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The Areté Quarterly

Inside This Issue

Welcome

The investment landscape is changing and so are the needs of investors – and Areté is here to help however we can. While we do actively manage stocks in our mid cap core strategy, we have also introduced a Personal CIO Service [here] in order to make our expertise more accessible to a broader audience. In these services and any future ones, Areté will always focus on conducting good research, independent thinking, and putting our clients' interests first.

In order to stay apprised of our latest thinking on the investment landscape, please take a look at our blog [here]. Finally, please always feel free to contact us with questions or comments.

Business Update

January 15th marks the Martin Luther King holiday this year and it also marks the tenth anniversary of Areté Asset Management. Just like King in his famous speech, I had a dream when I started Areté - and this is a good time to reflect on what has happened over those ten years.

One of the main reasons I started Areté was because I thought there was an enormous opportunity to provide a better deal for investors. I saw the investment ecosystem as one plagued by high fees, too many "products", uncoordinated services, and a pervasive lack of concern about client welfare.

Despite this rather dismal assessment, I also viewed these problems as eminently fixable. I think there are a lot of smart and well-intended professionals, there is a lot of excellent research and insights that can really help investors and there is constantly improving technology that can reduce costs, improve efficiency, and enable ever-higher functionality.

There were also other reasons to be positive. One is that a pretty good body of knowledge already existed as to what types of investment practices tended to be more effective for thoughtful, long term investors. Thanks to the writings of David Swensen and several others there were already good blueprints that just required the will to execute them. With a clear focus on serving clients, a natural orientation to independent thinking, and an ethos characterized by the belief that knowledge is "the origin of wealth", I saw the opportunity not so much as inventing a brand new approach as creatively recombining pre-existing components.

Importantly, while I always thought such a proposition would be attractive, I never thought it would be sufficient on its own to cause investors to switch en masse from other managers. I saw the really big impetus for switching as being an economic imperative; as progressively more retirement funds became progressively more underfunded, a better and more efficient solution would become a necessity.

After ten years now, my idea for Areté, to be blunt, has not worked as a business. That said, I've been fairly pleased with the value proposition and very pleased with Areté's ability to continuously incorporate and leverage technology in ways that benefit clients. I also believe that I got many of the big things right. From the start I have kept the costs of running the business very low and that is probably the single biggest reason why Areté is still around. Further, my idea that the cost of service would be increasingly important has been corroborated by the massive flow of funds out of expensive mutual funds.

However, I did not anticipate the persistence or pervasiveness of loose monetary policy after the financial crisis. Initially intended as emergency measures to restore financial stability, the repeated expansion such policies affected markets by boosting asset values and affected investor behavior by changing incentives in ways that substantially reduced demand for what active managers do.

One effect of infusing markets with so much liquidity has been to overwhelm normal fundamental factors in determining stock prices. This creates an incentive to simply chase returns, to grab what you can while you can. Further, when returns are not so much earned as bequeathed, it creates an incentive to enjoy the party while it lasts and worry about solving longer term problems for another day.

Such incentives fundamentally reshape the basis of competition for investment services. Liquidity and momentum driven markets favor asset gatherers over long term, valuation based investors and this creates an exceptionally hostile environment for active management. While it has vastly restrained the business opportunity for Areté, as I mentioned [here], it has also created headwinds for many of the smartest and most resourceful hedge funds out there. These funds have been closing down because the market just has not been rewarding their skills in identifying mispriced securities and managing risk.

While such markets are unsustainable longer term, central banks have plenty of ammunition to keep them rolling for longer than it makes sense for active managers to swim against the tide. This environment also creates an interesting paradox as to what constitutes fiduciary duty. Should active managers remain fully exposed knowing that their value add relative to index funds is likely to be negligible and that their risk profiles keep going up along with valuations? Or should they gradually pare back exposure as valuations rise knowing that it could be many years before stocks get cheap enough to buy again?

This is exactly why loose monetary policy is so harmful to active management and to the exercise of investing in a more general sense. Such policies almost completely undermine the value of ongoing analysis and risk management by reducing them to an either/or decision of whether to be invested or not and an unknowable timing decision as to when to change course.

This is pretty much where things stand today. On one hand, I don't view the business of active management as being viable in the environment that has persisted for most of the past ten years. On the other hand, as things get progressively more out of whack, and progressively more people become vulnerable to a market fallout, there is likely to be a monster opportunity for what Areté does at some point in the future.

In the process of waiting for the market to "normalize", I have become less optimistic about the future of active management as a business; it is simply too vulnerable to policy choices. While this is bad for me and Areté, I think it is just as bad for investors looking for reasonably priced professional investment advice.

All of that said, for the time being I continue to do everything in my power to build the tools Areté has at its disposal to help clients get the most out of their investing activities and to adapt to changing conditions (such as introducing the Personal Chief Investment Officer (CIO) service). I remain extremely optimistic about what technology can accomplish when applied in a thoughtful way and remain poised to pounce when market conditions permit.

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 more cheaply in the future.

Portfolio Characteristics (12/31/17)

	Arete MCC*	Midcap Index**
Size		
Average Market Cap ($ mil.)	10,543	10,125
Median Market Cap ($ mil.)	6,615	7,740
Minimum Market Cap ($ mil.)	385	392
Maximum Market Cap ($ mil.)***	37,867	62,504
Number of holdings	18	780
Valuation		
P/E current year	30.1	29.4
P/B	3.0	5.4
P/S	2.1	2.7
Yield (%) ****	3.3	2.5
Valuation drivers		
ROE (%)****	6.1	10.6

Source: Calcbench
**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.
*****Note:* Average of available yields

General portfolio characteristics for the quarter continue to confirm that the equity portion of AMCC is a representative mid cap portfolio. The average market cap for AMCC is very similar to the mid cap index and the median is a little lower. Although AMCC is much cheaper on the basis of P/S and P/B, it is important to note that valuation metrics have become less informative as the number of holdings has declined to just 18 currently.

