

ARETE INSIGHTS

What's my line?

I have average grades from an average college. While I compete with thousands of others, we all agree to not compete on price. As a result, I make about twice as much as I could with the same education and capital in any other profession. What's my line?

If you guessed financial adviser, you would be correct. Last quarter I addressed the issue of inefficiency as manifested in many actively managed funds. This quarter I'm addressing a strain of inefficiency that's probably even more important to most investors. The pricing of most financial advisory services is an extremely important factor in determining investment outcomes because a large proportion of investors pay for advice and because a huge chunk of it is significantly overpriced.

Just as I noted that inefficiency among active managers is a prevailing trend rather than a blanket condition, this by no means implies that all advisors overcharge or that they aren't decent people. It merely identifies an economic reality that has serious implications for your financial health.

In the recent article, "[How to avoid the coming crunch on advisor compensation](#)", Dan Richards discusses in public what very few have dared to before: He tries to establish a reasonable basis for advisor

compensation. He starts with the facts. According to *Investment News*, normal compensation for a partner at a financial advisory firm is \$324,000 and for an advisor who operates a sole practice it is \$217,800.

Richards also conducts a fair amount of research on compensation for other jobs with similar responsibility levels and educational and capital requirements. According to his comparisons with norms for similar professionals, financial advisers should earn about half of what they do now.

While the title of Richards' article forebodes downward pressure on advisor compensation, it also begs the question of how it became so disconnected from the rest of the economy in the first place. One

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likely cause is that advisers commonly structure fees as a percent of assets under management (AUM) rather than on an hourly basis as most other professions do. As a result, advisers benefit from both their clients' capital and from the natural upward bias in capital market returns, neither of which is

directly related to the adviser's contribution.

Another likely cause of the disconnect is that adviser compensation is also largely protected due to oligopolistic competition. Despite there being thousands of advisors, Richards reveals, "The major players in the advice business compete fiercely on

everything except price, where there is recognition that cutting prices would lead to a downward spiral in which no one would benefit except customers." This doesn't sound much different than the insular environment Michael Lewis described regarding high frequency trading reported in the [Q114 Arete Quarterly](#), "The deep problem with the system was a kind of moral inertia. So long as it served the narrow interests of everyone inside it, no one on the inside would ever seek to change it."

While this state of affairs may seem like just one more obstacle for investors to overcome, there are glimmers of hope. For one, just like there are some active managers fighting the legacies of inefficiency to provide better value, so too are there some advisers working hard and experimenting with fee structures in order to deliver great value to their clients.

In addition, there are some good roadmaps already established by some of the larger and more sophisticated institutions. They have confronted many of the same issues and have developed constructive responses, many of which can fairly easily be replicated by individuals and small institutions.

This opportunity is corroborated by Dan Richards in another piece, "[Four Inevitable Changes that Threaten Your Business](#)". He describes that, "Closing the gulf between smart money and dumb money" is a "fundamental structural shift" imminent in the investment industry. According to him, such a "yawning gap between more informed and less informed buyers isn't sustainable in any business."

One easy place to start to close the "yawning gap" is with price negotiation. Clearly larger clients have more leverage to negotiate, but you can always make the effort. Is there a good reason to pay a percentage of AUM or can an hourly rate be agreed upon? Also, if it doesn't work the first time, you can always keep trying and keep evaluating alternatives. Things are changing and there's a good chance persistence will pay off.

Also, if you can't find reasonably priced advisory services, you might consider doing some of the work yourself. There is a lot of good information available for free. Further, there are a lot of emerging technology solutions that aim to disrupt the industry by making basic services available for extremely reasonable prices.

Finally, as I noted in the [Q413 Arete Insights](#), many institutions are turning to their best active managers for advice. Realizing that many existing relationships are no longer fit for purpose, these institutions are leveraging expertise where they find it. It is easy for individual and small institutional investors to follow this lead by asking their active managers to share their insights into the investment landscape.

In conclusion, advisory services can be extremely important in managing one's financial affairs; nobody is arguing that they aren't. The price of such services is in question, however, and poses the distinct threat of gradual but persistent erosion of wealth. Indeed, the *Economist* stated the case clearly in a recent briefing on fund management: "Good advice is certainly worth something ... but an investor should not pay 1% to 1.5% a year to an adviser."

Governance: I can see [more] clearly now

Fresh on the heels of tax season and extending through some of the most pleasant weather of the year, proxy voting can seem like an ill-fated endeavor. Mounds of dense material add insult to injury and can challenge even the most industrious shareholders.

There are rewards for going through the proxy materials though. One is that the proxy statement reveals a great deal about the primacy of interests of the board and often of management too. As such, it is like a code book that can be used to decipher hidden messages in the company's financial statements and other communications.

In addition, since very few investors meaningfully integrate proxy voting with research, doing so transcends conventional functional silos so as to provide a broader and truly differentiated perspective. This especially resonates with those of us who have served on boards and understand the links between what goes on behind the scenes and what gets communicated.

It is also important to highlight that the process of reviewing and voting proxies is far less cumbersome than it used to be. Logistics have improved a lot as receiving emails and voting online is a lot easier than dealing with paper forms in the mail. Although proxy materials can still be dense and overloaded with legalese, many companies are making efforts to highlight important changes and key information in easy-to-read tables. Further, with a clear focus on potential conflicts of interest, one

can be fairly selective in reading proxies and still derive disproportionate benefit from the exercise.

In regards to corporate governance itself, the trend is unmistakably one of improvement. While I have generally been fairly skeptical of much change in governance, I happily acknowledge that there are a lot fewer staggered boards today, there are meaningful discussions

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with top investors regarding executive compensation, the most egregious compensation features have been explicitly terminated, and there has been a healthy

amount of board member renewal/refreshment.

