Fourth quarter 2019
Volume 12, Issue 4

THE ARETÉ QUARTERLY

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 also provide a Personal CIO Service [here] in order to help investors who want access to our expertise on a more modular basis. In these services, and any future ones, Areté will always focus on conducting good research, thinking independently, 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

The most persistent challenge I have faced has been figuring out how best to serve investors in an environment in which the Fed (and other central banks) implement monetary policy with such zeal as to almost eradicate any perception of risk in markets.

For as long as such policies continue to succeed, the best thing to do, arguably, is simply ride the wave of monetary support through passive funds. The only problem, and it's a big one, is that there is no effective way to determine when investors will finally lose faith in central banks. For most investors, unfortunately, the cost of being wrong is extremely high.

This challenge was put into even starker contrast after I read David Kidder's book, *New to Big*. Kidder's purpose with the book is to describe how large corporations can vastly improve innovation efforts by instilling different practices and habits.

Inside This Issue

In doing so, he works from the same kind of customer-centric approach that I used in establishing Areté. He asks, "Who experiences the problem acutely enough to seek a solution?" He goes on to describe the types of new business opportunities with the most potential: "Successful solutions solve a problem that is big, painful, and persistent: a repeated behavior or constant need that customers wrestle with on an ongoing basis."

By contrast, he also describes what those big opportunities are not: "And the solution cannot be a vitamin, something that is nice to have and that you might even buy once, but that, on a day to day basis, probably sits unused at the back of the shelf. It must be a painkiller, something you ensure is always in stock and easily accessible because it solves your immediate need, effectively and consistently."

In today's investment environment, after a year in which every single asset class was up, there was no acute pain to be felt. This is exactly the business challenge that loose monetary policy has created: It has alleviated the short-term pain of losses and volatility so much that very few people experience enough pain for which to seek a solution. Research and risk management are currently solutions without a problem.

None of this is to say that there will not be severe pain felt at some point in the future, and I strongly suspect that will be the case. But this really highlights the challenge monetary policy has created for investment services. It has changed the pattern of investment pain, which used to be felt regularly to some degree, to a pattern in which investment pain is virtually imperceptible for long periods of time, but then extremely severe periodically.

In addition to distorting markets in many ways, then, monetary policy has also distorted the pattern of demand for investment services. What used to be a persistent, ongoing, need to manage risk and interpret signals has now become a need to ride the wave of policy-induced market appreciation while it lasts and then, somehow, miraculously sidestep the inevitable and disastrous fallout.

This pattern diminishes the business value of investment research in many ways. For one, the ongoing insights and analyses of investment research (such as security selection and asset allocation) have little value during intervening periods. The predominant market risk factor is not related to economic fundamentals but rather to monetary policy.

The value of investment research is also diminished because it becomes realized only after periods that are many years apart. This creates an extremely risky business model because its value is not regularly visible and as such, can appear to be wholly unnecessary insurance.

Two silver linings exist in this otherwise dismal landscape, though. One is that many skilled and experienced analysts are leaving the industry for greener pastures. Legendary money managers are closing shop. The net effect is that the amount of competition is rapidly declining. If, and when, the market environment deteriorates, there will be precious few providers with the skill and credibility to analyze companies and industries again. This is part of what keeps me going.

Another silver lining is that the benefits of investment research extend well beyond the boundaries of active money management. Industry research and competitive analysis provides insights into other companies whether they be public or private. Technology trends transcend companies and industries. Virtually all research provides valuable grass roots evidence on economic activity. Historical analyses provide valuable context for what is possible and what is extremely unlikely. All of these things can be brought to bear on a wide variety of challenges related to, or completely unrelated to, money management.

Indeed, this is exactly the thinking I used when I established the Personal CIO service a few years ago. What I am doing now is reviewing much of the work that I do on a daily and weekly basis that does not make it into portfolio decisions. I am looking for projects and/or theses that I use in establishing my own strategic perspective of the markets that I can package in a way that can also be useful to others - and useful regardless of what markets are doing.

I see this as a sensible extension of my work for a couple of reasons. One is that I always have a huge number of research projects in process so I have no concerns about generating sufficient content. Another is that even with the emergence of what I call alternative research organizations that have vastly improved access to high quality, unconflicted research, there is still a struggle to understand exactly what those insights *mean*. In other words, there are still a lot of people who need a painkiller.

Finally, several different data points suggest that many investors are eyeing the remarkable market advances with deep suspicion. The outflow of money from equity mutual funds is one indication of this. I have also heard a fair amount of anecdotal evidence that a lot of individual investors do not buy into the rosy market forecasts. In short, many investors who are accountable for their own retirement are worried - and, I believe - rightly so. Areté is here to serve them.

As I review and formalize research content with the intent of making it more widely available, I do so with the same intent I have always had - to help investors invest better. If you have any comments or suggestions as to how I can better accomplish that goal, please let me know. Thanks!

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.

Portfolio Characteristics (12/31/19)

	Arete MCC*	Midcap Index**
Size		
Average Market Cap ($ mil.)	9,870	11,094
Median Market Cap ($ mil.)	8,624	8,423
Minimum Market Cap ($ mil.)	541	365
Maximum Market Cap ($ mil.)***	44,313	78,616
Number of holdings	16	802
Valuation		
P/E current year	29.4	26.7
P/B	2.4	5.8
P/S	2.1	2.8
Yield (%) ****	4.1	2.6
Valuation drivers		
ROE (%)****	6.4	12.0

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

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.

