Fourth quarter 2013
Volume 6, Issue 4

THE ARETE QUARTERLY

Inside This Issue

Welcome

The new year often harkens a time of hope and new beginnings. Sometimes it's just nice to have a tough year behind us and sometimes there are new tangible opportunities to savor. Either way, wouldn't it be nice if you didn't have to just wait and see how things turned out? Wouldn't it be nice if you could script your own story?

In an important sense, you can do exactly this. *The Anatomy of Story: 22 Steps to Becoming a Master Storyteller*, by John Truby, provides a fun and accessible roadmap to create your own page turner. In the context of investing, which tends to get very serious very quickly, storytelling provides a useful, but more light-hearted exercise.

For example, what if you were the main character in a story in which you faced down investment challenges and adversity? It's hard going at first, and you have setbacks, but ultimately you rise above the challenges and succeed in your quest!

As Truby states upfront, "Stories are really giving the audience a form of knowledge— emotional knowledge— or what used to be known as wisdom, but they do it in a playful, entertaining way." The key point is that, "All stories are a form of communication that expresses the dramatic code," which in turn, "is an artistic description of how a person can grow or evolve." In short, stories are tales about growing and evolving.

Truby goes on to to describe that, "The focal point is the moment of change, the impact, when a person breaks free of habits and weaknesses and ghosts from his past and transforms to a richer and fuller self … And that's why people love it [storytelling]."

So as you are drafting your own investment story, what "habits and weaknesses and ghosts from the past" does your hero struggle with? How does the character transform into a "richer fuller self?"

I know I've personally had many revelations through my career as an analyst and portfolio manager and one early "weakness" was simply learning to respect the knowledge I had developed. I had always thought that the big investment firms somehow had a higher level of understanding than I did. If something they did struck me as odd or misguided, I first assumed I must be missing something.

After I paid down my student loans and began to invest more seriously, I enjoyed a fair amount of investment success and realized I wasn't missing anything. I increasingly realized that asset growth drove decisions at a lot of firms in ways that eroded the value that investors received. Even as a portfolio manager, many important factors were completely outside of my control.

So, coming back to your story, what issues does your hero struggle with? Does s/he get overwhelmed by day-to-day activities that squeeze out time to work on investing? Does the hero get stuck in the weeds of details and miss some really important issues? Does he or she never quite feel comfortable about where the pitfalls are and how to avoid them? How will your hero overcome those obstacles and transform into a "richer fuller self?"

While I always hope things turn out well for people on a personal level, from a business standpoint, I am deeply ambivalent about the outcomes. On one hand, Arete's hallmarks of valuation and long investment horizon benefit disproportionately when swarms of market participants chase fads, obsess over short-term trading, and accept risk indiscriminately. We make money by being on the other side of those decisions and appreciate the opportunities they afford us.

On the other hand, we also believe strongly that large swaths of investors who aren't inclined to such frivolity, still aren't getting nearly as much value from their money managers as they deserve. For these investors, Arete can be a valuable resource in exploring possibilities for their heros.

In sum, the importance and seriousness of the investment process paradoxically often inhibits a constructive discussion of it. In these cases, storytelling may serve as a useful antidote to re-frame and reconsider important issues. If you're interested in writing or re-writing your investment story, please consider Arete in helping your hero to overcome obstacles!

Business Update

When people ask me, "How's business?" there are always so many things going on, that it's often hard to summarize in any meaningful way. One thing I can say with certainty is that the tools available for information gathering, analyzing, and learning keep getting better and cheaper. These advances vastly improve the process of building knowledge and are a big part of what makes my job so fun!

Indeed, knowledge building is one of the areas for which I am truly optimistic, and not just for Arete. Technology writer and author, George Gilder, contrasted manufacturing of physical items with that of knowledge: "Material is conserved, as physics declares. Only knowledge accumulates. All economic wealth and progress is based on the expansion of knowledge."

This phenomenon is important to Arete's business for a variety of reasons. For one, due to my own personal interests and intellectual curiosity, Arete is particularly adept at learning and building knowledge. The company's independent ownership also substantially facilitates this activity by strongly incentivizing interpretations of information that are well anchored to economic reality and investors' needs. As a result, the business is establishing yet another dimension of competitive advantage.

Knowledge building is valuable for more than just internal purposes, however; it also helps Arete connect with, inform, and serve investors. This is so because the distribution of knowledge is deeply uneven across the marketplace of investment service providers. Very few are constructed so as to gather, process, analyze, and synthesize information into a base of knowledge that can cut through the noise. At any level of investing, this is extremely important.

