Fourth quarter 2015
Volume 8, Issue 4

THE ARETÉ QUARTERLY

Welcome

Please remember that the *Areté Quarterly* now contains primarily a quantitative description of the Arete Mid Cap Composite. For our views on the markets and investment industry, please check out the Areté blog at www.areteam.com/blog.

Inside This Issue

Business Update

When I founded Areté, I had a vision of where the investment management industry was and where I thought it was going and saw an opportunity. In a sense, it wasn't that original; I just thought as technology improved capabilities and reduced costs, that the type of very high quality management services that large instutional investors enjoyed would be economical on a much smaller scale. Interestingly, nobody else was doing it.

I always thought of this effort in two parts. One was to do a great job of research, analysis and management. The other was to offer the services at a *reasonable* price and with great transparency and therefore fulfilling a socially useful function. These two parts combined comprise what I consider a *quality* investment business. Indeed, that is why I named the company Areté: it means quality in Greek philosophy.

While the Fed's policy of supporting asset prices and suppressing volatility the last seven years has created an environment fairly hostile to active management and much more conducive to simply "riding the wave" with passive exposure, there are indications that both the landscape for investing as well as that for investment services is changing.

As I note in the Areté Market Overview Q415 [here], there are three broad economic trends that must be resolved in order to establish some sense of stability. Although the timing of such resolution is uncertain (as are earthquakes, avalanches, and sandpiles), resolution will happen – and it will happen regardless of what the Fed says or tries to do about it.

This creates a new and more challenging environment for investors, but as I also note in that blog post, "the landscape for investment services is likely to undergo at least as much change as that for investments themselves."

More specifically, "Most conventional investment approaches are designed for conventional environments. Mutual fund investment strategy can be completely undermined by fund flows, passive strategies rely on reasonably efficient market pricing and good asset allocation, both of which may be challenged. Many exchange traded funds (ETFs) have significant liquidity mismatches in their structure. Further, new customers will be looking to save first, and will only invest with solutions that are far more efficient and appropriately encompass (new) societal values."

The conclusion I draw is that although the Fed's actions since 2008 have largely forestalled the business opportunity for Areté, there are strong indications that things are changing. A more challenging investment environment will highlight the value of active investing and independent research. In addition, societal values that are placing greater emphasis on efficient solutions are more likely to favor Areté's quality/cost proposition. I see these as promising signs that people will increasing appreciate why Areté is "a better way to invest".

Thanks for your interest and take care!

David Robertson, CFA
CEO, Portfolio Manager

Portfolio Characteristics – Areté Mid Cap Core

A key proposition for Areté'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.

All of 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 and retain the option 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 although the median is now considerably smaller. 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.

Portfolio Characteristics (12/31/15)

	Arete MCC*	Midcap Index**
Size		
Average Market Cap ($ mil.)	6,696	7,832
Median Market Cap ($ mil.)	2,587	6,063
Minimum Market Cap ($ mil.)	2	380
Maximum Market Cap ($ mil.)***	26,588	30,199
Number of holdings	22	830
Valuation		
P/E current year	24.2	24.2
P/E forecast Y1	17.2	19.7
P/B	2.3	4.9
P/S	1.2	2.1
Yield (%)	2.4	3.0
Valuation drivers		
ROE (%)****	11.9	13.1
LT eps growth forecast (%)	9.3	10.9

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.

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

Sector exposure (percent of assets on 12/31/15)

Economic sector***	Arete MCC*	Midcap Index**	Percentage Comparison
Consumer Discretionary	1.9	16.3	11.7%
Consumer Staples	0.0	6.3	0.0%
Energy	0.0	4.4	0.0%
Financials	14.9	23.4	63.6%
Health Care	5.8	9.9	58.5%
Industrials	2.1	12.7	16.6%
Information Technology	1.6	14.8	10.8%
Materials	2.5	5.2	47.9%
Telecommunications	0.0	1.0	0.0%
Utilities	2.3	6.0	38.2%
Equity exposure	31.1	100.0	
Cash and equivalent	68.9	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.

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, partly by way of managing risk, and partly by not redeploying cash from acquisitions, several sectors are now below our normal guidelines of 50% - 150% of benchmark weights.