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 slightly lower than the mid cap index and the median is slightly higher. 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 16 currently.

Sector exposure (percent of assets on 12/31/19)

Economic sector***	Arete MCC*	Midcap Index**	Percentage Comparison
Consumer Discretionary	0.3	11.3	2.6%
Consumer Staples	0.0	4.1	0.0%
Energy	0.0	3.9	0.0%
Financials	3.0	12.9	23.3%
Health Care	4.5	10.2	44.0%
Industrials	0.0	13.8	0.0%
Information Technology	2.3	18.0	12.8%
Materials	9.3	5.2	180.4%
Real Estate	6.7	9.5	70.5%
Communication	0.0	4.3	0.0%
Utilities	4.2	6.8	62.1%
Equity exposure	30.3	100.0	
Cash and equivalent	69.7	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 fairly stable levels over the last several quarters.

Active share* (12/31/19)

Period	Percent**
Q419	96.6
Q319	96.1
Q219	95.6
Q119	95.5
Q418	95.8

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 was one transaction in the quarter in which we added to the OI position to bring it back up to a full 2% weight. OI reflected a pattern that became increasingly evident throughout the year; despite ongoing advances by the major indexes, several industries got pounded. Retail, shipping, transportation, energy, and industrials all suffered widespread weakness. One likely factor was that passive funds bet against these industries as economic conditions proved weak. In some cases, however, the "baby got thrown out with the bathwater".

More specifically, although OI definitely is affected by economic growth, demand for glass containers for the food and beverage industry is fairly stable. Further, its biggest cost factor is energy which typically gets better when growth is lower. Further yet, although the company reported mildly disappointing earnings in the second and third quarters, the vast majority of the miss was due to transient factors. Longer-term developments were actually positive. These results should have barely affected the share price but instead it fell by 50% between July and October. This created a nice opportunity to add to a company we know and with great cash flow at a significant discount.

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 3.54% (net of fees) for the quarter versus 7.06% for the Russell Midcap Index® (RMC) (see pages 8 – 10 for performance and related disclosures). Major indexes were up strongly as the Fed increased liquidity to support the repo market. Although AMCC's defensive positioning held back overall performance, the holdings performed well.

Stock performance* (9/30/19 - 12/31/19)

Best performers

Company	Return in quarter (%)
Lands End	48.1
Detour Gold	31.2
Davita	31.5
Owens Illinois	28.6
Yamana Gold	24.2

Worst performers

Company	Return in quarter (%)
Seritage Growth Properties	-5.7
Exelon	-5.6
Royal Gold	-0.8
Capitol Federal	-0.4
NRG Energy	0.4

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

As the market continued its runup in the fourth quarter, gold continued to do well and that was reflected in DRGDF and AUY. DRGDF received an extra boost with a takeout offer from KL. LE bounced back strongly after a weak quarterly report, but this stock has been extremely volatile. DVA and OI also bounced back after weak reports earlier in the year which disproportionately hurt those stocks at the time.

Among the underperformers, SRG made the list again which appears to be collateral damage from the horrible performance of mall REITs throughout the year. Exelon was also down modestly due to revelations that it received a grand jury subpoena in regard to lobbying activities in the State of Illinois.

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, 2019

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	5.03	4.00	18.52	4	NA	984,681	984,681	100%	1,181,490
2018	-2.06	-3.03	-9.06	4	NA	954,785	954,785	100%	1,152,786
2019									
January	3.37	3.13	10.79	4	NA	984,623	984,623	100%	1,184,800
February	0.21	0.21	4.30	4	NA	986,645	986,645	100%	1,187,424
March	0.54	0.54	0.86	4	NA	991,993	991,993	100%	1,193,131
April	0.13	-0.12	3.81	4	NA	990,777	990,777	100%	1,191,761
May	-2.46	-2.46	-6.14	4	NA	966,369	966,369	100%	1,167,153
June	2.94	2.94	6.87	3	NA	994,399	994,399	100%	1,198,127
July	0.82	0.57	1.43	3	NA	1,000,389	1,000,389	100%	1,205,458
August	0.99	0.99	-2.85	3	NA	1,010,288	1,010,288	100%	1,217,617
September	0.07	0.07	1.97	3	NA	1,010,997	1,010,997	100%	1,217,395
October	0.79	0.54	1.05	3	NA	1,016,458	1,016,458	100%	1,223,476
November	1.55	1.55	3.57	3	NA	1,032,219	1,032,219	100%	1,240,535
December	1.41	1.41	2.29	3	NA	1,046,822	1,046,822	100%	1,257,036
Q1	4.15	3.90	16.54	4	NA	991,993	991,993	100%	1,193,131
Q2	0.53	0.28	4.13	3	NA	994,399	994,399	100%	1,198,127
Q3	1.89	1.64	0.48	3	NA	1,010,997	1,010,997	100%	1,217,395
Q4	3.80	3.54	7.06	3	NA	1,046,822	1,046,822	100%	1,257,036
YTD	10.73	9.65	30.54	3	NA	1,046,822	1,046,822	100%	1,257,036

**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®).

Areté Asset Management Mid Cap Core performance composite disclosures continued:

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.