One striking testament to the disparity in knowledge capabilities was revealed by John Minahan, former Director of Research for NEPC, one of the largest and most reputable pension consulting firms. In a presentation in February 2011, Minahan told the Baltimore CFA Society that he essentially learned the investment business from the managers he was responsible for evaluating. According to Minahan, the resources at money management firms tend to be so much greater and therefore they are often privy to much greater insights.

This arrangement often leaves individual and small- to mid-sized institutional investors in a bind. For most investors, their primary contact is an advisor, consultant, or relationship manager, not the person or people directly involved in the investment process. While some of these representatives are outstanding and extremely well-informed, many are not. The frustration from just such a situation in a recent meeting was expressed by way of the rhetorical question, “Do you ever really talk to the person managing the money?” The vast majority of the time you don’t.

As a result, one of the ideas I’m exploring is to see if there are ways Arete can help bridge this important gap between the types of insight investors need, both individually and as fiduciaries serving on behalf of others, and what they are currently (often not) receiving from their primary relationships. One key area where I fear many mistakes are being made is in determining expected returns -- which directly affects asset allocation decisions. Some things may be as simple (but important!) as establishing an appropriate investment policy. It is hard being a chief investment officer in the best of times; it is much harder when you just don’t have the resources.

One goal I have with this effort is simply to get in front of more investors this year to talk about how Arete does things and to explore ways in which to better leverage its knowledge base. While stocks and valuation remain core strengths, my Kellogg degree and CFA training, along with experience approaching twenty-five years now, give me a broad set of skills from which to help investors analyze, evaluate, and hopefully improve their situation. If you know of a person or an organization that might be interested in exploring ideas to work together, I’d really appreciate hearing about them.

Finally, in the *Ideas* section of Arete’s website, I point out that, “The culture of Arete is built around ideas. One way in which we try to differentiate ourselves is to apply fresh thinking to everything we do.” This statement highlights the reality that ideas and knowledge management are core to the fabric of Arete and have been from the very beginning. As a result of this orientation, it is rare that I don’t have some insights that can be helpful and I always have fun tossing ideas around. If you have any interest in brainstorming some possibilities with me, please let me know.

I'd love to grab lunch or a cup of coffee and see if there is anything Arete can do!

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.

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 (12/31/13)

	Arete MCC*	Midcap Index**
Size		
Average Market Cap ($ mil.)	7,360	7,261
Median Market Cap ($ mil.)	5,205	5,503
Minimum Market Cap ($ mil.)	140	744
Maximum Market Cap ($ mil.)	25,389	27,535
Number of holdings	34	808
Valuation		
P/E current year	23.3	19.9
P/E forecast Y1	21.5	20.1
P/B	2.0	3.7
P/S	1.2	1.6
Yield (%)	1.5	2.4
Valuation drivers		
ROE (%)***	11.2	25.4
LT eps growth forecast (%)	7.6	12.1

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.

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. ROE is noticeably lower, but is subject to many distortions and has not been especially reliable.

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 general guidelines of 50% - 150% of benchmark weights.

Since cash started accumulating three years ago, we have been fairly aggressively researching new names. With valuation as a significant consideration, however, we have found few opportunities to deploy it. As a result, we should be in a good position to act fairly quickly when valuations approach more reasonable levels.

Transactions review – Arete Mid Cap Core

In the fourth quarter we continued our measured approach to reducing stock exposure as valuations continued to stretch past bounds of reasonableness. Each of the sales were made on an individual stock basis and reflected both valuation concerns as well as heightened risk.

CSE was sold down to about a 1.5% position after having a strong run which was extended with its merger with PacWest Bancorp. Priced at over 1.5x book value, the stock was pretty fully valued and its sale represented a very nice gain over its cost basis of under $4 per share. In addition, the majority of the merger offer is for PACW stock so the successful integration of dramatically different business models will pose a risk to future appreciation. Nonetheless, the strategic rationale of combining CSE's lending prowess with PACW's branch network and deposit gathering franchise makes sense and we retain some exposure.

Sector exposure (percent of assets on 12/31/13)

Economic sector	Arete MCC*	Midcap Index**	Percentage Comparison
Consumer Discretionary	1.8	18.8	9.6%
Consumer Staples	0.0	5.4	0.0%
Energy	4.5	6.5	69.6%
Financial Services	16.6	21.0	78.9%
Health Care	9.1	10.4	87.1%
Materials & Processing	5.6	6.7	83.9%
Producer Durables	8.7	13.1	66.2%
Technology	9.2	11.6	79.2%
Utilities	5.3	6.3	83.6%
Equity exposure	60.8	100.0	
Cash and equivalent	39.4	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.

