Second quarter 2022
Volume 15, Issue 2

THE ARETÉ QUARTERLY

Welcome

As it becomes progressively more apparent that the investment landscape presents unique challenges, it is also becoming progressively more apparent that conventional investment approaches are not sufficient for meeting those challenges.

Areté is a unique organization for unique times. With an orientation to research and analysis, these activities are applied for the purpose of solving problems and helping investors do the best they can. Each investment decision and communication is made with the mindset of having skin in the game.

If you are interested in getting more (or different) investment insights, please take a look at our blog [here]. Content for the posts is selected and created on the basis of being important, relevant, and useful.

In addition, *Observations by David Robertson* provides a weekly collection of insights and analysis that are intended to be especially relevant for long-term investors. You can find the letters on the substack platform at: https://abetterwaytoinvest.substack.com

Finally, please always feel free to contact us with questions or comments.

Business Update

The second quarter was another difficult one for many investors as both stocks and bonds lost ground - again. The Vanguard fund VBIAX, a representative 60/40 fund, lost 12.1% in the period.

Inside This Issue

The headwinds for conventional balanced funds continued as the All-Terrain allocation strategy performed in line with expectations. The key was to mainly avoid stocks and bonds – both of which had become extremely expensive.

In a sense, we are in a period of managed decline by the Fed. Having gotten a good chunk of investors beholden to its "communication" strategy and subsequently "corralled" into passive products, the Fed realized a great deal more power to effect outcomes.

By guiding the direction of asset prices through interest rates and jawboning, the Fed could either dial up risk appetite – or dial it down. In doing so, it could also impose some control on economic growth and prices. But it only works if a big chunk of investors just passively follow.

Now with inflation posing a persistent concern, the Fed is deploying a "dial it down" playbook. For those investors who are "corralled" the news is bad. Their investments and retirement accounts are effectively being used as a tool to reduce inflation. Good for the Fed, bad for investors.

Not for all investors, however. Not only is it possible to avoid much of the pain, but it is also possible to find opportunities in the disarray. You have to do something different, however, and you have to be able to get enough conviction to act. That happens with rigorous research and analysis. This is exactly what Areté is built to do.

As a result, I am as optimistic about the potential for Areté as I have ever been. It has taken longer than I would have liked to get here, but investment conditions could hardly be more conducive to Areté's value proposition.

As always, I try to provide regular updates on my thinking and I encourage anyone interested to check them out. "Observations" is a newsletter I started on Substack in early 2020 and have evolved into a weekly update of my thinking about markets and portfolio strategy. The Areté Quarterly continues to provide a more detailed analysis of the investment strategy.

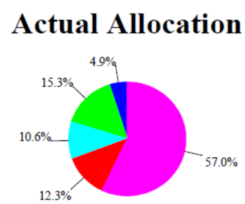
Finally, I always welcome feedback, comments and questions. I know markets can be confusing and there is a lot of conflicting information and advice out there. If you want to know what I think, just ask! That's what I'm here for.

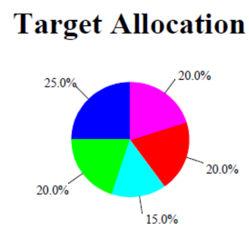
As always, thanks for your support!

David Robertson, CFA
CEO and founder, Areté Asset Management

Asset Allocation

In the current actual allocation cash is still the largest position followed by gold and now uncorrelated. Relative to last quarter, the cash portion remained fairly similar to the prior quarter. The inverse correlation weight grew due to outperformance – exactly what should happen when stocks and bonds are down. The uncorrelated weight grew due to an addition but was partly offset by weak performance. Finally, the gold position declined due to weak performance in the quarter. The chart below refelcts a representative account from the All-Terrain composite.





As a reminder, the easiest way to think about the strategic priorities of the All-Terrain strategy is as an effort to get the most out of the valid market opportunities that exist. In other words, it is more about finding attractive assets and creating thoughtful diversification than about speculating which hot stock might do well.

The current environment is dominated by the Federal Reserve's (loudly) expressed desire to increase rates and embark on Quantitative Tightening. These actions will substantially worsen liquidity which in turn will eventually weigh on financial assets. This is happening at a time when stocks are still fairly close to all-time highs.

As a result, the primary goal currently is to stay mostly clear of stocks and bonds. This explains the high cash levels. Finding attractive inflation hedges is still an important effort, though somewhat less urgent in light of the Fed's increased vigilance. Other than that, I will be watching the trajectories of commodities, stocks, and bonds in anticipation of slowing growth and inflation.

Transactions review

Again, there were a few more transactions in quarter. Two were sales of stocks, NLY and CFFN, which are both interest rate sensitive and vulnerable to higher short-term rates.

