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THE ARETE QUARTERLY

Welcome

We hope everyone had nice enjoyable holidays as we welcomed in a fresh new year!

The end of the year is often a time for reflections and resolutions so we made some time to reflect on the business landscape for money management. In an effort to get a fresh perspective on the industry we used the discipline of game theory to frame our study and to try to better-understand the interaction of various players.

For those not especially familiar with it, game theory can be described as the study of, "interactive, strategic decision making among rational individuals." Game theory provides useful insights into some of the thorniest management problems by transcending academic disciplines as diverse as math, economics, politics, and psychology.

One of the very readable books on game theory is *Co-opetition*, by Adam Brandenburger and Barry Nalebuff. It dates back to 1996, but does a terrific job of applying game theory to real business situations and highlighting simple and useful principles.

Importantly, the very name of the book was coined to emphasize the balance of cooperation and competition in the business world. This open framework stands in stark contrast to the conventional model of pure competition and zero-sum games. In fact, the image of "cut-throat" competition comes to mind much more easily than any paradigm for business cooperation.

Inside This Issue

As our world has become ever-more complex, however, the mindset of pure competition has failed to capture many important relationships and opportunities that businesses encounter. An increasingly important player in such encounters is that of a complementor, which is essentially the opposite of a competitor. Brandenburger and Nalebuff explain, "A player is your complementor if customers value your product more when they have the other player's product than when they have your product alone." For example, hot dogs are more valuable to most people when mustard is available to garnish and complement the hot dog.

The notion of complementors may be more relevant to the investment industry than any other. The task of managing investments is so broad that many participants require more than one distinct service. For example, it is common that asset allocation/financial planning and fund management services have more value to an investor when paired than when used individually. As a result, the opportunity for collaboration derives naturally from both providers putting the client's interest first.

One way to think of this is that, "Companies are complementors in making markets and competitors in dividing them up." An important consequence, and one relevant for intra-industry relationships, is that the potential for growing the market by advancing complementary relationships may quite possibly be greater than that for competing for a bigger slice of the same pie.

As always, we appreciate your comments and suggestions regarding any aspect of the business which might make our services more useful to you. We hope you find our proposition compelling and always look forward to talking with you.

Business Update

Since I founded Arete nearly two years ago now, I have made a concerted effort to keep all aspects of the business current. I regularly review the business plan, the ADV, the website, and other materials to make sure you see and hear my current thinking. As part of this process, I have most recently reviewed and refreshed Arete's mission statement.

First and foremost, the primary thrust of Arete's mission statement has not changed and is not likely to change. I always want this organization to be about striving for "functional excellence in money management." This statement also serves as my personal commitment to all of Arete's investors.

When I first conceived the mission statement, I wanted it to be extremely clear that the company was created to deliver high quality money management. My feeling was—and is—that far too many organizations in the industry do not offer a compelling value for their investors. I wanted to clearly differentiate Arete in this respect.

In doing so, however, I failed to appropriately acknowledge all of the smart, hard-working, well-intentioned, and value-creating people and institutions in the industry. Indeed the population of all parts of the industry by high quality people has always been a big part of what makes the business so gratifying (and edifying) for me. The revised mission statement is a clearer and more robust expression of Arete's objectives and its intended relationship with the investment community at large. Please feel free to check it out on our website at www.areteam.com.

When I think about business development, I always start at the same place—with the client. What do investors need? What are their biggest problems? Where does Arete's mid cap product best fit into this landscape? How can we best work within the landscape of complementors, vendors, and clients to create the greatest value?

I believe there are some basic rules of engagement for this endeavor. One is that there needs to be a strong standard of fiduciary responsibility. Based on what I see and hear, investors want to be able to outsource more investing activities, but they don't trust providers as much as they would like to. Many providers, especially the large financial conglomerates (but there were many), demonstrated clearly that systemic tendencies toward self-interest too often prevail over fiduciary duty. Can a community of unrelated providers do better? This is a major challenge. I do believe the industry can grow by better-serving investors. As a group, however, we must do a better job of earning and keeping trust.

