Third quarter 2010
Volume 3, Issue 3

The Arete Quarterly

Welcome

Since it was founded, Arete has considered its ability to apply lessons learned *in* the business of researching and analyzing stocks *to* the business of investment management as a skill that was unique to most of the industry. To us, it just seemed to make sense that the trials and tribulations and best practices of other industries could be used to improve one's own. We always considered it one manifestation of "fresh thinking" that we try to apply to everything we do.

This perspective was cast into a new and more revealing light during a presentation by Michael Mauboussin at a recent Baltimore CFA Society luncheon. In that presentation, Mauboussin discussed his most recent book, *Think Twice*, which highlights the many ways in which decisions can go wrong and how to avoid them.

One of the ways decisions can go wrong is to focus inordinately on the "inside view." According to Mauboussin, "The inside view considers a problem by focusing on the specific task and by using information that is close at hand and makes predictions based on that narrow and unique set of inputs." We have all seen plenty of examples of this. It usually involves something like looking at last year's growth rate and applying the same rate to the upcoming year. Convenient? Yes. Analytically rigorous? No.

Mauboussin argues that a useful complement to the decision making process

Inside This Issue

is to ask "if there are similar situations that can provide a statistical basis for making a decision." In other words, are there analogies to other industries or other types of situations that can provide useful context? He calls this the "outside view."

In applying Mauboussin's lessons to the real world, some of our favorite examples of the two views come from the money management industry itself. For instance, let's consider the profitability of the money management business. A report by McKinsey & Company entitled, *The Asset Management Industry in 2010,* reports, "Year after year, it seems, the industry turns out enviable, solid performance — indeed . . . overall profit margins have held remarkably stable over the past market cycle, just shy of the 30 percent mark."

How should we assess this performance? Mauboussin's framework defines two different perspectives from which we can view the industry's "enviably" high profitability.

The inside view, as is so often the case, is aptly illustrated by industry insiders. When we ask the management teams of large money managers about profitability, we often hear comments like, "We provide incredibly high value to our clients. The value proposition is about far more than investment performance. It is about providing security so they can sleep at night."

What does the outside view say? According to Jane Marcus and Terry R. Bacon in their 2004 report, *Developing Better Asset Management Leadership*, "There has not been a profound belief in doing what is right for the client . . . The industry grew out of a Wall Street culture where you manufactured a product and sold it to the client, instead of finding out what the client wanted . . . This has always been a high-margin business, so there was little impetus to analyze profitability, so there has been poor cost and expense control."

How can there be such a wide gulf between these two views? Upton Sinclair once remarked, "It is difficult to get a man to understand something when his salary depends upon his not understanding it." Is this a possible explanation? Absolutely. Is it likely? We believe so.

We also believe this explains why Arete's practice of "fresh thinking" is unique to the industry. Not only is intellectual honesty is essential for us in making good investment decisions, it is also crucial for accurately assessing our value proposition to investors.

Marcus and Bacon make quite clear that one of the most important themes from their study was "the importance of developing more effective leadership in the industry." Alas, Mauboussin's concluding remark speaks volumes about the state of the industry: "Everyone talks about how important it [decision making] is," he says, "but they don't spend time on it. Leadership is incredibly important." We couldn't agree more.

Business Update

Several years ago I attended the Baltimore Book Festival in Baltimore's Mount Vernon neighborhood and had the pleasure of listening to David Simon, creator and producer of the HBO series, *The Wire*. Not surprising to anyone who has watched the series, Simon's perspective of inner-city life reflects a compelling mixture of clarity, compassion, and concern. One of his messages that always stuck with me was, "If you don't do something to make things better, you are complicit in the perpetuation of the problems."

As a city-dweller, I have taken that message to heart regarding my neighborhood, but found it hard to stop there. I guess I also saw a lot of parallels with the investment industry: There are a lot of problems that make things unfair and unnecessarily dangerous to a lot of people; there is a lot of gaming and misinformation; and, it is often hard to tell the bad guys from the good guys. Even if you try to do the right thing, you may get hurt by the many corrupt forces.

