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THE ARETE QUARTERLY

Welcome

As a continued reminder, the text content of this and 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 the more interesting investment services stories involves the prospects for active management in light of continued rate suppression by the Fed. As I've discussed in places like the recent Q414 market overview blog, continued Fed interventionism significantly disrupts the value proposition of active management.

Since active managers are trained to analyze economic and financial fundamentals and to invest money where they find attractive returns, their efforts have been repeatedly subverted by the Fed through its own efforts to prop up the market every time things slow down.

It's bad enough that most active managers have been relegated to the fairly tedious task of simply following the Fed's moves, but the prospects for active management are also uncertain. In a significantly overvalued market, there are vanishingly few cheap stocks for active managers to apply their skills to. For investors just seeking exposure to the market, index funds serve that function well.

While these challenges have existed for Arete, they have plagued the entire active management business. They have also persisted for so long now that we are beginning to see a number of funds close down. While some of this is a healthy culling of an overpopulated universe, much of it is the inadvertent extermination of businesses as an unintended consequence of the Fed's low rate policy.

It is worth considering the distinct possibility that the Fed continues its low rate policy for even longer. If it does, it could cause irreparable damage to the active management industry and in doing so, may also significantly impair the ability of the market to recover from future disruptions. There just won't be the investors left who are willing and able to invest when things look bleakest.

In the meantime, I've been focused on how Arete can keep providing value regardless of Fed policies. Since these policies necessarily limit the potential for active management, I've been actively soliciting clients, friends, and acquaintances for their interest in various types of research work that Arete does.

A couple of very interesting things have come out of this effort. One is that there seems to be a widespread sense of uneasiness as to the direction of the economy, the markets, and public policy. Some have more concern than others, but I've run into exceptionally few people who don't have some desire to get their arms better wrapped around the situation. Another interesting finding is that there is an enormous distrust/disdain of bulge bracket financial service firm advice. Nobody believes it and it doesn't help.

I see this as creating some very interesting and unique opportunities for Arete. For starters, one of my great strengths is to identify what I'll call "controversial propositions". This is easy because it's really just a function of being curious and asking the obvious questions, unconstrained by anything other than a desire to just figure things out.

The point of asking such questions is not to criticize, but rather to open up investment discussions and to consider more possibilities. Sometimes we need to consider unusual or outlandish possibilities in order to reveal new perspectives on a challenge. Often an additional benefit to this exercise is to increase interaction and engagement with other investors or investment committee members. At the end of the day, after all, these are all fun and intellectually challenging topics!

I hope this effort does a couple of things for Arete. First, it should certainly help provide a more robust stream of revenues than from active management alone and as such should go a long way in making the business model more robust. Second, I'm really hoping that by sharing more of my thinking with a wider group of people, more people will have a deeper appreciation of all of the ways in which Arete can help with their investment challenges.

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!

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 (12/31/14)

	Arete MCC*	Midcap Index**
Size		
Average Market Cap ($ mil.)	8,531	8,466
Median Market Cap ($ mil.)	4,684	6,296
Minimum Market Cap ($ mil.)	158	275
Maximum Market Cap ($ mil.)***	31,852	33,592
Number of holdings	29	845
Valuation		
P/E current year	20.8	23.2
P/E forecast Y1	20.2	21.3
P/B	3.6	4.7
P/S	1.6	2.0
Yield (%)	1.9	2.3
Valuation drivers		
ROE (%)****	9.2	12.6
LT eps growth forecast (%)	8.6	12.0

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 fairly 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.

Sector exposure (percent of assets on 12/31/14)

Economic sector***	Arete MCC*	Midcap Index**	Percentage Comparison
Consumer Discretionary	5.3	17.3	30.6%
Consumer Staples	0.0	5.8	0.0%
Energy	0.2	4.3	4.6%
Financials	18.1	21.0	86.4%
Health Care	7.2	11.7	61.5%
Industrials	5.0	12.8	39.1%
Information Technology	6.9	14.5	47.5%
Materials	2.7	5.8	46.9%
Telecommunications	0.0	0.7	0.0%
Utilities	5.9	6.2	95.1%
Equity exposure	51.3	100.0	
Cash and equivalent	48.6	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.
****Note*: Economic sector classifications were changed from Russell to GICS beginning Q414.

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 exposures are all below benchmark weights due to the high cash position. As we have continued to raise cash, partly through sales of overvalued positions, and partly by not redeploying cash from acquisitions, several sectors are now below our normal 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.

Transactions review – Arete Mid Cap Core

The position in HNT was sold in October after a very good year and a very good run the last couple of years. As has been the case with many holdings over the last few years the sale was prompted primarily by valuation and risk concerns; the strong performance by healthcare companies in general gave us the opportunity to exit at an attractive price.

