

ARETE INSIGHTS

Welcome

I love books and one of my favorite book titles is *Philosophy: Who Needs It*. I am partial to the subject because I studied philosophy extensively as an undergraduate. I am also amused by the irony. At the mention of philosophy I can almost hear someone ask sarcastically, “Who needs it?”

The book was authored by Ayn Rand who is far better known for her epic novels *Atlas Shrugged* and *The Fountainhead*. Rand believed, “Philosophy plays a central role in all human activities . . . Every action, every thought, has at its root certain assumptions and that we need to examine those assumptions to live a full, meaningful life.” (Wikipedia)

I often have a similar feeling about the investment landscape. Perhaps I could write a book called *Investment Management: Who Needs It*. As Rand argues regarding philosophy, I could argue that investing plays a central role in our well being. I could also argue that investment actions, and inaction, have certain assumptions that need to be examined to fully realize retirement goals.

For most of us, assumptions are largely based on our experiences. Our experiences are shaped into mental models that help us understand how the world operates. Most of the time, these models tend to be fairly

efficient and effective in guiding our daily actions.

The major exception to this general rule is when our past experiences are limited relative to the set of conditions we may face in the future. This was a key theme of Nassim Nicholas Taleb’s book, *The Black Swan*. The idea is that not only can things happen outside of our normal set of experiences, but these “anomalies” can have a big impact on our lives.

For many, assumptions have been shaped by the economic experiences of the last thirty years. This was a period of strong economic growth, strong investment returns, and low inflation. In short, the investment experiences we have had that seem “normal” to us, are decidedly abnormal in the broader context of history. We have had the great good fortune to live through investment nirvana.

Many investors, naturally, are using this experience as the basis for making retirement decisions. They have watched funds appreciate with the markets over time. They know many people before them who have retired comfortably and expect the same. As a result, I believe many investors are assuming they just need to “wait it out” in order to retire comfortably themselves. I believe this is an extremely dangerous assumption to make.

For better or worse, I see a very different intermediate future for investing. Although

“I hope people take Rand’s advice. Challenge the assumption that you don’t have to do much to plan your retirement.”

there are several reasons that support my view of more challenging markets going forward, I will list three here.

First, the bull market from 1982 to 2000 stands out as unique in the history of investing. Returns were exceptionally high and well beyond historical norms for both equity and fixed income. Fixed income returns have remained strong providing a fortuitous boost to those shifting allocations away from equities in preparation for retirement. Based on valuations and historical experience, there is every reason to believe that market returns will be lower for the foreseeable future.

Second, the work force in the U.S. is aging, as it is in many developed economies. This matters because as Baby Boomers begin to retire, they also move out of the most productive parts of their careers. Since productivity is a key driver of economic growth, growth will slow directly as a function of this demographic shift.

Third, public and private debt is at extremely high levels. All historical evidence points to the fact that it takes a long time to work debt levels down. We are in the very early innings of this deleveraging process and the effort this time will be impeded by demographic forces.

I don't in any way wish to scaremonger or to coerce people to believe "the sky is falling." It is not. But I do hope people take Rand's advice. Challenge the assumption that you don't have to do much to plan your retirement. Reconsider your retirement plans by incorporating a far less friendly investment environment into your assumptions.

I offer these challenges for a few different reasons. For one, I think it is always a healthy exercise to challenge assumptions to make sure you stay on the right track. Second, I believe there are a fair number of people who are relying on too rosy forecasts to meet their retirement goals. Finally, the downside risk is substantial. It is extremely difficult to make up savings deficits after retirement.

For those who find they are not on track to meet retirement goals, it is far better to find out early rather than late. If you find out early, the challenge is manageable; action can be taken on several fronts. To me the best response is to work hard, save as much as you can, and do everything possible to invest those savings well.

On that note, I have always believed that investing plays a central role in our well being. I created Arete because I thought there would be a demand for good investing – characterized by superior performance and lower fees. I have never believed that more than I do today.

Please let us know if we might be able to help you.