Another important rule of engagement is transparency. I designed Arete with a high degree of transparency by disclosing the investment philosophy, mental models, market assumptions and other aspects of the business so investors can easily judge the merits of the offering. I have believed from the start that the better one understands what Arete does, the clearer its value proposition will be.

A couple of industry factors serve to dilute the value of transparency though. One factor is that the industry really has no uniform standards by which to judge products. A significant motivation of mine when I sat for the CFA was that I believed in the CFA Institute's efforts to promote ethics and analytical rigor. Other organizations are also working hard to increase professionalism in the industry. Nonetheless, outside of a few notable successes such as the Global Investment Performance Standards (GIPS), there are very few evaluation standards to guide investors.

Another factor is that the proliferation of investment services, products, and providers has created a morass of messages and marketing for investors to wade through. The beneficiaries of such chaos are often weaker products—because it can be hard to differentiate them from better ones. There is an awful lot of noise to filter through.

Insofar as this is the case, I see at least a couple of opportunities to improve the investment environment. First, investment professionals need to keep working to provide a better set of "rules" by which to judge products and providers. Second, the best way to reduce noise in the market is for investors to vote with their feet. There are huge differences in quality among providers but unless investors make significant efforts to identify and reward quality, there is no economic incentive for things to improve. Ultimately, better rules and greater scrutiny of providers will reduce "noise" in the industry and promote a healthier ecosystem of investment services.

Throughout the upcoming year, as I continue to expand my sales and marketing efforts, I look forward to exploring ways to better-serve investors' needs.

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.

Portfolio Characteristics (12/31/09)

	Arete MCC*	Midcap Index**
Size		
Average Market Cap ($ mil.)	5,472	4,386
Median Market Cap ($ mil.)	5,379	3,459
Minimum Market Cap ($ mil.)	484	263
Maximum Market Cap ($ mil.)	15,529	15,529
Number of holdings	49	773
Valuation		
P/E current year	13.7	15.5
P/E forecast Y1	18.3	20.8
P/B	2.5	2.5
P/S	0.7	1.0
Yield (%)	0.9	2.5
Valuation drivers		
ROE (%)	15.5	14.9
LT eps growth forecast (%)	10.6	11.1

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.

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 are a little bit higher for AMCC than for the mid cap index and most valuation metrics remain modestly lower. The valuation driver of ROE is slightly higher than the midcap index but forecast growth for AMCC fell slightly below that of the benchmark.

Sector exposures remained relatively unchanged from last quarter and for the most part, well within our general guidelines of 50% - 150% of benchmark sector weights. The only exception in the quarter was Materials and Processing which finished just slightly above our 150% guideline.

Sector exposure (percent of assets on 12/31/09)

Economic sector	Arete MCC*	Midcap Index**	Percentage Comparison
Autos & Transportation	0.0	0.2	0.0%
Consumer Discretionary	20.6	16.1	127.9%
Consumer Staples	3.3	5.8	56.6%
Financial Services	16.9	19.9	85.0%
Health Care	10.7	8.6	124.8%
Energy	7.1	7.4	96.2%
Materials & Processing	11.8	7.6	155.3%
Producer Durables	13.3	12.5	106.6%
Technology	7.8	13.3	58.7%
Utilities	6.5	8.7	74.7%
Equity exposure	98.0	100.0	
Cash and equivalent	2.0	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.

We mentioned last quarter that we don't manage the portfolio from the top-down by targeting certain sector weights. Those weights, however, can serve as expressions of various risks and opportunities.

One example that stands out for us is the contrast in relative weights between the Materials and Processing sector and the Technology sector. We consider both sectors to be largely driven by economic growth and therefore also inherently cyclical.

