be some modest differences that cause imperfect comparisons.

Sector exposures are quite different from benchmark weights, in part due to the high cash position but in part due to different exposures. Cash has remained at fairly high but stable levels over the last several quarters.

Sector exposure (percent of assets on 06/30/17)

Economic sector***	Arete MCC*	Midcap Index**	Percentage Comparison
Consumer Discretionary	0.9	14.6	6.2%
Consumer Staples	0.0	4.4	0.0%
Energy	0.0	5.5	0.0%
Financials	8.5	14.2	59.7%
Health Care	4.8	10.5	45.9%
Industrials	0.0	13.6	0.0%
Information Technology	1.6	14.8	10.8%
Materials	3.9	5.7	68.2%
Real Estate	7.3	9.9	73.7%
Telecommunications	0.0	0.6	0.0%
Utilities	2.9	6.2	47.1%
Equity exposure	29.9	100.0	
Cash and equivalent	70.1	0.0	

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

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.

Active share* (6/30/17)

Period	Percent**
Q217	94.9
Q117	96.0
Q416	96.3
Q316	96.3
Q216	96.1

**Note*: Computed for AMCC composite
***Note*: Active share > 80% is considered "very active"

Transactions review – Areté Mid Cap Core

We did not implement any transactions in the quarter. We continue to find most valuations excessive but are modestly encouraged by some recent instances of value starting to perform better.

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 0.09% (net of fees) for the quarter versus 2.70% for the Russell Midcap Index® (RMC) (see pages 8 – 10 for performance and related disclosures). AMCC continues to underperform when the market presses higher (due to its high cash position), but that cash also provides a significant buffer against material downside.

Stock performance* (03/31/17 - 06/30/17)

Best performers

Company	Return in quarter (%)
Owens Illinois	17.4
Gaming and Leisure Properties	12.7
Royal Gold	11.6
TD Ameritrade	10.6
The Saint Joe Company	10.0

Worst performers

Company	Return in quarter (%)
Lands End	-30.5
Sears Holdings	-22.9
Seagate Technology	-15.6
Yamana Gold	-12.0
NRG Energy	-7.9

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

The key theme (and themes were again the story as opposed to company-specifics) for the bottom performers was perceived balance sheet risk. LE and SHLD also got caught up with the market's resurgent dislike of bricks and mortar retailers. That these companies have a fair amount of debt and that retail is having its troubles is not new. In a sign of the times and what we view as a harbinger of things having gone too far, ProShares recently registered to list ultra-short leveraged ETFs on traditional retailers.

Among the top performers, performance was fairly modest and with that, there was very little, even by way of themes, that can explain it. OI probably benefited from its substantial exposure to Europe as growth seems to have improved modestly there and AMTD absolutely benefits from higher interest rates. Other than that, there was little to attribute the performance to.

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, 2017

Period	Gross-of-Fees Return (percent)	Net-of-Fees Return (percent)	Russell Midcap® Index Return (percent)	Number of Portfolios	Internal Dispersion (percent)	Total Composite Assets ($)	Composite Assets With Bundled Fees ($)	Percentage of Composite Assets With Bundled Fees	Total Firm Assets ($)
2008*	-37.97	-38.16	-35.01	3	NA	207,031	207,031	100%	207,031
2009	48.63	47.83	40.48	3	NA	471,867	471,867	100%	673,806
2010	16.86	15.78	25.48	3	NA	546,315	546,315	100%	877,368
2011	-8.20	-8.88	-1.55	3	NA	497,767	797,767	100%	897,918
2012	15.20	13.84	17.28	4	NA	798,766	798,766	100%	897,341
2013	23.18	22.00	34.76	4	NA	974,605	974,605	100%	1,172,496
2014	4.01	2.99	13.22	4	NA	1,003,729	1,003,729	100%	1,200,564
2015	-7.56	-8.44	-2.44	4	NA	919,035	919,035	100%	1,206,652
2016	4.07	3.02	13.80	4	NA	946,825	946,825	100%	1,142,297
2017									
January	1.21	0.96	2.41	4	NA	955,884	955,884	100%	1,151,614
February	0.35	0.35	2.83	4	NA	959,248	959,248	100%	1,155,102
March	0.52	0.52	-0.16	4	NA	964,207	964,207	100%	1,160,504
April	-0.25	-0.49	0.77	4	NA	959,478	959,478	100%	1,155,546
May	-0.19	-0.19	0.91	4	NA	957,634	957,634	100%	1,153,535
June	0.78	0.78	0.99	4	NA	965,081	965,081	100%	1,161,186
Q1	2.09	1.84	5.15	4	NA	964,207	964,207	100%	1,160,504
Q2	0.34	0.09	2.70	4	NA	965,081	965,081	100%	1,161,186
YTD	2.43	1.93	7.99	4	NA	964,207	964,207	100%	1,161,186

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

Areté Asset Management Mid Cap Core performance composite disclosures follow:

Compliance statement

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

Areté Asset Management Mid Cap Core performance composite disclosures continued:

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

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

Calculation methodology

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

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

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

Areté Asset Management Mid Cap Core performance composite disclosures continued:

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

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

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

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