In fact, this view is not so different from what I see and hear from many individual investors. People don't know what to do, but they strongly suspect the game is rigged against them, and they don't know who to trust. Increasingly, they are withdrawing money from equity funds and/or hoarding cash for lack of more palatable alternatives.

Longer term, this isn't good for anybody. Individuals will not meet retirement goals if they do not invest and the investment industry may very well contract if people don't trust it.

I have tried to make things better, in part, by forming Arete. In doing so I wanted to offer investors a very *fair* value in contrast to the many overpriced and underperforming products that currently exist.

I have also realized, however, that Arete is but one small voice in a very large and rowdy crowd and as such, has very limited ability to affect public opinion — and ultimately primary demand. As long as the investing public is broadly wary of the entire industry, there is little perceived value in trying to differentiate competent and ethical players from others. Therefore, in my effort to try to make things better, I agreed this summer to lead the Baltimore CFA Society. I view this effort as a common quest with the CFA Institute to help improve the professionalism of, and ultimately restore trust in, the money management industry.

The CFA, for those who are not familiar, stands for chartered financial analyst and is the pre-eminent global professional designation for investment analysis. There are about 100,000 CFAs across 137 societies around the world. The CFA Institute is "dedicated to developing and promoting the highest educational, ethical, and professional standards in the investment industry." I find it interesting that the core tenets of the CFA, ethics, tenacity, rigor, and analysis were all notable for their absence in the key mishaps leading to the financial meltdown in 2008.

How can CFAs and the CFA Institute make things better? As a stock analyst, I always look for two basic things. One is a solid business that can generate a lot of cash. The other is a management team and Board of Directors that will distribute that cash fairly to shareholders. I think investors want the same thing. They want investments that leave them better off and they want to work with investment professionals who have substantial analytical skills and put the interests of their clients first.

The enormous opportunity I see is that the answer to the wants and needs of the investing public *already exists* in the form of CFAs. In fact, the CFA Institute's stated objective is to have "global financial markets that service society's interests." I think most investors would be heartened to know that such an organization exists.

The only problem is that the vast majority of investors don't know the CFA Institute exists and have no idea what the CFA is. It's hard to make things better by improving credibility when people don't even know that a source of help exists. I look forward to doing what I can to help raise the profile of both the Baltimore CFA Society and the CFA Institute.

In the meantime, if you have any suggestions for how Arete or the Baltimore CFA Society can more effectively pursue this quest, please let me know. Working together, maybe we can all help to make things a little better.

Thanks and take care!

David Robertson, CFA
CEO, Portfolio Manager

Portfolio Characteristics – Arete Mid Cap Core

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

We believe maintaining a truly representative mid cap portfolio is important for two reasons. First, a truly mid cap portfolio faithfully plays its role in a broader asset allocation scheme. Second, it allows for accurate assessment of performance. Without an appropriate benchmark it is difficult if not impossible to judge whether performance differentials are due to skill or luck, and are sustainable or transient.

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

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

Portfolio Characteristics (9/30/10)

	Arete MCC*	Midcap Index**
Size		
Average Market Cap ($ mil.)	5,609	4,834
Median Market Cap ($ mil.)	4,164	3,656
Minimum Market Cap ($ mil.)	244	208
Maximum Market Cap ($ mil.)	18,115	18,006
Number of holdings	49	789
Valuation		
P/E current year	19.5	22.5
P/E forecast Y1	16.8	18.5
P/B	2.6	2.9
P/S	1.0	1.4
Yield (%)	0.9	2.4
Valuation drivers		
ROE (%)	10.6	17.2
LT eps growth forecast (%)	10.5	11.6

Source: The Applied Finance Group™
**Note:* Excludes ASCMA allocation resulting from DISCA corporate action.
***Note*: Arete currently does not subscribe to the Russell Indexes and therefore the statistics presented here represent approximations of the Russell Midcap® Index.