We finally sold out of the position of NIHD after court documents made clear that a restructuring of the company's debt would erase any value for equity holders. This was an especially disappointing performance given that so many of the problems were either created or exacerbated by management missteps.

Active share* (12/31/14)

Period	Percent**
Q414	93.5
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"

We got a chance to add to our position in AUY when the company wrote down the value of a couple of its mines and the market punished the stock brutally. AUY is still one of the better gold mine operators and has some of the lowest all-in costs of production. While recent lower gold prices will cause some producers to seriously reconsider much of their production, AUY is fairly well protected by its attractive position on the cost curve.

The transaction involving the acquisition of FWLT stock by AMEC plc occurred in November. We received a little over 50% of the deal value in cash and the remaining in AMEC ADRs which we subsequently sold. While FWLT was far from a blow-out investment, it was fortunate to receive a decent value in cash and to complete the exit before the full force of lower oil prices hit.

Along the same lines, we also sold the full position in DRC. This investment worked out well and culminated in an attractive acquisition by Siemens. Although we had no particular reason to believe the deal was not going to go through, the price was hovering within cents of the acquisition price and turmoil in the energy markets posed a greater risk than we wanted to accept for a tiny upside.

Finally, we sold half of the position in TOL during the quarter. We had mixed feelings about this portfolio decision as we still think TOL has one of the best management teams in the homebuilding industry as well as one of the most attractive segments with its relatively affluent target market. Nonetheless, housing prices have started weakening, it is a very cyclical industry, and demographic trends suggest further weakening of home demand. Further, community absorption, which tends to be a leading indicator for TOL, has been declining in each of the last four quarters. Net/net, we decided it was best to reduce the position.

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* (9/30/14 - 12/31/14)

Best performers

Company	Return in quarter (%)
Investment Technology Group	32.1
Lands End	31.2
Sears Holdings	30.7
Mylan	23.9
Xcel Energy	18.2

Worst performers

Company	Return in quarter (%)
Peabody Energy	-37.5
Genworth Financial	-35.1
Yamana Gold	-33.0
NRG Energy	-11.6
The Saint Joe Company	-7.7

**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 2.16% (net of fees) for the quarter versus 5.94% for the Russell Midcap Index® (RMC) (see pages 8 – 10 for performance and related disclosures). While it was disappointing to underperform in the quarter, this masks a very important story within the quarter. In the first two weeks of the quarter, when the market was down strongly and the RMC was down 5.24%, AMCC was down only 1.53%.

This pattern 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 but has the potential to reverse very quickly.

Top performance was affected by the broader market as well as by company-specific news. The broad support for defensive stocks throughout the year likely had an important impact on the performance of both MYL and XEL in the healthcare and utility sectors. ITG performed extremely well in the quarter, but has performed poorly over the last few years so much of this was just some normalization. LE jumped after its first quarterly report after its spinoff from SHLD with a very strong report and outlook. SHLD also performed well which largely just represented a rebound after the stock was hammered in the third quarter due to rumors of liquidity problems.

Bottom performers were also affected by a combination of broader market forces and company-specific factors. Perhaps most importantly, none of the bottom performers was a major index component. With such strong inflows into index funds over the last few years, index inclusion has often provided a great deal of support for stocks, and conversely, has allowed non-members to get hit even harder.

The strong dollar also negatively affected commodity businesses such as BTU, AUY, and NRG. In addition, as oil prices dropped, concerns rose over high yield debt in particular, but cascaded through the market to affect all indebted companies such as BTU, GNW, AUY, and NRG.

By far the clearest company-specific problem in the quarter was GNW's announcement regarding problems in its long-term care business. While we weren't surprised to find that reserves needed to be increased, the market's reaction was especially harsh in driving the stock price well below the value of its other businesses and effectively assigning negative value to long-term care. This reaction seems overdone but GNW management has not done itself any favors by failing to stay on top of a business that has been suffering a number of headwinds for several years.

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, 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
October	2.42	2.18	3.08	4	NA	1,003,910	1,003,910	100%	1,201,811
November	0.43	0.43	2.56	4	NA	1,008,267	1,008,267	100%	1,205,054
December	-0.45	-0.45	0.21	4	NA	1,003,729	1,003,729	100%	1,200,564
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
Q4	2.40	2.16	5.94	4	NA	1,003,729	1,003,729	100%	1,200,564
YTD	4.01	2.99	13.22	4	NA	1,003,729	1,003,729	100%	1,200,564

**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.

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.

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Arete Asset Management Mid Cap Core performance composite disclosures continued:

*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.