Best regards,

David Robertson, CFA
CEO, Portfolio Manager

Insights

Have you ever seen a sign or a warning label that caught your attention as being absurdly self-evident? "Do not use in shower" was on a hair dryer. "Do not use while sleeping or unconscious" was on a hand-held messaging device. When we see

things like this we are often amused, and sometimes confused. Then our curiosity takes over and we wonder what happened to cause a need for such a label?”

We came across a similar situation three years ago when Arete was formed. In the process of becoming registered as an investment advisor, we had to fill out the form ADV. In doing so, we often found that the questions defied comprehension. Eventually, though, we realized that each question on that form is there for a reason: It represents some way that some advisor deceived, manipulated, or abused investors. Now each question serves as a type of warning label. We have actually come to view the form ADV as a chronicle of malfeasance in the investment industry.

This is actually a pretty useful insight and one that individual investors can use to their advantage. Most people consider the security of their investments to be of paramount importance – and rightly so. Nobody wants to be a Madoff victim.

The good news is that all of the information and disclosures presented in form ADV are easily accessible to the public. Every registered adviser can be investigated through the Investment Adviser Public Disclosure website at:

http://www.adviserinfo.sec.gov/%28S%28ysxtjxrktchep32xyu5fal45%29%29/IAPD/Content/lapdMain/iapd_SiteMap.aspx

All of the warning labels are there for you to see. Whether you completely read through several different ADVs or do some

spot checks to confirm certain important points, it is a useful exercise. Further, it is as easy as sitting at your computer for a few minutes.

Interestingly, this exercise is not so much one of “finding a needle in a haystack” as many may believe. A couple of recent articles about hedge fund risk provide an interesting glimpse into the business.

In one study of a group of hedge funds, researchers found that one in seven reported at least one infraction of legal, disciplinary, or regulatory compliance (“Estimating Operational Risk for Hedge Funds: The ω -Score”, *Financial Analyst Journal*, and “Can Hedge Fund Operational Risk Be Quantified?”, *CFA Magazine*). In other words, this isn’t a wild goose chase;

there are a lot of problems and many are out in the open for investors to see.

The research revealed two more very interesting insights. First, while most due diligence efforts focus

on investment research process and financial condition, studies suggest this effort may be misguided. Operational risk “has been shown to be a better predictor of fund failure than financial risk. More specifically, “an astounding 50 percent of hedge fund failures could be attributed to operational issues.”

The second interesting insight is that, “the likelihood of poor subsequent performance increases with exposure to operational risk. This suggests that operational factors such as disciplinary violations do more than warn against fund failure. These factors are also associated with fund performance.

To sum up, warning labels exist for a reason and nowhere is this more important than the investment management business. The reality is that the industry is characterized by managers with an extremely wide array of ability and ethics. With no formal requirements for educational and professional standards, anyone can give it a shot.

While this condition creates a challenge for investors, there are tools that can help. Research is pointing the way to more effective and efficient due diligence processes. The evidence strongly suggests that efforts can be improved by focusing more on operational issues. Also, the Investment Adviser Public Disclosure website is a great resource by providing easy access to the ADVs of registered advisers and therefore to the most important operational issues.

Lessons from the Trenches

One of our goals with the *Arete Insights* newsletter is to share our insights into how the investment management business really works. Due to several requests from readers, we are creating a new section to expand upon the scope of our “Insider’s View.” “Lessons from the Trenches” will highlight our approach to stock research. Our intent is to share with you some of the tips, tricks, and other tools we have incorporated into our work that may provide you some insights into how we engage in our craft.

Arete is unique in many of the things it does and one great example is the way we integrate proxy voting into our research

process. Many firms view proxy voting as a non-core function and outsource it to third parties. I view it as yet another opportunity to gain insight into companies and to best represent the interests of Arete’s clients. How can that be “non-core” to an investment operation?

Many people rank reading proxies right up there with watching grass grow and I can’t say I felt any different when I started as an analyst. Lots of gobbledygook, and for what?

My conversion began with my quantitative and modeling work early in my career. I knew very well from that experience that as useful as models could be, they were still always imperfect representations of reality. I also knew the value of models were only as good as their inputs: Garbage in, garbage out.

