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The Arete Quarterly

Welcome

As a reminder, and as a message to those who may have missed the last quarterly letter, the text content of this and all future editions will be considerably shorter than in past letters. This change will allow the *Arete Quarterly* to be more focused on portfolio analysis and will also facilitate much more regular publication of general commentary through the Arete blog. If you haven't visited www.areteam.com/blog yet, please take a look when you get a chance.

Inside This Issue

Business Update

One of my projects over the summer was to refresh and improve the presentation I use to talk about Arete with prospects and interested parties. When I founded Arete, I really focused on thinking freshly about how things *could* and *should* be done instead of mindlessly following convention. I wanted Arete to be something special, not just a slightly different iteration of a model I already knew didn't work well.

As I conducted marketing research, studied the industry, and formulated the value proposition, it became clear that my perspective encompassed trends and changes affecting the entire investment industry. Because of this fairly unique strategic perspective, and because it is difficult to understand Arete's proposition without it, I am emphasizing the notion of a fresh perspective with the title, "Reimagining money management."

For starters, this update addresses much more directly some of the important dynamics occurring in the landscape for both investing and investment services. I see the investment industry on the cusp of fairly dramatic change -- most of which centers on the notion of sustainability.

Although I think many investors also sense this to be the case, they still often frame questions and discussions around what has worked in the past and not around what is likely to succeed in the future. When I get a chance to talk about the investment environment and the implications for investors first, everything about Arete makes a lot more sense. Notably, these ideas seem to resonate especially deeply with those whose own money is on the line.

Another thing I want to accomplish with the presentation is to highlight the central activity of knowledge management at Arete, but also at all good active management firms. Despite flawed execution by many, active management remains the R&D center of the industry because it is really the only business that focuses resources on developing proprietary insights to such a high degree. People don't go to paralegals for litigation representation or to medical equipment sales reps for surgery and yet that is effectively what happens in the realm of investing all the time.

This disconnect is unfortunate because it leaves many investors significantly isolated from extremely important sources of investment expertise such as active managers. While investment performance over time is certainly important, I don't see any reason why the relationship between investor and investment expert should be so narrowly defined. As a result, I'm spending a fair amount of effort to come up with new and creative ways to share information and useful insights with investors in ways that extend well beyond just the performance of Arete's mid cap strategy. If you have some ideas, I'd love to hear them!

When I do get the chance to describe Arete's research process in greater detail, one of the interesting things I find is that people are often surprised by the depth of analytical work and by Arete's different perceptions of market drivers. The vast majority of the time I have found the process of sitting down and reviewing different assumptions and evidence to be a mutually beneficial exercise. Investors get a chance to see the investment landscape through my eyes and often gain incremental insight and perspective. I often come out with a better understanding of where problems exist and often gain an advocate for Arete.

With this work essentially complete, the next step in this endeavor is to get out over the next several months to tell the Arete story. If you have any interest in hearing it, or know someone who might, please let me know. I'd love to be able to describe my views of the investment environment and all of the reasons why I think Arete provides a better way to invest.

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 (9/30/14)

	Arete MCC*	Midcap Index**
Size		
Average Market Cap ($ mil.)	7,768	8,127
Median Market Cap ($ mil.)	5,244	5,971
Minimum Market Cap ($ mil.)	169	228
Maximum Market Cap ($ mil.)***	30,476	44,185
Number of holdings	32	837
Valuation		
P/E current year	21.5	23.0
P/E forecast Y1	19.0	20.5
P/B	3.5	4.6
P/S	1.4	2.0
Yield (%)	1.8	2.4
Valuation drivers		
ROE (%)****	9.5	12.7
LT eps growth forecast (%)	9.8	12.2

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

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 as well as options to buy cheaper in the future.

Portfolio characteristics for the quarter continue to confirm that the equity portion of AMCC is a very representative mid cap portfolio. Market caps for AMCC are extremely similar to the mid cap index and AMCC is considerably cheaper on the bases of Price-book and Price-sales which tend to be more stable metrics. Notably, Price-book still compares well despite a substantial rise from the inclusion of an anomalously high figure from GLPI.

