

ARETE INSIGHTS

Welcome

With this edition of *Arete Insights* I am testing out a slightly different format. While the nature of the content still focuses very much on issues and insights that I believe investors can benefit from, I will make a greater effort to target specific “pain points” for investors and also suggest actions that can be taken to address those challenges.

My intent in this exercise is to make Arete’s insights more practicable and “user-friendly”. One possible path to this ongoing improvement effort is to post these articles in a blog that will facilitate more frequent communication. Whether it’s regarding content, format, or anything else, I would very much appreciate hearing any feedback you have that can make Arete’s insights more useful. Please always feel free to reach me at drobotson@areteam.com with comments or suggestions.

Thanks in advance for your help!

David Robertson, CFA
CEO, Portfolio Manager

The efficient frontier

Many investors cast a suspicious eye to any form of active management and instead opt for index funds or exchange traded funds (ETFs). Many other investors, however, intuitively sense that there must be opportunities for active managers to outperform, but can’t quite put their finger

on why so many fail to keep up with their benchmarks. If Arete’s outlook for low future returns is anywhere close to being correct, many passive investors will be extremely disappointed with those low returns and active management is likely to attract a lot more attention.

What has been fairly well appreciated in academic and some professional circles, but not well covered for individual investors, is that there are very specific and identifiable structural flaws that handicap many active managers. When you do the research, it becomes incredibly clear that the correct conclusion is not that active management cannot be done successfully, but rather that a majority of active managers do not offer good value but somehow still manage to get by with it.

The most important structural flaw of most active funds, in a word, is *inefficiency*. As consumers we have experienced the forces of efficiency improve our lives in many ways from Walmart’s “Everyday low prices” to CarMax’s “No haggle” pricing and to innumerable websites and blogs that post free content. The internet and other technologies have disintermediated inefficient supply chain components almost everywhere. Nonetheless, the realm of active management in particular (and investment services broadly) remains curiously inefficient.

The two areas ripest for improved efficiency are fees and portfolio construction. Regarding fees, most of the important costs to run a money management operation have come down

substantially and fees will need to better reflect these savings.

Further, a significant, and often majority of fee structures, are allocated to marketing and distribution costs. In an age when one can access a website or view a Form ADV (Advisor's regulatory statement) essentially for free, there is no good economic rationale for paying so much for these functions.

Whether fee reductions happen quickly, as a critical mass of investors push back on existing fee arrangements, or gradually, as progressively more Gen Xers and Millennials prefer to avoid legacy infrastructure burdened with unnecessary costs, doesn't matter much for the big picture. Change is afoot.

In addition to fees, there is likely to be increasing pressure for more efficient portfolio construction. The vast majority of active mutual funds have a majority of equity exposure that overlaps their benchmarks. In other words, when you hire an active manager, you may be expecting to benefit from all of their best ideas, but typically, you're not. You're getting some of their best ideas along with a lot of average ideas and you're still paying full price. It's like buying a basket of apples with three good apples on top and three bad apples on the bottom, but still paying for six apples. On that basis, those three good apples are not cheap.

Until these changes become much more pervasive, there are a couple of things you can do to help yourself out, and both focus on efficiency. A really good place to start is to look for very high active share -

preferably above 80% or so. That way you truly get the best ideas the manager has to offer. Some institutional databases are now allowing active share to be reported; you should look for it too.

The second thing you can do is to screen funds and managers by the reasonableness of their fees. Part of this is looking for relatively low fees, but part is also comparing those fees to active share. For example, a fund with fees of 1% could be attractive, and especially so if active share is very high at 90-95%. If that fund's active

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share is only 33%, though, it translates to an active fee of 3% which is extremely high. One hint:

If you have an extremely hard time getting the information, or if it's not available at all, the answer is not likely to be good.

Investor advocate

Very few people would dispute that the arena of investing is fraught with challenges. Tons of information, waves of sales pitches, endless lines of "fine print", and a massive proliferation of services all serve to make the important task of investing one that most people would prefer to avoid.

I always felt the same way about the subject of politics. This was an interesting anomaly because I tend to be a pretty curious person and I enjoy learning about most subjects. The realm of politics, however, seemed so overtly manipulative and impenetrable that it didn't seem worth the effort.

There aren't many things I say "Never" to, though, so when I got introduced to *Meet the Press* when it was hosted by Tim Russert, my interest really blossomed. A political insider himself, having worked with Senator Daniel Moynihan and Governor Mario Cuomo, Russert had a deep understanding both of how politics worked and what it could accomplish.

Through his interviews and intense questioning on the show, Russert was always working to get his guests to reveal what they *meant* by forcing them to *define* what they said. Noticeably, he was never mean or uncivil, but he could be extremely demanding. His mission seemed to be in revealing the issues, not in promoting particular positions.

Through his translation of what had previously sounded like unintelligible rhetoric, I began to understand its meaning. After a while, I started seeing more clearly what was really going on and in most cases I could see how both sides had valid points that needed to be considered. In essence, he created a lens of understanding.

While these exercises were intellectually stimulating, they also served a far greater practical purpose. Before discovering Russert, I had often felt that the process of voting was agonizing. I knew I was getting hugely biased information but I also knew I didn't have the tools or the time with which to fairly evaluate it. It was an unfair fight made worse by the realization that if I took too strong a position, I could inadvertently support someone averse to

my interests. Armed with the knowledge of political reality, Russert allowed me and the rest of his audience to make better electoral decisions.

This experience is especially relevant to investors now that economic and financial information is taking on ever-greater political importance. Excessive debt burdens are being shifted from the private sector to the public sector making them everyone's problem now. In the process, it is subjecting nearly every economic and financial statistic to potential for some degree of deception through reporting, interpretation, or both.

