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THE ARETE QUARTERLY

Inside This Issue

Welcome

Travelling can be anything from a great adventure to a dreadful experience. Of course much of it depends upon one's perspective and attitude. One of the thorny issues with different cultures is that they are — different. Some people relish these differences, but others are appalled.

A recent tour package to China we saw attempted to assist travellers in getting the most out of the experience. In its "Parting Words of Advice," the brochure recommended visitors "travel with an open mind and expect the unexpected."

These words of advice can serve today's investors well too. The volatility wrought by the financial crisis in 2008 and rekindled again recently is a clear indication that we are no longer in the investment environment to which we had grown accustomed during twenty-five years of disinflation. As we "travel", we should expect the unexpected and it will help to keep an open mind.

At very least, we should always keep in mind that our destination is a very different place. The China brochure reminds people, "Thou shalt not expect to find things as thou has them at home. For thou has left thy home to find things different."

Indeed, the markets are now clearly in an era of digesting debt loads that in many cases have become excessive. Whether this will involve just moderately slower growth or outright deflation is not so important here (see *Market Overview* for further discussion), as recognizing that an environment of deleveraging will be different.

Disinflation, as we have seen, fosters stability which makes it easier for businesses, consumers, and all economic agents to plan. Better planning enhances confidence, which increases transactions, which increases overall business activity in a virtuous circle. It is easy to conduct business and for investors to become optimistic about prospects in this environment.

An environment of deleveraging, on the other hand, involves more challenges. Because too many people have too much debt, people become ever-more cautious about spending money for fear of not being able to make their payments. This caution is reflected in purchases being canceled or defered which leads to lower economic activity and gradually erodes business confidence. Since there are many types of businesses and consumers, the adjustment process takes time and is often riddled by fits and starts with little overall direction.

When people travel to China, they are advised that it, "requires patience and potential delays are to be expected due to [a lower] standard of service." This too is apt advice for today's investors. Twenty-five years of disinflation was an amazingly wonderful environment for stocks and bonds alike. It will likely take longer to generate returns from risk assets in a deleveraging environment and investors should "expect delays."

While travel normally incurs certain costs, that doesn't mean the journey can't be enormously enjoyable. Certainly one is likely to be exposed to new things and new ideas which is inevitably stimulating intellectually. Often we learn that certain customs and conditions may seem odd or inefficient at first, but in a different context are perfectly sensible and often charming. A different context can also provide a great deal of fresh perspective on conditions at home. Finally, no one place has a monopoly on excellence and examples can be found around the world. All of these apects of travel can lead to an extremely enriching experience.

In sum, travel abroad provides some useful lessons for today's investment environment. One lesson is that there will likely be *differences* from the past. Also, it helps to be *flexible* in order to facilitate dealing with those differences. Finally, it helps to establish *reasonable expectations*. We may be away for a while, so we might as well make the best of it.

Bon voyage!

Business Update

It seems like the last year has been especially busy. As the market rose late last year and early this year, I found it increasingly difficult to invest cash in new client accounts. I grew even more concerned when market averages were hitting highs at the same time that I saw a number of market risks increasing. An important consequence of becoming incrementally less positive on the market was that I also pulled back on some marketing activities temporarily.

The partial hiatus from a full marketing campaign was driven by Arete's focus on investing. For example, when I see risks and act accordingly, I say so. I am not going to say one thing, and then do another. I am also not going to quote whatever most-optimistic statistic I can find to try to persuade people to invest. I don't think it is honest to try to grow assets regardless of circumstances, but I also don't think it is interesting or rewarding.

What is interesting to me is figuring out the countless puzzles that comprise the market. Certainly these puzzles have become more complicated as conventional equity analysis and economics have become far more intertwined with social and political trends. There is just no easy way to bring so many things together than to read a lot and to think things through — and that takes time.

I also find it rewarding to be able to apply my expertise and efforts to improve the well-being of clients. For example, as I became incrementally less positive on the market, it was very straightforward for me to raise cash for Arete's mid cap core strategy (to help shield portfolios from losses) and to share my insights with clients.