As a note, we changed the calculation of ROE from an average to a median. As it was, this particular measure was volatile and provided little information content. Indeed, as the markets have run up under the Fed's policy of quantiative easing, the benchmark's average ROE has become increasingly biased by a relatively small number of extremely high returns.

Sector exposure (percent of assets on 9/30/14)

Economic sector	Arete MCC*	Midcap Index**	Percentage Comparison
Consumer Discretionary	3.5	18.2	19.3%
Consumer Staples	0.0	5.4	0.0%
Energy	5.2	5.9	87.6%
Financial Services	14.8	21.6	68.6%
Health Care	8.0	10.6	75.5%
Materials & Processing	5.9	6.8	87.4%
Producer Durables	8.1	12.9	63.0%
Technology	6.5	12.1	53.8%
Utilities	4.4	6.6	66.8%
Equity exposure	56.4	100.0	
Cash and equivalent	43.5	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.

Sector exposures are all below benchmark weights due to the high cash position. All sectors, with the exception of consumer staples and consumer discretionary, however, are still within our guidelines of 50% - 150% of benchmark weights.

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. Arete's Mid Cap Core portfolio consistently exhibits active share well above the 80% level considered to be very active.

Active share* (9/30/14)

Period	Percent**
Q314	93.1
Q214	94.1
Q114	93.5
Q413	93.2

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

Transactions review – Arete Mid Cap Core

In the third quarter of 2014 we initiated a handful of transactions, all of which can be comfortably described as "housekeeping".

We added to AUY opportunistically to build out the position in the portfolio at a much lower price than our original purchase. We continue to like the company's operational performance and low cost position and we also continue to like having exposure to gold as an insurance policy against a wide array of potential risks.

We sold our entire position in AES during the quarter. We originally purchased the stock on the basis of strong global economic growth prospects and considerable expertise in operating electric utilities in a number of foreign countries. Unfortunately we have lost a fair amount of confidence regarding most aspects of that original hypothesis. We are especially concerned about the risks of capital intensive projects in countries that are vulnerable to rapid outflows of money.

We reduced our position in HNT partly as a function of valuation and partly as a matter of general risk management. The stock has performed extremely well of late and appears to be discounting a great deal of success with new programs that are not at all certain. This was a good opportunity to reduce the risk exposure.

MYL had a great run and as a result had become a top position in the portfolio. While we still like the stock and believe it is undervalued, it still has great deal of debt and no longer has such a clear pathway to continued revenue growth. As a result we took the opportunity to reduce the position size.

Finally, we also reduced the position in STX for similar reasons. While we still like STX and still have a larger than average position size, it had become extremely large for all the reasons we had expected – hugely underappreciated ability to generate cash flow based on high asset utilization. That said, the hard drive industry is cyclical and STX stock can be quite volatile so we took the opportunity to take some more shares off the table.

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.

Stock performance* (6/30/14 - 9/30/14)

Best performers

Company	Return in quarter (%)
Dresser Rand	29.1
Lands End	22.5
Spirit Aerosystems	12.9
Health Net	11.0
TD Ameritrade	6.4

Worst performers

Company	Return in quarter (%)
Sears Holdings	-36.9
Sears Canada	-28.7
Yamana Gold	-27.0
Owens Illinois	-24.8
Genworth Financial	-24.7

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

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 returned -4.40% (net of fees) for the quarter versus -1.66% for the Russell Midcap Index® (RMC) (see pages 8 – 10 for performance and related disclosures). While it was disappointing that the fairly defensively positioned portfolio underperformed in a down quarter, it is useful to note that virtually all of the underperformance occurred in the one month of positive performance. This has been a recurring theme since the Fed starting its quantitative easing programs: QE tends to benefit major index constituents and momentum stories disproportionately and leave other stocks behind. This dynamic has created a difficult period for high active share portfolios everywhere.

