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The Areté Quarterly

Welcome

As it becomes progressively more apparent that the investment landscape presents unique challenges, it is also becoming progressively more apparent that conventional investment approaches are not sufficient for meeting those challenges.

Areté is a unique organization for unique times. With an orientation to research and analysis, these activities are applied for the purpose of solving problems and helping investors do the best they can. Each investment decision and communication is made with the mindset of having skin in the game.

If you are interested in getting more (or different) investment insights, please take a look at our blog [here]. Content for the posts is selected and created on the basis of being important, relevant, and useful.

In addition, *Arete's Observations* provides a weekly assessment of important investment news and insights and these posts provide excellent exposure to our thinking. You can find the letters on the substack platform at: https://abetterwaytoinvest.substack.com

Also, in addition to managing a mid cap core equity strategy, Areté now also provides insights and expertise on a personal basis through the Personal CIO Service. If you would like to learn more, please take a look on the website [here]. Finally, please always feel free to contact us with questions or comments.

Business Update

Last week Jeremy Grantham put out a piece on investment bubbles that also contained a good bit of wisdom about the investment business. He described:

Inside This Issue

"Most of the time in more normal markets you show up for work and do your job. Ho hum. And then, once in a long while, the market spirals away from fair value and reality. Fortunes are made and lost in a hurry and investment advisors have a rare chance to really justify their existence. But, as usual, there is no free lunch. These opportunities to be useful come loaded with career risk."

These comments provide excellent context for the opportunities and challenges confronting Areté. When I formed Areté in 2008 I felt strongly that investors deserved something better from advisors than just "showing up for work". When the financial crisis followed shortly thereafter, I was actually somewhat encouraged that investors would be angry enough to demand something better.

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It turns out I was only partly right. Investors were angry but they only demanded something very modestly better - passive funds. As such, most investors had the same basic relationship with the market: Just be there.

This solidified a terrible bias in the industry: Always be turned "on", i.e., always be fully exposed to the market. Certainly the strong performance of stocks has reinforced that belief. Importantly, however, the last thirty-eight years stand out in history as being an incredible outlier. Nothing in global financial history justifies such a dogmatic position.

This state of affairs raises two interesting points. One is that with such uniform belief in stocks, and with "the market spiraling away from fair value and reality", the time is approaching in which fortunes are likely to be lost. The other point, however, is the contrarian effort to avoid fortunes being lost is still "loaded with career risk". While I think the opportunity to make a contrarian call and to have a lot of cash ready to redeploy at better prices is historic right now, I have thought that opportunity to be attractive for several years now.

This situation presents three major challenges/issues for Areté as I see it. The first is to be prepared if/when there are major market disruptions, which I suspect there will be. Major selloffs in late 2018 and again in early 2020 suggest simmering instability.

Further, it is almost impossible to have the kind of speculative behavior currently transpiring in markets and not have it leak into illiquid assets. This is the same basic problem that occurred in the financial crisis in 2008 and is likely to occur again next time around, albeit probably with different assets. I want to be ready to pick up the pieces.

Also, I am seriously considering expanding the mandate for portfolio management from just stocks to also include index funds and exchange-trade funds (ETFs). In considering such a move, I do not want to significantly change the objective of the Arete midcap strategy which is to invest in a portfolio of securities that in aggregate have the best chance of generating attractive long-term returns. Rather, the goal of the modification would be to use such funds as a complement to the core stock strategy in order to better manage exposure to various macro trends.

Finally, given the long wait for stocks to become attractively valued and therefore to improve the prospects for the money management operation, I continue to explore other ways to generate revenue. Mainly I want to leverage the knowledge base from my 30+ years of investment experience and ongoing research. The *Observations* letter is one way to do that.

The challenge, and I've got to admit this is frustrating, is that knowledge and research are not working in the market right now and haven't been for a long time. I think that has to change, but for the time being I will be trying to find the pockets of investors who still appreciate those efforts.

As always, thanks for your support!

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 (12/31/20)

	Arete MCC*	Midcap Index**
Size		
Average Market Cap ($ mil.)	10,079	12,894
Median Market Cap ($ mil.)	9,168	9,611
Minimum Market Cap ($ mil.)	567	321
Maximum Market Cap ($ mil.)***	41,207	58,939
Number of holdings	15	823
Valuation		
P/E current year	22.5	26.2
P/B	3.1	7.2
P/S	3.4	6.8
Yield (%) ****	3.7	3.2
Valuation drivers		
ROE (%)****	5.6	11.2

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 lower than the mid cap index and the median is similar. 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 15 currently.