Further, it seems as if the entire tenor of the relationship between boards and shareholders has improved. Whereas the norm used to be more of an adversarial relationship between the board and shareholders, it is much more common now for boards to engage in an ongoing dialogue with shareholders. Management teams are increasingly, though still not commonly, asking for feedback on important issues in meetings with shareholders. These are all welcome improvements to which I can say I have been pleasantly surprised.

None of this is to say, however, that governance is suddenly outstanding. It would still be hard for me to give a grade of higher than B- to the companies I review.

In order to assess governance quality, I often conduct a thought experiment by which I imagine an “ideal” communication from the board. In that ideal, the board

wants nothing more than to provide me, as a shareholder, with the most relevant information in the most concise and digestible way possible. They will provide context and support materials when necessary, but they won't distract me from key issues. Out of respect for my time and my duty to clients, they will do everything possible to facilitate my decision making. Any result that deviates from this ideal reveals either incompetence or intentions other than faithfully representing me.

Clearly by this standard, many board communications fall far short. Normally it doesn't take long at all in reviewing a proxy statement to get a solid sense of whether the intention is to truly communicate, to obfuscate, or to abdicate responsibility by only exerting the least effort possible to comply with legal and regulatory requirements. Anything other than clear, concise communication suggests intent on the part of the board other than that of fulfilling its responsibility to shareholders.

That said, the one specific proxy decision for which I find the most deficient communication involves executive compensation. There is no doubt it is a complicated subject, but the key issues really aren't: Did the CEO do a good job? If so, what is the value of that good job to the company? If not, what is the value of a subpar job?

Many companies provide a litany of performance metrics without even the slightest mention of why particular thresholds were selected. Consultants contribute large frameworks with lots of variables. The only missing ingredient seems to be critical thinking -- why?

One particular aspect of CEO compensation that needs serious review is the concept of "at risk". At best it is a euphemism for getting paid more, at worst it is a deliberate attempt to rig the compensation game in favor of the CEO and at the expense of shareholders. To you and me, "at risk" means you get an incentive bonus if you do especially well. If you perform poorly, you're out of a job. "At risk" for CEOs allows huge upside but almost completely eliminates downside risk. Shareholders rightfully expect that awful performance that results in losses for them should entail the risk of loss for the CEO as well.

In general, the purpose of governance structures is to oversee executive decision making and risk management so as to allow managers to focus on day-to-day operations. When boards of directors not only allow, but endorse, such sloppy work, it sends a signal that there may be other things which are escaping their attention.

In summary, the proxy statement can provide a great deal of insight into a company's culture, power structure, and decision making processes. As such, it serves as something of a code book from which to decipher hidden messages in the company's communications. In doing so, it also provides a window into how value may ultimately get realized in the stock. This valuable guide can solve a lot of puzzles for those who are diligent enough to study it.

The invisible hand

One of the most frustrating situations for a stock analyst is when a stock moves against its fundamentals. Normally, markets are fairly efficient in discounting new

information. When they are, analysts who are close to their stocks usually have a pretty good feel for how a stock will react to news.

Sometimes, however, stocks don't behave so predictably and this has been happening more frequently lately. Increasingly, stock performance is moving against fundamental performance which is causing many analysts to scratch their heads. It seems like there is something else going on; it seems like some "invisible hand" is at work.

The truth is something less mystical but no less real. As momentum has pushed valuations to high extremes and Fed policy is evermore in the spotlight, the cost of capital is increasingly the marginal variable affecting prices. Since the cost of capital tends to move in very long cycles, it is all but "invisible" to an analyst following company moves from day to day.

As a valuation factor, the cost of capital is important for a few different reasons. First, it has a long-term and pervasive effect on valuation because it affects each year's cash flows. As a result, changes can have an enormous impact on a stock's valuation. Second, as mentioned, it tends to move in long cycles and thus can introduce a very significant "tailwind" or "headwind" to valuations.

The graph below from Applied Finance Group shows that the general trend in cost of capital has been downward ever since 1980. Not only has this produced cost of capital levels so low as to seem surreal, but

has created a massive tailwind for equity valuations over this time period.



This leads to a third reason why the cost of capital is so important: It is a risk factor that can be managed. The imminent threat of a reversal in trend combined with the large impact cost of capital can have on valuations suggests the distinct possibility of a new regime of higher and persistently rising cost of capital. This condition is like a coiled spring; once unleashed it can be quick and powerful.

Such conditions certainly warrant caution regarding equity exposure in general, but also suggest risk mitigation measures that can be taken on a security level basis. In fact, different business models and different patterns of cash flows have different sensitivities to a change in the cost of capital, much like long-term bonds are more sensitive to changing interest rates in the fixed income world.

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The types of companies that are most affected by rising capital costs are those with cash flow prospects far out into the future. Biotech stocks and internet startups are extremely sensitive. Large companies with relatively low costs of capital are also very sensitive to increases. Many of the attributes commonly associated with quality such as strong competitive

advantages and strong returns are also vulnerable because so much of their valuations are attributable to future cash flows. Companies that do or can monetize assets in a fairly short period of time tend to be less affected.

In summary, although beta (market exposure) chasing behavior has been well rewarded the last few years, the downward trend in the cost of capital which has facilitated these moves can't continue forever. As such, it is a good time to start managing the risks of change if you haven't already. For those oblivious or indifferent to the direction of the cost of capital, the invisible hand may well turn into the invisible fist.

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 forebearance 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.