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It is annoying that information is being so widely misappropriated, but this is the world we live in. PR people know perceptions can be manipulated and also know that most of us are too busy to take on yet another project. The best we can do is to recognize the situation for what it is and to apply the resources we do have to the task.

One constructive response to the investment challenge is to find one or more "investor advocates" to help sort through the vast amounts of economic information and misinformation. In looking for advocates, credentials count big: Does the person have the skillsets to analyze the numbers? Does the person, or has the person, worked in the trenches, as Russert did, to really learn the landscape? Do they have an educational and experiential background that demonstrates strong analytical skills? If not, they are unlikely to

understand what is going on any more than anyone else.

Another trait that you want in an investor advocate is nonpartisanship. A big part of what made Russert so effective was that he did not play sides (except for his Buffalo sports teams!). He knew that if he did, he would lose credibility. Regarding investor advocates, it is fair to ask if they can articulate both risks and opportunities for various positions. The clarity of their answers, or lack thereof, will be revealing. It is natural for someone to talk their own book, but if they do not or cannot acknowledge the potential downside of their views, they may very well be flying blind.

A third trait that is extremely important in an investor advocate is accessibility. Many people in the business are knowledgeable and some are fairly nonpartisan. It is extremely rare, however, to find someone who is both - and can also be easily reached. Unless you can get perspective "from the horse's mouth" in regards to how the environment affects you, an otherwise knowledgeable viewpoint may not be very helpful.

The downside to a politicized economic environment is that it increases the costs of processing and understanding information. Further, it increases the probabilities of very poor outcomes for those who do NOT make the effort to understand and manage to the circumstances. Ignorance is rarely blissful for long in capital markets.

On the other hand, greater challenges create an environment amenable to greater performance differentiation. Those of you who develop strong relationships with investor advocates will be well positioned

to harvest good returns when and where available and to manage risk in whichever way is most appropriate for you. And finally, you just might end up finding the investment issues pretty darn interesting!

A risk by any other name ...?

Anyone who has spent time evaluating investment services is familiar with the goal of "risk adjusted return." The concept is intuitive enough: Return should be calibrated by risk rather than judged on its magnitude alone. Too often, though, the comfort of this self-evident tradeoff belies the multiple challenges in fully understanding either term. The unfortunate consequence is that it becomes all too easy for investors to unwittingly take on risks of which they are not fully aware.

A good example of one such risk resides with valuation. Over suitably long investment horizons, a great deal of evidence and a wide array of analytical methods exist to support the case that US equities, in general, are quite expensive at current levels. In simple terms, the more prices rise relative to underlying earnings power, the riskier they become. In other words, a great deal of valuation risk exists right now.

Risk in this sense means that the intrinsic value for stocks (as a group) is significantly lower than the current price of market indexes. Since market forces tend to pull prices back to intrinsic value over time, it is fair to think of intrinsic value as an anchor, or a quasi-permanent condition. Conversely, when prices deviate from intrinsic value substantially, it is fair to think of those situations as more

“transient” in nature. For long-term investors, this is a critical distinction to make in preserving your wealth.

Another risk that is often under-appreciated is that the global financial system allows extremely fluid movement of credit and liquidity across national borders. As a result, the effort by much of the developed world’s central banks to keep interest rates artificially low means that a lot of investors have been desperately searching to maintain investment income by reaching for yield in other places. Incoming flows of credit and liquidity can keep pushing valuations in such places higher, but when those flows reverse, the whole system can lock up. This is a big part of the problem in many emerging markets right now.

The nature of this risk may be hard for reasonable, valuation-based investors to fully appreciate because they would never engage in such crazy behavior themselves. Unfortunately, just as in all aspects of life, some people behave in a way that affects all of us. Usually it’s a minority and we absorb those inconveniences with the realization that others more than make up for it. What is different now is that easy money policy is actually encouraging dangerously aggressive behavior.

To illustrate, you may be a perfectly safe driver, but if you are on road jammed with people going 120 mph and darting in and out of lanes, it’s not going to be a safe drive for anybody. So it goes in emerging markets. Now imagine that the pavement suddenly runs out and turns into a windy, potholed, gravel road. It will be incredibly

dangerous for everyone there and people will get hurt.

Many concerns about risk are often gently shoved aside by the use, and we would argue abuse, of statistical models. The problem lies in the assumption of normal distributions in a huge proportion of “risk” models. Here the risk isn’t endemic to the market itself, but in the false security that bad models can provide.

One of the very interesting characteristics of markets is that they are complex and adaptive systems. This means that participants act not just on the basis of information, but also on the basis of what other participants are doing. An extremely important consequence of this type of system is that feedback loops can develop which lead to extreme situations.

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This is important because it tells us that the shape of outcome distributions actually change over time. Further, it is right at the times that feedback loops are forming and growing that normal distributions tend to be most inaccurate. As a result, it is also at these times that investors are likely to be exposed to much greater risk than they realize despite the comforting messages of “risk management” they may hear.

In wrapping up, risks are inherent to investing and as such cannot be completely avoided. They can be much more thoroughly understood, however. One way to do so is to develop expertise in valuation and other risk types or to find someone with such expertise. Unless you know what you’re really getting into, it’s hard to know how much you might lose.

Finally, whether you believe our assessment of risks or not, we propose a test. Ask of yourself: What would you regret more - missing out on a rally that might continue a while longer, or losing a lot of money due to risks that were completely foreseeable? How you answer this will reveal a great deal about your investment goals and personality.

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.”

There are many indications of conscientiousness and most focus on fidelity to fiduciary principles. The

avoidance or forbearance of conflicts of interest, independent ownership, and sincerely helpful advice are all good signs of conscientiousness.

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.