As a result, I found the best way to use a model was not to blindly grind data through it. Rather, it is important to pay attention to the quality of the data and to understand how it might be biased. In other words, it is important to *calibrate* the data based on the context from which it is created.

When you look at hundreds and hundreds of companies, you realize the same numbers can mean different things. Some management teams under-promise and over-deliver. Some are eternally optimistic and do the opposite. Many have identifiable tendencies. In order for these to be comparable and useful in a model, they need to be adjusted.

As a result, I started paying more attention to any research that might tip off the tendencies of a management team. In the

process of looking at proxies more carefully, I noticed some interesting patterns. For example, I noticed many compensation plans are structured such that a very modest improvement in fundamental performance produces a very large increase in incentive compensation. Such a “tipping point” can provide useful insight into consensus forecasts and a useful signal of management’s intent.

Another signal of management’s intent can be found in the metrics used to determine incentive compensation. While almost all metrics involve assumptions from management, some are more prone to outright manipulation than others. I have found, for example, that earnings per share is used fairly widely in plans and is also particularly susceptible to manipulation.

Signals by themselves don’t prove anything, but they do provide information which can be used productively. One thing I do is to consider each of a company’s accounting and other policies together as a “mosaic”. Do the policies tend to be aggressive or conservative? Do the policies and governance practices tend towards self-interest on the part of senior management or towards fiduciary duty to shareholders? In both cases, the answer provides a context from which to calibrate the fundamental metrics.

My standard of quality in this exercise is a successful partnership. Arete invests money with management teams to make business decisions on our behalf. An important part of my job is to determine whether or not the business is a good one to invest in. It is underappreciated, however, how important it is to also have a good partner. If the partner is continually searching for ways to hive off more of the

profits for himself at our expense, it will have to be an exceptional business for us to realize any benefit.

Howard Schillit aptly describes the analytical exercise in his book, *Financial Shenanigans*. The focus of the book is primarily on various ways in which management teams can manipulate accounting numbers to their own benefit – and how investors can spot these tricks.

As Schillit describes, “Companies with structural weaknesses or inadequate oversight provide fertile breeding ground for shenanigans.” He goes on to recommend that analysts should probe for strong governance in the form of appropriate checks and balances, strong Board members to protect shareholder interests, knowledgeable and independent auditors, and any efforts to circumvent regulatory scrutiny.

Many investors and analysts still prefer to forego the practice of reading proxies and instead rely on industry and media sources to provide shortcuts. Schillit notes this practice is imbued with its own risks: industry magazines can get things terribly wrong. For example, he cites, “Recipients of *CFO* magazines respected Excellence Awards include the 1998 winner, WorldCom’s Scott Sullivan (currently in jail); the 1999 winner, Enron’s Andrew Fastow (currently in jail); and the 2000 winner, Tyco’s Mark Swartz (currently in jail).”

In sum, I have become a big fan of proxies because of the informative signals they can provide. Reading and voting proxies improves corporate governance, improves the quality of research, and provides important warning signs. The proxy process

is completely integrated with Arete's research effort and is absolutely core to its mission of delivering functional excellence in money management.

Arete's Value Proposition

The specific features of our investment package, highlighted below, describe exactly what we try to do, and how we have organized our business in order to deliver an extremely attractive value proposition to our investors.

Commitment to putting our clients first

We are completely committed to putting the interests of our clients first. We do not employ any soft dollar arrangements because we believe these essentially end up being hidden fees for customers that are appropriately business expenses and should therefore be covered by the management fee. We do not operate in any other businesses that may provide conflicts of interest. All client accounts are treated exactly the same; no preferences are shown because the same trades are placed for every account at the same time. We also provide performance reporting so you can judge for yourself how we are doing.

Independent

Our firm is independently owned and operated which we believe gives us the best chance to make the best possible decisions for our clients. We have no significant outside owners which may have interests that could conflict with the interests of our clients. Some industry experts consider independence to be a competitive advantage.

Reasonable fee structure

We employ a very straightforward and reasonable fee structure of 1% of assets under management for assets up to \$1 million with lower rates beyond that. This compares to many mutual funds which have expense ratios in excess of 1.5%. In addition, we don't employ performance fees because we believe such fees often provide incentive to the manager to take inappropriate risks in order to realize those fees. Such fees also serve as a persistent drag on performance.