Active share* (12/31/15)

Period	Percent**
Q415	96.6
Q315	92.3
Q215	93.0
Q115	94.2
Q414	93.5

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

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

Transactions review – Areté Mid Cap Core

There were no transactions in the quarter. We are encouraged by the emergence of some more interesting values arising from recent market turmoil in industrial, commodity, and energy stocks. For reasons we outline in the Market Overview Q415 [here], we will most likely be fairly patient before deploying too much capital though. Some modest glimpse of value is a lot better than none at all!

Performance review – Areté Mid Cap Core

The Areté 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. 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.

Areté's Mid Cap Core (AMCC) strategy returned -.39% (net of fees) for the quarter versus 3.62% for the Russell Midcap Index® (RMC) (see pages 7 – 9 for performance and related disclosures). More than all of this differential occurred in the month of October when the market ripped back after a very difficult third quarter. Given AMCC's high level of cash and low exposure to benchmark names, it typically does not participate to nearly the same degree in such technically driven upswings.

The list of worst performers reveals some broad trends in the market – commodities, energy, and high yield exposure were absolutely hammered. BTU, NRG, GNW and STX have all been suffering disproportionately among concerns about economic growth, falling commodities prices, and widening credit spreads. RGLD was the one stock that actually suffered for company-specific reasons; one of its mining partners suspended operations and another is at risk of doing so. Both gold streams are secured, but details like that don't matter much in this market.

The best performers seemed to reflect circumstances more than anything insightful. MYL bounced nicely, but only after having been crushed in their aggressive effort to acquire Perrigo. ITG also bounced nicely, but only after getting slammed as a result of a significant SEC fine for misconduct.

Stock performance* (9/30/15 - 12/31/15)

Best performers

Company	Return in quarter (%)
Mylan Inc.	34.3
Investment Technology Group	27.6
Weyerhaeuser Co.	9.7
Yamana Gold	9.4
TD Ameritrade	9.0

Worst performers

Company	Return in quarter (%)
Peabody Energy	-62.9
Royal Gold	-22.4
NRG Energy	-20.7
Genworth Financial	-19.3
Seagate Technology	-18.2

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

Investment Philosophy

We firmly believe in the critical importance of a cogent investment philosophy for any investment operation. In order to emphasize this point, and to assist you in understanding how we work, we provide an abbreviated version of our investment philosophy here. The text of our investment philosophy is also provided, in its entirety, in our Form ADV, Part II which is available upon request at any time.

Performance derives from exploiting mispriced securities.

The key to investment performance is finding and exploiting market inefficiencies in the form of mispriced securities. There are two components to this. One component involves determining the fair price of securities in the form of underlying intrinsic value, which we do primarily through calculating discounted cash flows.

The second component of exploiting mispriced securities is establishing a clear understanding as to the various mechanisms at work that allow mispricing to occur. By understanding the mechanisms and motivations of the marginal buyer and seller, we believe we can more accurately estimate the probabilities and expected values of investment opportunities.

Nobody has perfect information.

Competitive pressure and technological development have conspired over the years to make most data and analysis commodities which no longer provide a meaningful competitive advantage. What can provide an advantage, however, is *how* that information is used and *how* it gets interpreted in making investment decisions.

In order to convert the raw material of information into the useful output of a good investment decision, it is necessary to assimilate and synthesize the information into some meaningful form. We believe the most effective way to accomplish this is to thoughtfully deploy resources available according to the nature of the research tasks at hand.

Research culture and research prioritization are also important in relation to analyzing and synthesizing information. We believe that the best way to leverage the collective knowledge and experience of a research team is to encourage active and open dialogue designed to explore multiple perspectives and to challenge individual assumptions, biases, and beliefs. Only by enduring such scrutiny do the best ideas rise to the top. Further, in order to fully leverage these ideas, we believe research efforts must be dynamic and flexible in allocating resources such that ideas receive attention in proportion to the expected benefit to the portfolio.

Execution is crucial for investment success.

In order to create value, an investment strategy needs to be implemented continuously and comprehensively. Actions speak louder than words. We believe the most effective efforts focus on a few simple, but key concepts that work to ensure proper execution of a firm's investment strategy.