While these ongoing trends affected portfolio performance at a high level, there were some interesting breaks from past patterns under the surface. First, there were two down months in the quarter which indicated a clear slowing of momentum. Second, one of the most prominent themes among the top performers in the AMCC portfolio was the rare success of value.

For example, the best performer of the quarter was DRC upon notice of its acquisition by Siemens. We have always like the potential of DRC in light of increased exploration of unconventional oil and gas fields. Despite the seemingly obvious potential, Siemens stepped in and priced it more appropriately than the market would.

LE shot up when it reported earnings in early September and handily beat revenue and earnings forecasts. Partly this was unusually pleasant news in an otherwise dismal retail environment. It also seemed to be at least partly the triumph of real economic fundamentals over silly market narratives: the market has habitually punished SHLD and anything related to it.

SPR has also been performing well since its new CEO took over and has finally had a chance to correct a series of management missteps. SPR is an extremely valuable supplier to Boeing (and others); it's nice to finally see it doing what it is capable of.

Many of the worst performers are again familiar names. SHLD has had a difficult time transitioning its retail business, but arguably the bulk of value lies in its real estate. The stock fell upon the announcement of a loan provided by ESL Investments (the major shareholder) and claims that the terms were unfavorable. While SHLD has certainly suffered missteps, the negative sentiment and its low float make it subject to volatility caused by short-term speculators.

AUY was down substatially in the quarter but only as a function of the trend of the strong US dollar and negative momentum. OI lowered its guidance for the quarter which is not too surprising given its significant exposure to European economic growth and multiple currencies.

GNW was down signficantly when it announced it was going to review the reserves for its troubled long-term care business. While we certainly must consider the possibility of a significant impairment, the stock is still subject to overwhelmingly negative sentiment. It is odd that such sentiment continues to persist for a company which has strong businesses, never engaged in fraud (unlike many others), and never received any government bailout money in the financial crisis (unlike most of the banks).

We also note that NIHD sought chapter eleven protection at the end of the quarter. This is been an extremely disappointing development given what we still consider to be subtantial asset value -- especial in its significant bandwidth rights. While the story isn't over -- legendary investor George Soros has been buying the stock, it certainly provides lessons on what a management team should not do.

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, 2014

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									
January	-0.99	-1.23	-1.95	4	NA	962,606	962,606	100%	1,159,913
February	2.83	2.83	5.87	4	NA	989,831	989,831	100%	1,188,450
March	0.94	0.94	-0.27	4	NA	999,148	999,148	100%	1,199,683
April	0.09	-0.16	-0.57	4	NA	997,580	997,580	100%	1,197,931
May	1.07	1.07	2.22	4	NA	1,008,260	1,008,260	100%	1,208,804
June	1.93	1.93	3.29	4	NA	1,027,768	1,027,768	100%	1,228,915
July	-3.47	-3.71	-2.95	4	NA	989,631	989,631	100%	1,189,149
August	2.50	2.50	4.83	4	NA	1,014,406	1,014,406	100%	1,213,936
September	-3.14	-3.14	-3.34	4	NA	982,813	982,813	100%	1,179,408
Q1	2.77	2.52	3.53	4	NA	999,148	999,148	100%	1,199,683
Q2	3.12	2.86	4.97	4	NA	1,027,768	1,027,768	100%	1,228,915
Q3	-4.16	-4.40	-1.66	4	NA	982,813	982,813	100%	1,179,408
YTD	1.57	0.81	6.87	4	NA	982,813	982,813	100%	1,179,408

**Note*: Peformance through 12/31/08 is from inception of composite on 7/31/08.
***Note*: One new account contributed additional funds which were not at least 90% invested by the end of the quarter.
Per our rules for inclusion, this account was 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®).

Arete Asset Management Mid Cap Core performance composite disclosures continued:

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. 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.

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.