Sector exposures did not change much from last quarter and for the most part, remained well within our general guidelines of 50% - 150% of benchmark sector weights. The primary area of note was in the Consumer Discretionary sector where the addition of DEXO along with superior performance of existing holdings increased the relative weight of the sector right up to its guideline maximum of 150%. Materials and Processing also finished slightly above our 150% guideline as those stocks also slightly outperformed the benchmark for the quarter.

Sector exposure (percent of assets on 9/30/10)

Economic sector	Arete MCC*	Midcap Index**	Percentage Comparison
Consumer Discretionary	24.3	16.1	150.9%
Consumer Staples	3.5	5.7	61.4%
Energy	7.0	8.1	86.4%
Financial Services	17.4	20.5	84.9%
Health Care	9.1	8.5	107.1%
Materials & Processing	11.3	6.7	168.7%
Producer Durables	11.6	13.8	84.1%
Technology	6.9	11.9	58.0%
Utilities	6.6	8.7	75.9%
Equity exposure	97.7	100.0	
Cash and equivalent	2.3	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.

Transactions review – Arete Mid Cap Core

During the third quarter we engaged in two transactions for composite portfolios. We sold Amerigroup (AGP) and shortly thereafter we reinvested about half the proceeds into Dex One Corporation (DEXO).

The sale of AGP was a straightforward execution of our sell process: The stock reached full valuation and we sold it. While we have always liked the opportunity for expanded penetration of Medicaid managed care providers, there is no doubt that earnings are inherently volatile and that future earnings are even more uncertain than usual with the ultimate effects of health care reform yet to be manifested in specific rules.

We first purchased AGP at around $23 and sold around $39 and were happy to take the profits. If we see the stock in the low 20s again we will absolutely consider repurchasing it.

The process of DEXO getting into the portfolio is another revealing story of how we do research and eventually buy stocks. We had followed DEXO in its former incarnation as R. H. Donnelley for several years but could never quite get past its ever-growing burden of debt. We ended up being right; in May 2009 the company filed for chapter 11.

When the company emerged from bankruptcy in January 2010 under its new name, we took a fresh look. We found the company with the same business, but $6 billion less in debt than the $9 billion it had when it went bankrupt. The company remains extremely profitable and generates a great deal of cash even in a weak economy. If we are right that the Yellow Pages business will remain viable for at least a few years, we can expect a hefty return.

Market Overview

Last quarter we talked about the relatively strong performance of higher growth and momentum stocks. While the performance of the third quarter was considerably stronger than that of the second, the overall complexion was similar. The market was still driven by "narratives" which emphasized the risk of deflation short-term, and inflation longer-term. This dynamic drove demand for safe, income generating investments and stocks showing consistent earnings growth in the context of a slow growth environment.

It does not surprise us that stocks are trading the way they are given the ample evidence of weak economic growth and the perils of borrowing too much money. The interesting part is that despite these widely understood challenges, many investors do not seem to appreciate that other investors have exactly the same information. As more and more people do the same things, valuations get stretched beyond reasonable limits, and many of these trades start looking very "crowded."

In the increasingly mad rush for the same types of assets, some perfectly good ones are being left almost completely unnoticed. One of the very interesting opportunities we are seeing unfold is that for stocks with strong cash flow generation that are either not paying dividends or are paying out only a very small portion of earnings. Without high growth or high cash dividends, they just aren't "sexy" enough right now. This may be easier for us to see than many others because of the bottom-up nature of our research.

These stocks strike us as enormous opportunities. The market is discounting them as if they were not useful or attractive assets. Yet when we dig into the companies, they seem to be extremely attractive and acting extremely responsibly.

Many, it is true, are correlated with overall economic growth which can very well be expected to be slower than in the past. Nonetheless, many are also extremely profitable and generating a great of cash. It is not hard at all to find companies with sustainable double digit free cash flow yields.

Given the uncertainty of the future, however, these companies are being conservative and allowing substantial cash reserves to accumulate. If and when economic growth prospects emerge, capital can very quickly be deployed to grow business organically. If low growth persists, capital can be deployed to increase cash dividends or share repurchases. This allows for maximum optionality; the companies can wait for greater clarity before dedicating capital. To us it sounds like prudent management. If the market wants to keep making these opportunities available, we are happy to oblige!