Separate Accounts

We manage separate accounts for clients rather than pooling contributions from various clients. Assets are held in custody by a nationally recognized custodian and clients receive quarterly statements of exactly what is in their individual account and a list of transactions executed for that account. There is no ambiguity. We believe the separate accounts structure greatly improves the visibility of the investment process as well as the portfolio accounting. We believe this high degree of visibility serves as a significant layer of protection for clients against neglect or malfeasance.

Distinctly mid cap

The aggregate characteristics of your mid cap portfolio will be anchored to those of the Russell Midcap Index. Since we find the mid cap stock universe very attractive for finding new stock ideas, we have no need to look outside that universe. When managers venture outside of their universes, they can compromise the value the portfolio brings to a broader asset allocation scheme.

Actively managed

Your portfolio will be actively managed giving you a real chance to outperform the benchmark. Index funds seek to replicate benchmark performance, but fall short when management fees are included. Some funds try to stay close to their benchmark and “closet index” in order to minimize the chance of significant underperformance. You will get a portfolio that benefits from our experience and expertise in stock selection in the form of a diversified group of our best stock ideas.

Long-term perspective

Our research focuses on long-term insights, not on short-term noise and trends. We believe that over longer periods of time, stocks migrate toward their intrinsic values. We also believe this phenomenon can be exploited by those who are both skilled enough to make reasonably accurate estimates of intrinsic value and patient enough for them to be realized. During shorter, interim periods, however, the numerous and diverse effects of trading activity make it excessively difficult to consistently determine the direction of stock prices.

Relatively low portfolio turnover

Our investment style is oriented to a longer-term time horizon of three to five years. As a result, our portfolio turnover tends to fall in the 20-40% range compared to the industry average of over 100%. Lower turnover means lower transaction costs for you and also tends to mean lower capital gains for taxable accounts.

Manager Evaluation

We very much appreciate the time and effort it takes to evaluate investment managers. As a result, we offer a few criteria for assessing quality investment management that we believe capture the vast majority of the issues that matter most in differentiating investment quality. The three core concepts of conscientiousness, commitment, and competence are simple, but effective. These criteria also serve as the foundation upon which we have built our service offering.

It is important to note here, that the three core concepts described below are general concepts. These general concepts form an overall framework for evaluation. Fund expense, for example, is a specific metric that represents elements of each the three general concepts.

Conscientiousness is the single most important characteristic in our minds. It is the foundation of fiduciary duty - putting the interest of the client first. It often, however, takes a back seat to conflicts of interest. As David Swensen describes in his book *Unconventional Success*, “The overwhelming number of mutual funds fail to meet the fundamental criterion of fidelity to fiduciary principles, as pursuit of profit overwhelms responsibility to investors.”

Commitment is the degree to which the performance and quality of the fund matters to a manager and captures how hungry the manager is to perform. In his book, *Hedgehogging*, Barton Biggs presents the test: “Suppose the Devil came to you with a Faustian bargain and said: I will have

you consistently scoring five [golf] strokes below what you are now if you will give me five performance points from what your fund would have returned over the same time period. Would you do it?" The answer often reveals where the manager is in his/her personal motivation cycle.

Positive signals for commitment include a manager's investment in the fund, investment in the organization, and personal sense of duty to his/her investors. Conversely, low or zero ownership serves as a warning flag because it identifies little economic risk to poor performance. Other warning flags include any signs of significant distraction such as excessively broad responsibilities within an organization, excessively broad obligations outside of the firm, and excessively strong commitments to personal hobbies or activities.

Competence may seem self-evident, but should not be taken for granted. While we

are certainly not suggesting anything close to a perfect linear relationship between levels of education attainment and investment performance, it is important to note that unlike many other professions (e.g. law, medicine), there are no substantial formal educational requirements for most investment jobs. Also, importantly, research does indicate a relationship between higher education and more prudent risk-taking.

Obvious things that can help include strong academic backgrounds and CFA certifications. Less obvious things include an investment philosophy that articulates a reasonable and understandable way to generate returns, and transparency which indicates confidence in the process.