PENN was sold shortly after the spinoff of its casino properties into the REIT, GLPI. We had been eyeing PENN for a reduction due to it's full valuation, the persistence of weak fundamental results in its gaming business, and the failure, thus far, for the market to adjust to such weakness. We got a bit lucky with the spinoff (though we knew it had been in process for a long time) as it afforded us the opportunity to reduce direct exposure to the casino business and yet still retain exposure to a strong dividend paying security.

IR was sold as its valuation rose with those of other industrial stocks. Although IR has almost always looked cheap, it's management has a long history of mediocre to below average performance, poor acquisitions, and excessive compensation. IR's leadership has had plenty of opportunities to significantly improve in better conditions, and failing to do so, we finally decided to reduce what we considered a significant exposure to operational risk should conditions weaken.

Market Overview

It seems silly, but the market is still following the Fed's lead like a little puppy obediently following its master. Despite the continued strength in the fourth quarter, however, we did notice a hint of a change in character of the market. This change was driven primarily by the consideration of, and eventual acknowledgement of, a reduction (tapering) of the quantitative easing program and revealed reactions similar to what we saw at the end of the second quarter when tapering first became a headline topic.

Even though the initial tapering is very modest, it likely signals an end to the era of easy directional bets. The bets have been made on the (we would argue flawed) logic that the market will go up in proportion to the amount of money being injected by the Fed. They also represent a belief that the Fed is in control. Since these bets are occurring during a period of record high margin debt and ever-increasing disconnection from economic fundamentals, the risk of big changes to the market dynamics from relatively small changes in uncertainty is quite high.

The evidence of large directional bets is substantial and varied. Certainly the flow of funds out of active mutual funds and into passive funds -- index funds and ETFs, is one key indicator. We also see the passive flows affecting individual stocks as the valuations of major index components are pulling away from those of stocks not in major indexes.

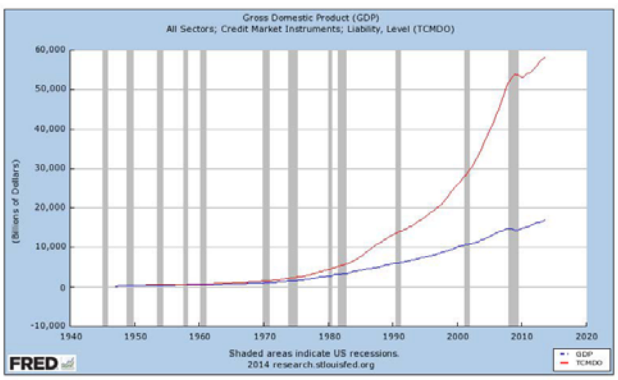
Unfortunately for investors, the market cap structure of most major indexes systematically exacerbates valuation errors, increasing their exposure to wild swings. Since overvalued stocks get overweighted in such indexes, and undervalued stocks get underweighted, new flows to index funds exacerbate market swings by stretching valuations on both ends of the spectrum.

Interestingly, the *relative* performance of Arete's mid cap core (AMCC) strategy tends to be a mirror image of the Fed-induced levitation. Since well over 90% of AMCC's holdings by weight are different from the index, it tends to have significant exposure to the undervalued and underweighted index components and therefore can behave very differently. Recent improvements in AMCC's relative performance also provides some indication that the era of directional bets may be peaking.

Insofar as this is the case, AMCC is positioned to benefit from two separate tailwinds. First, the strategy's large cash position will serve as a major buffer to market declines and also provide dry powder to invest in stocks that get oversold. Second, AMCC's holdings should be much more resilient as the market begins to discount an impending increase in cost of capital.

While these observations provide a useful encapsulation of the market action in the fourth quarter, it is still critically important to keep the big picture in mind. Despite an almost constant onslaught of distractions, the key issue has been, and continues to be, DEBT.

The graph below captures beautifully the increasing trajectory of total debt (red line) to GDP (blue line). No individual can maintain this path forever nor can any nation. The unsustainable path of debt relative to GDP constitutes a *system* from which all other financial phenomena emanate. Everything you read and hear about investing is affected by whether the source comes from within the system or remains outside of it.



Source: Federal Reserve Bank of St. Louis

It's important to understand systems because when strong ones are in place, they significantly constrain and/or overwhelm the impact of individual actions. Interestingly, none other than management guru, Peter Drucker, articulated the prominent role of systems when he discussed organizational design.