Importantly, I view the primary output of Arete as far more than just a mid cap core "product," but rather a unique and valuable investment "service." One of the reasons I founded Arete is because I saw an opportunity to better serve investors. I had seen and experienced many of the ways in which a lot of resources and education and expertise at investment firms can fail completely to make clients better off.

Although Arete is still relatively small, it offers several compelling advantages. It focuses on mid cap stocks which tend to have far more dynamic growth opportunities than large cap companies. It brings an orientation to research with a long-term time horizon which is extremely difficult for many firms to maintain. Finally, it provides access to me and the insights and ideas I develop from reading and researching every day. Clients can call or email any time.

Every business involves tradeoffs and when push comes to shove, I am happy to have the choice of focusing on investments and serving clients. My research over the past several quarters has revealed an investment environment that has become more fragile, and I have spoken freely about the risks I perceive. Although this approach precludes more aggressive marketing at times, I believe the sacrifice is more than compensated by the value of efficiently delivering investment expertise.

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 continue to confirm that AMCC is a very representative mid cap portfolio. Market caps for AMCC are very similar to the mid cap index and most valuation metrics are also fairly similar. ROE is noticeably lower, but is also significantly distorted by very negative numbers from a couple of smaller positions.

Portfolio Characteristics (9/30/11)

	Arete MCC*	Midcap Index**
Size		
Average Market Cap ($ mil.)	4,806	4,722
Median Market Cap ($ mil.)	3,968	3,544
Minimum Market Cap ($ mil.)	28	635
Maximum Market Cap ($ mil.)	16,206	16,475
Number of holdings	46	782
Valuation		
P/E current year	21.3	21.4
P/E forecast Y1	16.2	15.8
P/B	2.4	3.2
P/S	1.1	1.6
Yield (%)	1.2	2.8
Valuation drivers		
ROE (%)	8.8	15.0
LT eps growth forecast (%)	11.4	13.6

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 were mainly at the low ends of our general guidelines of 50% - 150% of benchmark weights this quarter due to our unusually large cash position. The Materials and Processing sector is still overweight but will fall considerably when the acquisition of Nalco Holding is completed.

It is important to note that cash was not raised through a wholesale culling of the portfolio. Instead, the vast majority of the cash was raised through exercising our normal sell discipline and through realizing the benefits of several acquisitions for cash. As much as anything, the accumulation of cash reflects an intentional delay in reallocation. Looking to the intermediate future, cash will serve as insurance against significant market dislocations, but will also allow us to make opportunistic purchases.

Sector exposure (percent of assets on 9/30/11)

Economic sector	Arete MCC*	Midcap Index**	Percentage Comparison
Consumer Discretionary	15.0	16.7	89.7%
Consumer Staples	4.1	6.5	63.3%
Energy	6.0	7.4	81.2%
Financial Services	16.0	20.2	79.1%
Health Care	8.8	9.9	88.9%
Materials & Processing	8.6	6.7	129.0%
Producer Durables	7.0	12.7	54.9%
Technology	5.7	11.2	51.0%
Utilities	6.5	8.7	74.6%
Equity exposure	77.7	100.0	
Cash and equivalent	22.2	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

Last quarter we wrote, "Given the increasing risks we have identified in the market the past several quarters, we have also implemented one additional measure to protect the portfolio. We have raised cash to levels well above the normal one to three percent we deem appropriate for operations." The market started discounting those risks in a very noticeable way early in the third quarter and continued throughout the period.

Meanwhile, we retained our risk management vigilance and executed three more transactions in the quarter. We sold

Precision Castparts, we sold Discovery Holdings, and we sold half of our position in Kinetic Concepts.

Precision Castparts has been one of the great companies and great stocks we have encountered. It has always produced exceptionally high economic returns on capital and has been one of the very few companies truly gifted at making value-added acquisitions. Nonetheless, the stock price rose to the upper limits of what we considered fair value and therefore was a fairly straightforward exercise of our sell discipline. The decision to sell was made a bit easier given that its market cap also exceeded $20 billion and was larger than any other stock in the mid cap index.

We have really enjoyed watching Discovery Holdings grow market share, build its audience, and finally start monetizing its success in a meaningful way. Although we do not anticipate any major problems in the business, the stock has appreciated enough to make it fully valued. In addition, the business model has a great deal of operating leverage which makes it especially vulnerable to slowing economic growth — which we consider to be an important risk for at least the next couple of quarters.