Sector exposure (percent of assets on 12/31/20)

Economic sector***	Arete MCC*	Midcap Index**	Percentage Comparison
Consumer Discretionary	0.4	11.6	3.5%
Consumer Staples	0.0	3.8	0.0%
Energy	0.0	2.6	0.0%
Financials	3.6	11.1	32.5%
Health Care	3.6	12.9	27.9%
Industrials	0.0	15.1	0.0%
Information Technology	0.0	20.5	0.0%
Materials	9.4	5.4	173.4%
Real Estate	6.2	6.9	89.8%
Communication	0.0	5.0	0.0%
Utilities	3.9	5.1	76.5%
Equity exposure	27.1	100.0	
Cash and equivalent	73.1	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.

Total	100.2	100.0

Sector exposures remain quite different from benchmark weights, in part due to the high cash position but also due to different exposures. Cash has remained high as excessive valuations have precluded the addition of new holdings.

Active share* (12/31/20)

Period	Percent**
Q320	96.3
Q320	96.3
Q220	96.2
Q120	96.1
Q419	96.6

**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 but that result belies the considerable amount of research conducted and high level of interest in adding to positions. More specifically, several commodities-related stocks were lined up to buy in the quarter when commodities in general took off. The environment of strong liquidity and multiple signals of speculative excess suggested the dramatic moves were more related to short-term trading calls than valuation-based additions. As a result, the additions were forestalled until better entry points could be realized.

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.

Stock performance* (9/30/20 - 12/31/20)

Best performers

Company	Return in quarter (%)
The Saint Joe Company	105.8
Lands End	65.5
Davita	37.1
Capitol Federal Financial	34.9
NRG Energy	22.2

Worst performers

Company	Return in quarter (%)
Kirkland Lake	-15.2
Royal Gold	-11.5
Yamana Gold	0.5
Seritage	9.1
Owens Illinois	12.4

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

Areté's Mid Cap Core (AMCC) strategy returned 3.45% (net of fees) for the quarter versus 19.91% for the Russell Midcap Index® (RMC) (see pages 7 – 9 for performance and related disclosures). After playing catch up for the terrible first quarter, RMC finally pulled ahead of AMCC in the fourth quarter amid a blaze of speculative fervor. While it is always disappointing to underperform, it is never a safe bet that such high levels of speculation can persist for long.

The performance of individual stocks in the quarter reflected some of the broader market themes. JOE, LE, and CFFN all performed well as the narrative of reflation took off and boosted smaller cap stocks in particular. The gold stocks were weak in comparison as central banks reduced their purchases and as bitcoin stole much of the limelight for the time being.

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, 2020

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	10.73	9.65	30.54	3	NA	1,046,822	1,046,822	100%	1,257,036
2020									
January	0.16	-0.09	-0.80	3	NA	1,045,862	1,045,862	100%	1,255,939
February	-2.92	-2.92	-8.69	3	NA	1,015,294	1,015,294	100%	1,222,241
March	-5.22	-5.22	-19.49	3	NA	962,276	962,276	100%	1,164,373
April	4.14	3.89	14.36	3	NA	999,674	999,674	100%	1,207,109
May	0.84	0.84	7.03	3	NA	1,008,082	1,008,082	100%	1,215,937
June	0.26	0.26	1.80	3	NA	1,010,676	1,010,676	100%	1,219,085
July	2.83	2.58	5.87	3	NA	1,036,753	1,036,753	100%	1,248,941
August	0.32	0.32	3.52	3	NA	1,040,084	1,040,084	100%	1,252,199
September	-1.40	-1.40	-1.95	3	NA	1,025,517	1,025,517	100%	1,235,656
October	0.14	-0.11	0.64	3	NA	1,024,395	1,024,395	100%	1,234,049
November	1.91	1.91	13.82	3	NA	1,043,913	1,043,913	100%	1,253,982
December	1.63	1.63	4.68	3	NA	1,060,915	1,060,915	100%	1,271,549
Q1	-7.85	-8.08	-27.07	3	NA	962,276	962,276	100%	1,164,373
Q2	5.29	5.03	24.61	3	NA	1,010,676	1,010,676	100%	1,219,085
Q3	1.72	1.47	7.46	3	NA	1,025,517	1,025,517	100%	1,235,656
Q4	3.71	3.45	19.91	3	NA	1,060,915	1,060,915	100%	1,271,549
YTD	2.36	1.34	17.10	3	NA	1,060,915	1,060,915	100%	1,271,549

**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.