The first key to execution is structural in nature and involves a firm's independence. By maintaining independent ownership, an investment firm eliminates agency effects which can present a conflict of interest between clients and certain of its ownership groups. Independent ownership ensures that client and manager interests are optimally aligned.

The second key to execution is temperament. The best investors tend to have a temperament that provides them the courage and initiative to act, often going against the grain, when opportunities arise. However, the same temperament provides balance such that decision-making is not simply a risk-taking activity, but a very conscious and targeted effort to engage in propositions with high risk-adjusted expected returns.

Finally, another important element of execution is simply doing what you say you do in your investment process. Too often, perfectly acceptable investment processes fail when actual investment activities bear little resemblance to the process described in the marketing presentation. We call this the “marketing gap;” the difference between what is said and what is done. Execution is optimized when the marketing gap is minimized.

Areté Mid Cap Core Composite

Arete Asset Management, LLC
Mid Cap Core Composite
July 31, 2008 - December 31, 2015

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	4.01	2.99	13.22	4	NA	1,003,729	1,003,729	100%	1,200,564
2015									
January	-2.61	-2.61	-1.56	4	NA	977,504	977,504	100%	1,171,544
February	3.22	2.98	5.54	4	NA	1,006,595	1,006,595	100%	1,202,192
March	0.25	0.25	0.06	4	NA	1,009,091	1,009,091	100%	1,307,160
April	0.52	0.28	-0.91	4	NA	1,011,891	1,011,891	100%	1,310,162
May	-0.10	-0.10	1.46	4	NA	1,010,876	1,010,876	100%	1,308,576
June	-2.81	-2.81	-2.07	4	NA	982,483	982,483	100%	1,276,571
July	-2.12	-2.36	0.74	4	NA	959,340	959,340	100%	1,250,264
August	-1.59	-1.59	-5.28	4	NA	944,045	944,045	100%	1,234,471
September	-2.27	-2.27	-3.60	4	NA	922,598	922,598	100%	1,211,146
October	1.36	1.12	6.20	4	NA	932,932	932,932	100%	1,223,040
November	-0.10	-0.10	0.25	4	NA	931,964	931,964	100%	1,220,690
December	-1.39	-1.39	-2.68	4	NA	919,035	919,035	100%	1,206,652
Q1	0.78	0.53	3.95	4	NA	1,009,091	1,009,091	100%	1,307,160
Q2	-2.40	-2.64	-1.54	4	NA	982,483	982,483	100%	1,276,571
Q3	-5.87	-6.10	-8.01	4	NA	922,598	922,598	100%	1,211,146
Q4	-0.15	-0.39	3.62	4	NA	919,035	919,035	100%	1,206,652
YTD	-7.56	-8.44	-2.44	4	NA	919,035	919,035	100%	1,206,652

**Note*: Peformance through 12/31/08 is from inception of composite on 7/31/08.

Areté Asset Management Mid Cap Core performance composite disclosures follow:

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

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

Areté 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. Areté does not use leverage or derivatives in the management of portfolios. Additional information regarding policies for calculating and reporting returns is available upon request.

The composite
This U.S. Equity Mid Cap Core composite was created in August, 2008 and includes all fee-paying, taxable and non-taxable, discretionary, long only, fully invested portfolios benchmarked to the Russell Midcap Index. Every new portfolio is added to the composite in the first complete calendar month that it is "fully invested". For purposes of composite construction, a portfolio is "fully invested" if its equity composition is greater than 90% of the equity composition of the composite. Each portfolio will remain in the composite until its equity composition becomes less than 90% of that of the composite. A complete list and description of firm composites is available upon request.

*As of March 31, 2012, the composite has been redefined in order to clarify policy in light of unusually high cash positions recently. Prior to March 31, 2012, a portfolio was considered to be "fully invested" if greater than 90% of portfolio assets were invested in equity securities which implicitly assumed a nearly 100% equity position in the composite.

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.

Areté Asset Management Mid Cap Core performance composite disclosures continued:

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

Areté has not been verified by an independent verifier for its compliance with GIPS.