In addition to these two outright sales, we also sold half of our position in Kinetic Concepts. KCI stock has been pretty stable in the mid 60s awaiting the completion of its acquisition by private equity firm, Apax Partners LLP. We left a couple of dollars on the table relative to the ultimate acquisition price, but we thought it prudent to do so given the significant tightening of credit markets in front of the deal funding and the potential to experience a material adverse condition.

Finally, we also realized cash from National Semiconductor in the quarter. Texas Instruments closed the acquisition late in September and we decided to wait to reinvest the proceeds.

Market Overview

The volatility that erupted during the quarter is yet more evidence of how fragile the markets continue to be. In the past, we have outlined several risks which we believe have been contributing to the fragility. As a result, we haven't been especially surprised, or anxious, about the volatility. While these risks continue to play a large role, the more visible factor has been the sporadic and uneven process by which investors are adjusting their expectations.

As a reminder, expectations comprise a very important element of stock valuation. Fundamentals, in the form of cash flows, are also very important. While near-term cash flows can be measured fairly objectively, any stock valuation involves a long list of assumptions. Just like beauty is in the eye of the beholder, valuation is colored by expectations for companies as well as those for asset classes such as stocks.

Dennis Gartman, a professional trader, author of *The Gartman Letter*, and market commentator, put this into great perspective when he presented to the Baltimore CFA Society a few weeks ago. He made it very clear that his academic training in economics (which focuses more on fundamentals) was "worthless" to him as a professional trader.

Instead, after thirty-five years of trading, he has come to view trading and investing as the "discovery of the human condition." In other words, he believes it is much more important to understand the more human elements behind the formation of expectations. As a result, he believes the study of humanities is far more insightful than that of economics, and recommends studies such as philosophy, history and literature.

Gartman's comments are also deeply consistent with those of the great John Maynard Keynes. One of Keynes' most famous insights also touched on the human condition: "Most probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as the result of animal spirits - a spontaneous urge to action rather than inaction."

When people run up a lot of debt (as consumers have in the U.S.) and then start realizing the very real possibility they won't be able to pay off their debts, their behavior normally changes. Gary Shilling provides a great deal of insight to this phenomenon in his book, *The Age of Deleveraging: Investment Strategies for a Decade of Slow Growth and Deflation*.

Some people, when confronted with economic adversity, lose their "animal spirits," hunker down, and become prone to inaction. This behavior can be seen indirectly through lower growth and reduced market volume.

Other people, however, are more prone to make up any shortfalls at the casino. While speculative behavior results naturally, it is amplified by excessive liquidity and low interest rates. As Shilling describes, "The speculative investment climate spawned by the dot-com nonsense survived. It simply shifted from stocks to commodities, foreign currencies, emerging market equities and debt, hedge funds, private equity — and especially to housing."

The aftermath according to Shilling, is not likely to be a steady decline, but a process, "reflecting shorter, weaker economic expansions and longer, deeper recessions." Since, "Speculations never end voluntarily or in orderly fashions," significant volatility seems an almost inevitable outcome and therefore should not be surprising.

It is also useful to note that it is likely market volatility has been exacerbated by a relatively new development: the emergence of a wide range of exchange traded funds (ETFs). While these vehicles certainly have merits, they also have the consequence of facilitating speculation from a much broader audience across a wide array of assets.

As a result, it has become increasingly difficult to disaggregate the information content in the prices of stocks, gold, copper and other assets from speculative activity. In many cases it may very well be that volatility says more about the desperation of speculators than it does about the fundamentals. This increases uncertainty.

Given the environment of deleveraging and volatility, we believe the overall prospect for stocks and bonds is likely to be muted relative to history. All else equal, lower economic growth means lower profit growth and lower valuations for stocks. It is an important distinction that muted growth just means lower growth, though, not vast contraction.

In addition, in this tumultuous environment of cross-currents, all else is not always equal. Extraordinary monetary policy and government interventions affect all asset classes globally. ETFs can also facilitate speculation which can cause prices of some assets to far exceed their value as hedges or insurance. At very least, this environment demands a flexible approach and a very serious consideration of risks.