The main transaction was the addition of a significant weight to CTA, a new managed futures fund offered by Simplify Asset Management. The general case for managed futures funds in general is harvest the momentum that exists in many markets. Often this is related to commodities but can extend to rates and a whole host of other assets. One of the selling points of CTA, in particular, is that it avoids stock positions so as to provide greater diversification in a portfolio that already has stocks. This is a nice way to generate positive returns AND improve diversification at the same time.

Performance review

As investment strategy transitions over to the All-Terrain strategy, there will be some changes in performance evaluation, but many of the general principles will remain the same.

For example, the search for undervalued assets will remain the same, although the scope of that search will expand significantly from the universe of US mid cap stocks to a much broader universe of publicly traded securities and funds.

The overarching goal of providing attractive returns to investors on an absolute basis will also remain the same. As many markets become significantly overvalued, this is especially important to keep in mind.

Finally, the major change will be a greater emphasis on diversification. This new focus will elevate the importance of uncorrelated return streams and reduce the importance of individual security performance.

Since the Areté All-Terrain Allocation (ATA) strategy started at the end of August, performance is reported from that date.

For the second quarter, the ATA strategy returned -4.87% (net of fees) while VBIAX returned -12.13%. The significant outperformance again highlighted many of the major dimensions of the strategy.

Primarily, the large cash position proved useful in the context of both stocks and bonds going down for the quarter. Other diversifying investments also proved effective in offseting losses in some securities.

The large allocation to gold proved disappointing in the quarter as the prospect of more rate hikes dimmed the immediate prospects for a wide array of inflation hedges. Insofar as gold serves as a hedge on the confidence in central banks, however, the longer-term prospects are still very much intact.

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.

Asset allocation is a key funciton of wealth management

One of the most important functions for long-term wealth accumulation is to have access to certain asset classes when they are attractive and to be able to minimize exposure to other asset classes when they are extremely unattractive. In short, diversification moderates the long-term swings in portfolio performance and therefore significantly increases the chances of wealth accumulation over a reasonably long investment horizon.

Mispriced assets are an important source of performance

One of the keys to investment performance is finding and exploiting market inefficiencies. While such inefficiencies can arise in the form of mispriced securities, they can also arise in the form of over- or under-valued industries or asset classes.

Identifying such opportunities begins with the assessment of underlying intrinsic value. When disparities with market prices exist and clear rationale for such mispricing can be identified, there are opportunities to take advantage of the differential.

Information management is a core skill of investment management

Analyzing investment opportunities and developing portfolio construction is a dynamic exercise that involves a constant and ongoing process of gathering information, processing it, analyzing it, developing knowledge, and applying it for the benefit of clients.

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. This approach is notably distinct from the common practice of simply gathering assets.

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.

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 All-Terrain Composite

Arete Asset Management, LLC
All Terrain Composite
August 31, 2021 - June 30, 2022

Period	Gross-of-Fees Return (percent)	Net-of-Fees Return (percent)	Vanguard balanced Index Fund (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 ($)
2021	0.06	-0.20	2.22	3	NA	841,887	841,887	100%	1,460,255
2022									
January	-1.04	-1.27	-4.52	3	NA	831,184	831,184	100%	1,444,243
February	2.02	2.02	-1.96	3	NA	847,963	847,963	100%	1,470,743
March	3.65	3.65	0.84	3	NA	878,895	878,895	100%	1,520,113
April	-0.58	-0.83	-7.00	3	NA	871,564	871,564	100%	1,796,422
May	-0.88	-0.88	0.14	3	NA	863,873	863,873	100%	1,776,888
June	-3.22	-3.22	-5.66	3	NA	836,027	836,027	100%	1,726,023
Q1	4.64	4.40	-5.60	3	NA	878,895	878,895	100%	1,520,113
Q2	-4.64	-4.87	-12.13	3	NA	836,027	836,027	100%	1,726,023
YTD	-0.22	-0.68	-17.06	3	NA	836,027	836,027	100%	1,726,023

Areté Asset Management All-Terrain performance composite disclosures follow:

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 Vanguard Balanced Index Fund Admiral Shares (VBIAX), and its performance is reported in U.S. dollars.

Areté Asset Management All-Terrain 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. 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 All-Terrain allocation strategy composite was created in August 2021 and includes all fee-paying, taxable and non-taxable, discretionary, long only, fully invested portfolios benchmarked to the Vanguard Balanced Index Fund. 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" when it breaches the threshold of 90% similarity with core composite portfolios. Each portfolio will remain in the composite until its similarity with core composite portfolios falls under 90%. A complete list and description of firm composites is available upon request.

Fee schedule

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

Minimum account size

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

Dispersion

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

Verification

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