Given our belief in the strong prospects for global economic growth, we anticipate at least moderate inflation for commodities and raw materials. As such, we like the opportunities for pricing among many materials and processing companies. This contrasts sharply with our view that many technology products, especially electronics, are ultimately subject to deflationary pressures as productivity-driven supply routinely outstrips demand growth. The manifestation of these views on pricing at the individual company level is apparent at the sector level.

Transactions review – Arete Mid Cap Core

Overall, we have continued to be pleased with the basic set of holdings we started the portfolio with in July 2008. The one area that continued to get pummeled, however, was banks. The three transactions we executed in the fourth quarter were all part of an effort to rebalance holdings in the financial services sector.

The two purchase transactions in the quarter were prompted by the unusually weak performance of Synovus (SNV) and CapitalSource (CSE) through the year. SNV distinguished itself as being one of the few stocks that ended the year well below its level at the market low in March. To be fair, SNV management did (or perhaps, did not?) do a lot to deserve this distinction.

Riddled with rapidly rising non-performing loans in residential construction and housing, the company was forced to secure capital from the TARP program and later to raise equity as well. The fact that the company came into the year with a strong capital position is testament to how poorly their credits performed. As the stock took its final step down this fall, following a memorandum of understanding with the Fed and the bank regulators in Georgia, the stock was selling at well less than half its book value.

The tenets of our thesis for adding to SNV are twofold. First, new nonperforming loans are going to drop significantly. The biggest problem by far has been residential construction loans around Atlanta, but most of the problems have been captured by now. The book of performing residential construction loans around Atlanta loans is down to one-third its level less than two years ago. In other words, it is mathematically impossible to continue realizing losses at the same rate from this book.

Second, the threat of insolvency or massive dilution is far less than the market is discounting. While we do not expect SNV will need to raise more capital, it can. SNV has a decentralized structure with legally separate banking entities in very attractive markets. If worse comes to worse, one or more of these entities can be sold to shore up the balance sheet.

CapitalSource suffered a somewhat similar fate in having to deal with suddenly and substantially inflated non-performing loans. While CSE's concentration of middle market loans has been of concern, the bigger problem was failing to match its funding with its outstanding loans. Management has said they will never make this mistake again. We believe they learned their lesson.

The failure to match fund led to significant concerns about the company's liquidity. True to its word, management made significant progress in refinancing over the summer and into the fall and stands in good shape now. The market seems to be waiting for more concrete evidence, however, and at the time of purchase was pricing the stock at about one-half its book value.

In order to fund these transactions we needed a source of cash. While Fiserv (FISV) held up reasonably well through the financial crisis last year, we had grown increasing frustrated and concerned with the company. We were frustrated by the company's poor revenue growth and by its inability to translate acquisitions into profitable growth. We had also become increasingly concerned by the troubles facing many small and mid-sized banks which form the core of FISV's customer base. Specifically, we believe continued loan problems and limited access to capital will cause the universe of small and mid-sized banks to shrink considerably over the next couple of years.

Market Overview

Market returns in the fourth quarter were very solid but did ease from the extremely strong showings of the second and third quarters. At the same time, the market's "fear gauge," the VIX indicator of market volatility, declined to levels not seen since late August 2008.

Overall, we saw the market shift gears from a massive rebound to a slower pace of gains. While the pace slowed, gains were driven by an increasing sense of normalcy as capital markets reopened and companies began raising debt and equity again.

Improvement in the equity markets was evidenced by a number of secondary offerings, by some acquisitions, and ultimately by the reopening of the IPO market. All of this progress, from a dead standstill in March, created a degree of momentum that kept pushing prices higher through the end of the year.

At this point, it does appear to us as if the market has gotten a little ahead of itself on valuation. That said, we still like the prospects for the stocks in our portfolio and continue to find interesting opportunities. Further, the Fed's stance on keeping interest rates low for the foreseeable future is essentially a dare to not invest.

While this evidence presents a picture that is less than completely clear for the short-term, we don't want investors to lose focus on what we view as attractive longer-term prospects for US stocks. One point we highlight is that we did avoid the cataclysm of a full melt-down of the credit markets and financial system. That threat has passed along with the market prices that reflected such a dire possibility. As I heard the other day, "The end of the world just doesn't happen very often."