There is absolutely good news in all of this though. Without a doubt, volatility creates lots of opportunities. Untempered speculation creates very significant valuation disparities for disciplined, long-term investors. We don't have problems competing in the marketplace with rabid speculators desperate to sacrifice massive losses tomorrow for a few dollars today. While we are currently seeing some interesting opportunities, we strongly suspect we will see even bigger ones emerge in the not-too-distant future. In the meantime, we remain ready.

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.

Arete's Mid Cap Core (AMCC) strategy fell 19.66% (net of fees) versus a decline of 18.90% for the Russell Midcap Index® (RMC) in the quarter (see pages 9 – 11 for performance and related disclosures). We never feel victorious when performance is negative, but the cash we raised earlier in the year certainly helped cushion the blow. Further, we now have a valuable option in being able to redeploy the extra cash to stocks that have gotten a lot cheaper.

Individual stock performance told another interesting story this quarter. The fact that three of the top performers were utilities gives an indication of how difficult the quarter was for stocks. Arete's philosophy of buying undervalued stocks was also highlighted as three of the top five performers, Nalco, Kinetic Concepts, and Constellation Energy, were beneficiaries of takeout offers.

On the other side of the coin, the bottom performers continued to get pummeled. While we continue to believe that most, if not all, of these stocks are undergoing turnarounds that will spawn substantial value, there are few buyers willing to step in now. Any hint of liquidity needs is enough to send a stock into a downward spiral with share repurchase being the only cure in the short-term.

While some of our cyclical and turnaround stocks have gotten sucked into the vortex of negative momentum, our investment philosophy prevents us from selling on that basis alone. In many cases, we view these situations as ever-increasing valuation disparities that are bordering on silliness.

Stock performance* (6/30/11 - 9/30/11)

Best performers

Company	Return in quarter (%)
Nalco	25.8
Kinetic Concepts	14.3
Xcel Energy	1.6
Constellation Energy	0.3
Pepco Holdings	-3.6

Worst performers

Company	Return in quarter (%)
Eastman Kodak	-78.2
Dex One	-77.9
Energy Conversion Devices	-55.1
Synovus	-48.6
Oshkosh Corp.	-45.6

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

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 Asset Management

Arete Mid Cap Core Composite

Arete Asset Management, LLC
Mid Cap Core Composite
July 31, 2008 - September 30, 2011

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									
January	2.61	2.37	2.13	3	NA	559,270	559,270	100%	895,481
February	1.56	1.56	3.80	3	NA	568,001	568,001	100%	907,094
March	0.53	0.53	1.53	3	NA	571,008	571,008	100%	1,011,132
April	2.16	2.16	2.99	3	NA	583,327	583,327	100%	1,028,436
May	-1.99	-2.23	-0.42	3	NA	570,329	570,329	100%	1,008,298
June	-2.22	-2.22	-2.09	3	NA	557,644	557,644	100%	990,488
July	-4.58	-4.83	-3.63	3	NA	530,723	530,723	100%	949,361
August	-6.81	-6.81	-6.88	3	NA	494,557	494,557	100%	896,027
September	-9.41	-9.41	-9.63	3	NA	447,996	447,996	100%	826,060
Q1	4.77	4.52	7.63	3	NA	571,008	571,008	100%	1,011,132
Q2	-2.10	-2.34	0.42	3	NA	557,644	557,644	100%	990,488
Q3	-19.45	-19.66	-18.90	3	NA	447,996	447,996	100%	826,060
YTD	-17.38	-17.99	-12.34	3	NA	447,996	447,996	100%	826,060

**Note*: Peformance through 12/31/08 is from inception of composite on 7/31/08.
***Note*: One existing and two new accounts contributed additional funds which were not at least 90% invested by the end of the quarter. 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:

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

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

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

Arete Asset Management Mid Cap Core performance composite disclosures continued:

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

The composite
This U.S. Equity Mid Cap Core composite was created in August, 2008 and includes all fee-paying, taxable and non-taxable, discretionary, long only, fully invested portfolios benchmarked to the Russell Midcap Index. 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.

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.