As a note, we recently started using financial data provided by Calcbench. Historically we used data from our valuation vendor, Applied Finance Group. As a result, there may be some modest differences that cause imperfect comparisons.

Sector exposure (percent of assets on 12/31/17)

Economic sector***	Arete MCC*	Midcap Index**	Percentage Comparison
Consumer Discretionary	0.6	14.4	4.2%
Consumer Staples	0.0	4.1	0.0%
Energy	0.0	5.8	0.0%
Financials	9.0	14.6	61.7%
Health Care	5.3	9.4	56.4%
Industrials	0.0	14.2	0.0%
Information Technology	1.7	15.9	10.7%
Materials	4.2	6.0	70.5%
Real Estate	7.2	9.4	76.3%
Telecommunications	0.0	0.4	0.0%
Utilities	3.6	5.8	61.6%
Equity exposure	31.6	100.0	
Cash and equivalent	68.6	0.0	

Source: Calcbench
**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 quite different from benchmark weights, in part due to the high cash position but in part due to different exposures. Cash has remained at high but stable levels over the last several quarters.

Active share* (12/31/17)

Period	Percent**
Q417	95.0
Q317	95.2
Q217	94.9
Q117	96.0
Q416	96.3

**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

Once again, we did not execute any transactions in the quarter. We continue to find most valuations excessive and are especially leery that recent market performance is justified by economic improvement.

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.

Stock performance* (09/30/17 - 12/31/17)

Best performers

Company	Return in quarter (%)
Lands End	48.1
Mylan	34.9
Seagate Technology	26.1
Davita	21.7
Yamana Gold	17.7

Worst performers

Company	Return in quarter (%)
Sears Holdings	-51.0
Investment Technology Group	-13.1
Seritage Growth Properties	-12.2
Owens-Illinois	-11.9
Capitol Federal Financial	-8.8

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

Areté's Mid Cap Core (AMCC) strategy returned 1.33% (net of fees) for the quarter versus 6.07% for the Russell Midcap Index® (RMC) (see pages 7 – 9 for performance and related disclosures). AMCC continues to underperform when the market presses higher (due to its high cash position), but that cash also provides a significant buffer against material downside at a time when we view that downside potential as substantial.

In a liquidity driven environment, themes tend to dominate explanations for performance and that was certainly the case with AMCC's best performers. The relevant themes this time were sector rotation and reflation. In short, the things that haven't done as well rebounded. In AMCC, each of LE, MYL, DVA and STX rebounded nicely from earlier falls, although LE's rise was specifically linked to a good earnings report. AUY was up decently on the strength of gold and weakness of the dollar.

On the downside, the only exceptional performance was that of SHLD which continued to get pounded into and through the holiday season. The bear case is that the company is on its last legs and upcoming debt obligations will push the company into insolvency. While this is a possibility, it's nothing new and we believe understates the value of SHLD assets.

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, 2017

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	-7.56	-8.44	-2.44	4	NA	919,035	919,035	100%	1,206,652
2016	4.07	3.02	13.80	4	NA	946,825	946,825	100%	1,142,297
2017									
January	1.21	0.96	2.41	4	NA	955,884	955,884	100%	1,151,614
February	0.35	0.35	2.83	4	NA	959,248	959,248	100%	1,155,102
March	0.52	0.52	-0.16	4	NA	964,207	964,207	100%	1,160,504
April	-0.25	-0.49	0.77	4	NA	959,478	959,478	100%	1,155,546
May	-0.19	-0.19	0.91	4	NA	957,634	957,634	100%	1,153,535
June	0.78	0.78	0.99	4	NA	965,081	965,081	100%	1,161,186
July	0.91	0.66	1.47	4	NA	971,465	971,465	100%	1,168,565
August	-0.49	-0.49	-0.78	4	NA	966,677	966,677	100%	1,164,413
September	0.52	0.52	2.77	4	NA	971,749	971,749	100%	1,168,806
October	0.15	-0.10	1.67	4	NA	970,822	970,822	100%	1,167,206
November	0.15	0.15	3.36	4	NA	972,301	972,301	100%	1,168,627
December	1.27	1.27	0.93	4	NA	984,681	984,681	100%	1,181,490
Q1	2.09	1.84	5.15	4	NA	964,207	964,207	100%	1,160,504
Q2	0.34	0.09	2.70	4	NA	965,081	965,081	100%	1,161,186
Q3	0.94	0.69	3.47	4	NA	971,749	971,749	100%	1,168,806
Q4	1.58	1.33	6.07	4	NA	984,681	984,681	100%	1,181,490
YTD	5.03	4.00	18.52	4	NA	984,681	984,681	100%	1,181,490

**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.

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.

Areté Asset Management Mid Cap Core performance composite disclosures continued:

Fee schedule
The management fee schedule is as follows: 1% of AUM up to $1 million, 0.75% on AUM greater than $1 million, but less than $5 million, and 0.65% on assets greater than $5 million.

Minimum account size
There is no minimum account size for inclusion in the composite. Please note, however, the minimum initial account size accepted is $100,000.

Dispersion
Internal dispersion is currently not meaningful as there are five or fewer portfolios included in the composite. In the future, we plan to calculate dispersion using the dollar-weighted standard deviation of all portfolios included in the composite for each performance period.

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