In addition, we especially like the opportunity US stocks present. We are encouraged by many of the adjustments that individuals and companies have made and continue to see a strong foundation for future productivity growth. Also, valuations in a broad sense are reasonable, especially relative to some emerging markets which are being inflated by hot new money flows.

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, 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. A 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.

The market continued its strong perfomance in the fourth quarter with the Russell Midcap Index (RMC) posting a strong return of 5.92%. Arete's Mid Cap Core (AMCC) strategy returned 3.53% (net of fees) which lagged its primary benchmark. For the year, AMCC held up well returning 47.83% (net of fees) versus RMC's return of 40.48% generating an excess return of 7.35%.

Stock performance* (9/30/09 - 12/31/09)

Best performers

Company	Return in quarter (%)
Health Net	51.2
Sears Holdings	27.8
Nalco Holding	24.5
Amerigroup	21.6
Peabody Energy	21.5

Worst performers

Company	Return in quarter (%)
Commscope	-11.4
Eastman Kodak	-11.7
NRG Energy	-16.3
Investment Technology Corp.	-29.4
Synovus Financial	-45.3

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

The best and worst performing stocks tell a less interesting story than they have in the past. Many stocks seemed to continue rising based more momentum than on any clear improvements in fundamentals. That said, managed care stocks all rebounded strongly from valuation troughs as concerns over some of the more onerous aspects of health care reform receded.

The worst performers included two of our larger positions, Commscope and Eastman Kodak, and also reflected continued weakness among our financial services stocks. We believe the poor performance of many of our financial stocks can be attributed to two factors. First, loan portfolios continued to weaken with declining home prices and increasing concerns about commercial real estate. Fundamental weakness among small and mid cap banks was also exacerbated by the fact they do not enjoy the protective cover of being "too big to fail."

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 - December 31, 2009

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									
January	-7.54	-7.62	-7.40	3	NA	191,258	191,258	100%	191,258
February	-11.02	-11.02	-9.95	4	NA	318,767	318,767	100%	318,767
March	8.67	8.67	9.15	4	NA	346,401	346,401	100%	346,401
April	20.86	20.86	15.37	4	NA	418,645	418,645	100%	418,645
May	4.72	4.68	4.34	4	NA	438,238	438,238	100%	438,238
June	1.80	1.80	0.35	4	NA	446,106	446,106	100%	446,106
July	9.90	9.69	8.85	4	NA	489,344	489,344	100%	489,344
August	7.37	7.37	4.86	4	NA	525,423	525,423	100%	525,423
September	5.39	5.39	5.67	4	NA	553,725	553,725	100%	553,725
October	-6.98	-7.19	-4.40	4	NA	513,903	513,903	100%	513,903
November	5.51	5.51	4.83	3	NA	446,274	446,274	100%	642,123
December	5.73	5.73	5.70	3	NA	471,867	471,867	100%	673,806
Q1	-10.60	-10.67	-8.98	4	NA	346,401	346,401	100%	346,401
Q2	28.83	28.78	20.80	4	NA	446,106	446,106	100%	446,106
Q3	24.36	24.12	20.61	4	NA	553,725	553,725	100%	553,725
Q4	3.77	3.53	5.92	3	NA	471,867	471,867	100%	673,806
YTD	48.63	47.83	40.48	3	NA	471,867	471,867	100%	673,806

**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 threshhold 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 account contributed additional funds in November which were not at least 90% invested by the end of December. Per our rules for inclusion, this account was removed from the composite for these periods and will be returned once the funds are fully invested.

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.

Arete Asset Management Mid Cap Core performance composite disclosures continued:

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.

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.

Arete Asset Management Mid Cap Core performance composite disclosures continued:

Verification

Arete has not been verified by an independent verifier for its compliance with GIPS. Please note that the initial minimum period for which verification can be performed is one year.

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.