In the 2009 *Harvard Business Review* article, "What would Peter Say?", Rosabeth Moss Kanter wrote, "He [Drucker] took a broad look at the context surrounding organizations, noting jarring events he called discontinuities. Next, since the signs of difficulties ahead were there all along, he might follow up by telling us, 'Look at the underlying systems.' Drucker rarely named or blamed individuals; he saw root causes in the design of organizations – in their structures, processes, norms, and routines."

Drucker's analysis provides a useful analog from which to think about the system of the debt-driven economy and capital markets we have. First, when "discontinuities" occur, often the signs have been there all along. Just as the conditions of extended credit were around for decades before the financial crisis in 2008, it is important to realize that the fragility caused by those conditions has not gone away. The signs are still here.

Second, while there was plenty of blame to go around, the primary causes of the crisis in 2008 were not individual actions; the root causes were in the design of an economy and financial system that was completely dependent on continued credit expansion. This led to a "bigger is better" mentality throughout the economic ecosystem even though that design was not sustainable.

The effects of ever-expanding credit and "bigger is better" thinking have extended far and wide and have been especially pronounced in the investment business. It's important for investors to understand that a huge proportion of the investment services industry is also part of this same system, built on cheap credit and focused on growth, and therefore subject to the same risks.

Some consequences of this dynamic were captured well by Seth Klarman in his March 2, 2011 letter entitled, "Our National Predicament." In it, he described that, "Most investors feel compelled to be fully invested at all times -- principally because evaluation of their performance is both frequent and relative. For them, it is almost as if investing were merely a game and no client's hardearned money was at risk. To require full investment all the time is to remove an important tool from investor's toolkits: the ability to wait patiently for compelling opportunities that may arise in the future." The current vernacular in the market is *FOMO* -- "Fear of Missing Out."

One of the reasons Drucker's perspective is so useful is because it reconciles the inadequate investment results that inevitably result from a flawed system with the positive feelings most people have about their advisor(s)/manager(s). While it is absolutely fair to say that there are a lot of smart and well-intentioned people in the business, it is not fair to say that client portfolios benefit from all of their best insights -- that's not how the "system" works.

I've had plenty of my own run-ins with the "system" and it's been eye-opening. At one firm, we started receiving calls from headquarters every day shortly after the market closed at 4:00 demanding an explanation for the portfolio's relative performance. Needless to say, this effort placed a great deal of pressure to manage to a time horizon much shorter than what most investors expected.

In addition, I was a technology analyst in the late 1990s during the internet boom. At the time I clearly saw valuations extending way, way beyond reasonable levels and read dozens of IPO prospectuses that conveyed no viable business models. Despite daily efforts to reduce and manage the technology exposure, I lost the battle. Unfortunately, as a result, investors in the funds also lost a lot of money. It turns out there was an intractable commitment to maintain market sector weights despite overwhelming analytical evidence to the contrary. This is a good example of how the "system" works.

Lest you think the credit "system" is an outlandish narrative, it actually represents a well-known moral argument upon which many stories are based. Black Comedy is, "The comedy of the logic – or more exactly, the illogic -- of a system," as defined by John Truby in *The Anatomy of Story* (mentioned in the "Welcome" article). He continues, "This … form of storytelling is designed to show that destruction is the result not so much of individual choice but of individuals caught in a system that is innately destructive." *Dr. Strangelove* is a well-known example of this type of moral argument.

The insight from Black Comedy is hugely important: If you are "caught in a system that is innately destructive," the result has virtually nothing to do with individual choice. The lesson that derives from it is: If you are in such a system, either hope your assessment is wrong, or make sure to distance yourself from it.

As it pertains to the markets, this leaves investors with two very distinct general courses of action. If you don't believe the unsustainable debt thesis, by all means, increase your exposure to risk assets at any signs of credit extension or liquidity provision. If you do believe the unsustainable debt thesis, as Arete does, then you need to operate outside of that system to the greatest possible extent. In particular this means finding managers who don't "feel compelled to be fully invested at all times," who can "wait patiently for compelling opportunities to arise in the future," and who don't get caught up in the "bigger is better" race.

Indeed, the degree to which any investment firm operates outside of the "system" may be one of the best and most important differentiators available. Remember though that this won't be advertised; almost all industry participants are going to *say* the same things. The task is to figure out what firms are actually doing. The reward for successfully distinguishing will help keep you out of a system from which you have little control.