Performance review – Arete Mid Cap Core

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

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

Our target of 200-400 basis points of outperformance is based upon our experience with the strategy and upon our judgment of value creation. The primary metric we use to judge value creation is the information ratio. The information ratio compares a portfolio's excess return to its risk as measured by tracking error. Our goal is to outperform by a large enough margin relative to risk to clearly merit the cost in time and resources to evaluate investing with us.

Market performance in the third quarter rebounded significantly from a very weak second quarter and this was broadly reflected in Arete's performance. Arete's Mid Cap Core (AMCC) strategy returned 12.19% (net of fees) for the quarter but still modestly underperformed the Russell Midcap Index (RMC) return of 13.31% (see pages 9 – 11 for performance and related disclosures). Relative performance was negative in July and August, but reversed in September.

Stock performance* (6/30/10 - 9/30/10)

Best performers

Company	Return in quarter (%)
United Rentals	59.2
Thor Industries	40.6
Carmax	40.0
Autodesk	31.2
Penn National Gaming	28.2

Worst performers

Company	Return in quarter (%)
National Semiconductor	-5.1
Genworth Financial	-6.5
Seagate Technology	-9.7
Investment Technology Group	-11.5
Oshkosh Corp.	-11.8

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

The best performing stocks in the portfolio probably said more about market conditions than underlying fundamentals. In each case the strong performance in the quarter was primarily a function (and continuation) of extremely volatile price behavior. Each had sold off and hit a low early in the quarter and rebounded during the quarter. The fundamental investment case did not change in any instance.

The worst performing stocks didn't reveal much more than a continuation of the malaise that began with a sharp sell-off of several portfolio stocks in the second quarter. With the exception of ITG, which has suffered from lower trading volumes and profitability for several quarters, there weren't any material changes in fundamentals to explain the weak performance. The stocks performed well in 2009 and this year through April — and then didn't. The fundamental investment case did not change.

The bad news of this situation in the markets is that there is a great deal of price volatility and very little information being conveyed through daily prices. The good news, and what we ultimately thrive on, is that this is exactly the type of environment that lends itself to inefficient pricing. As such, we certainly are not having any trouble finding plenty of interesting new (and old) ideas to analyze!

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 - September 30, 2010

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									
January	-0.19	-0.19	-3.34	3	NA	470,985	470,985	100%	673,872
February	2.94	2.69	5.00	3	NA	483,663	483,663	100%	689,224
March	7.68	7.68	7.07	3	NA	520,819	520,819	100%	738,658
April	3.36	3.13	3.76	3	NA	537,099	537,099	100%	759,343
May	-9.66	-9.66	-7.35	3	NA	485,200	485,200	100%	790,766
June	-10.18	-10.18	-6.25	3	NA	435,813	435,813	100%	725,087
July	6.87	6.62	7.19	3	NA	464,682	464,682	100%	762,200
August	-6.30	-6.30	-4.40	3	NA	435,425	435,425	100%	720,103
September	12.29	12.29	10.58	3	NA	488,920	488,920	100%	795,537
Q1	10.64	10.37	8.67	3	NA	520,819	520,819	100%	738,658
Q2	-16.13	-16.32	-9.88	3	NA	435,813	435,813	100%	725,087
Q3	12.44	12.19	13.31	3	NA	488,920	488,920	100%	795,537
YTD	4.34	3.62	10.97						

**Note*: Composite returns for September 2008 have been corrected for an error that occurred in the calculation of accrued income. The new, new, corrected performance is higher by 10 basis points, which equals our threshold for materiality. The error occurred due to an ex-post post adjustment made by our reporting software. We have identified the source of the problem and have created procedures designed to avoid recurrence.

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

****Note*: One new and one existing account contributed additional funds which were not at least 90% invested by the end of September. Per our rules for inclusion, these accounts were excluded from the composite and will be added once the funds are fully invested.

Arete Asset Management Mid Cap Core performance composite disclosures follow:

Arete Asset Management Mid Cap Core performance composite disclosures:

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

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

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

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

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

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

Arete Asset Management

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