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.

Stock performance* (9/30/13 - 12/31/13)

Best performers

Company	Return in quarter (%)
Spirit Aerosystems	40.6
Investment Technology Group	30.8
Seagate Technology	28.3
Foster Wheeler	25.4
Autodesk	22.2

Worst performers

Company	Return in quarter (%)
NII Holdings	-54.7
Sears Holdings	-17.6
Yamana Gold	-17.1
Dex Media	-16.5
Annaly Capital Management	-13.9

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

Arete's Mid Cap Core (AMCC) strategy returned 5.84% (net of fees) for the quarter versus 8.39% for the Russell Midcap Index® (RMC) (see pages 12 – 14 for performance and related disclosures). As has often been the case over the past three years, the AMCC strategy tends to perform relatively well when the market discounts significant concerns, as it did in regards to tapering in the second quarter and late in the year, and tends to underperform when concerns dissipate and momentum returns as happened in the first and third quarters and into October.

The story of the top performers had much more to do with the macro environment than with any company-specific developments. Each of the top five best performers benefited from increased economic activity which became somewhat more visible through the quarter. While there was little evidence of a massive economic improvement, each of these stocks, with the exception of Seagate, have signficantly trailed the market as a whole and had plenty of catching up to do. Seagate also happens to be one of the largest holdings in AMCC which especially helped.

NIHD was the worst performer again reflecting very disappointing results in its two largest markets, Mexico and Brazil. As we've seen over much the past three years, the dynamic of liquidity-driven markets provides a stark contrast, and obvious pair trade, to any stock suffering short-term ills which often exacerbates negative performance. While NIHD was certainly guilty of mismanagement on a variety of fronts, changes were made to the leadership team which should help and the company still controls a large amount of valuable spectrum in important and growing economies.

The remaining poor performers all suffered similar fates in that they aren't large index components and aren't candidates for the momentum trade. SHLD stock continues to suffer from undue attention to its retail business when the valuation is much more driven by its real estate. AUY suffered along with all gold stocks. DXM got off to a weak start following the merger and needs to show some fundamental imporvement to change sentiment. NLY has continued to be disproportionately weak due concerns about interest rate volatility despite selling at a large discount to NAV.

It is useful to note that the AMCC typically performs very differently from the market during periods when momentum takes over. This was clearly the case in the third quarter when stocks rebounded sharply after their swoon in June. The main reason for this disparity is Arete's valuation discipline. The valuation discipline has caused the AMCC to have lower exposure to momentum stocks and much greater exposure to cash.

Similarly, there also seems to be a connection between the strength of the Narrative of the Fed and AMCC's relative performance. As such, we will be watching for indications of doubt about the omnipotence the Fed as a potential hint to better relative performance.

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 - December 31, 2013

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									
January	5.17	4.92	6.84	4	NA	838,074	838,074	100%	1,036,725
February	0.28	0.28	1.41	4	NA	840,390	840,390	100%	1,038,478
March	3.49	3.49	4.25	4	NA	869,712	869,712	100%	1,068,784
April	1.32	1.08	1.28	4	NA	879,095	879,095	100%	1,081,449
May	2.05	2.05	2.15	4	NA	897,114	897,114	100%	1,099,687
June	-0.75	-0.75	-1.21	4	NA	890,412	890,412	100%	1,091,751
July	3.12	2.87	5.80	4	NA	915,969	915,969	100%	1,117,888
August	-2.66	-2.66	-2.66	4	NA	891,573	891,573	100%	1,090,838
September	3.28	3.28	4.58	4	NA	920,807	920,807	100%	1,120,734
October	1.36	1.12	3.53	4	NA	931,129	931,129	100%	1,129,713
November	1.97	1.97	1.66	4	NA	949,435	949,435	100%	1,147,496
December	2.65	2.65	2.98	4	NA	974,605	974,605	100%	1,172,496
Q1	9.14	8.88	12.96	4	NA	869,712	869,712	100%	1,068,784
Q2	2.63	2.38	2.21	4	NA	890,790	890,790	100%	1,091,751
Q3	3.66	3.41	7.70	4	NA	921,138	921,138	100%	1,120,734
Q4	6.09	5.84	8.39	4	NA	974,605	974,605	100%	1,172,496
YTD	23.18	22.00	34.76	4	NA	974,605	974,605	100%	1,172,496

**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:

Arete Asset Management Mid Cap Core performance composite disclosures continued:

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.

Arete Asset Management Mid Cap Core performance composite disclosures continued:

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.

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.