

ARETE INSIGHTS

Welcome

With all of the volatility we have seen in the markets the last several weeks, I thought it would make sense to dedicate this edition to sorting out some of the issues. I have heard a lot of commentary lately, as I am sure you have. Much of it is confusing, some is misleading. I'll do my best to cut through the noise and to provide something helpful.

First and foremost, I don't see the causes of recent volatility as new phenomena. This storm has been brewing and I have made mention of significant and underappreciated risks on several occasions over the past year and a half. We have known that US debt is unsustainably high. We have also known that the European Union has serious problems with sovereign debt. In light of these clearly serious problems, I am surprised stocks have performed as well as they have.

I also don't believe the wild volatility of the markets the last few weeks sheds any new light on underlying fundamentals. Water has been building up behind the dam for a long time. The only difference is that now it is starting to spill over the top. This is not to say, though, that recent price moves are entirely devoid of information content.

Pressure on stocks in one direction or another reflects motivations of the marginal buyer and seller. With most market indexes and their valuation metrics hitting highs this year, there has been no

reason to buy broadly on the basis of long-term value. Conversely, long-term value sellers have had plenty of chances this year to liquidate and most likely have done so well before August. As a result, we can infer that most recent trading activity has been motivated by short-term concerns.

This insight is useful in two respects. For one, because recent trades appear to be short-term oriented, they say virtually nothing new about long-term intrinsic values.

Also, trading volumes have been low, trending down, and seasonally low during the summer. In the context of low volumes, it is not at all uncommon that price swings become amplified. The bottom line is that the stock market as a whole probably overshot on the way down in 2009, overshot on the way up earlier this year, and is fairly valued somewhere in between.

I enjoy discussions like this because they highlight some of the strengths of Arete. One of those strengths is providing useful, objective perspectives. I think sharing professional knowledge in a clear and straightforward way is a core requirement for any fiduciary.

Indeed, studying and deriving useful insights is also one of the great benefits of what I do. I get to read a lot of research from some of the best minds around the world. The really good news is that there are a lot of extremely smart people thinking about excessive debt and other

issues and they share a lot of constructive and creative ways to address them.

On the other hand, one of the challenges I face is filtering out all of the commentary that is not useful. Unfortunately, there are also a lot of people who are not nearly so helpful (See Lessons from the Trenches). One of the reasons I founded Arete was because I thought there was an opportunity to better represent and better serve investors by always putting their interests first. I take great pride in doing so.

If you have questions or would like to follow up with anything I address, please always feel free to call or email. Also, if you know of anyone else who may be interested in my analysis, please also feel free to forward this letter to them.

Best regards,

David Robertson, CFA
CEO, Portfolio Manager

Insights

We spend a lot of time at Arete trying to understand exactly what risks we are taking when we invest money on behalf of our clients. In the process, we read and review a lot of research in order to arrive at an unbiased view. Because we are so singularly focused on acting in the best interests of our clients, we call it like we see it, even if that call may impede our ability to increase assets in the short term. It also means our perspective often differs from the commentary of many of our competitors.

As we see it, there are three big, global problems right now. We believe the

biggest one, and certainly most immediate for US investors, is the excess amount of debt carried by government and consumers. As Mohammed El-Erian, of PIMCO, describes succinctly, "It's all about balance sheets." Willem Buiter, Chief Economist for Citigroup, highlighted the degree of the problem at the CFA Annual Conference in Edinburgh, "US debt to GDP is around 130% if Fannie Mae and Freddie Mac are included." For context, Ken Rogoff and Carmen Reinhart identify 90% of debt to GDP as the approximate threshold at which debt becomes so burdensome as to meaningfully impede GDP growth in their book, *This Time is Different*.

Seth Klarman, from Baupost Group, aptly summarized conditions in his annual letter this year, "The national economy had grown dependent on our living beyond our means." John Mauldin describes it more colorfully, "The biggest bubble in history is the bubble of government debt. It is a bubble in a world full of pins." To be clear, this is not some obscure, economic blather. It is big, it is real, and it affects all of us. The potential consequences, in varying degrees, are lower asset prices and a lower standard of living.

Of course, this is not the first time countries have become burdened with debt. As a result, there is a wide array of experience and potential policy responses to consider for reducing the debt burden. The most direct option is to simply allow markets to operate freely by re-setting prices lower when and where prices are disconnected from economic reality. Other alternatives include inflation and financial repression (in the form of artificially suppressed interest rates). Unfortunately the outlook for careful consideration of the

pros and cons of each approach is not positive.

Despite the enormous significance of the debt problems, political and policy response has been abysmally lacking to date. Klarman describes, "The imagination of our financial leaders remains so shallow that their response to a crisis caused by overleverage and excess has been to recreate, as nearly as possible, the conditions that fomented it, as if the events of 2008 were a rogue wave of financial woe that can never recur." Ken Rogoff, professor of public policy and economics at Harvard, added in a recent FT article, "The biggest deficit is not in credit, but credibility."

So how will things play out? What do we expect to happen? Again, the news is not positive. El-Erian provides his outlook, "Nothing suggests any of this will be handled competently, let alone smoothly." Regarding the outlook for policy options, he adds, "We do not expect policymakers and politicians to show the resolve required to boldly address the structural problems that currently hamper the global economy." As a result, we likely end up with a world that, "heals slowly and unevenly, and remains structurally impaired."

Russell Napier, author of *Anatomy of the Bear*, corroborated these views at the CFA Annual Conference, "The politicians should attack these problems with interest rates, but they don't have the guts." Just to make sure there was no misunderstanding regarding his views on policy response, he added, "There is no end to the deviousness of a government on the verge of bankruptcy."

Very broadly, we see public policy significantly biased towards taking short-term benefits at the expense of long-term prosperity. In other words, current policy is antithetical to investing in our future. This policy direction is what we find most unnerving, and therefore risky, about the current environment.

There are ample precedents on which to base this concern. Jared Diamond, for example, rigorously studied various factors that contribute to the success and failure of different societies in his book, *Collapse*. According to Diamond, despite various factors that can affect any *particular* society, only one, "society's responses to its environmental problems—always proves significant."

It is important to understand that to date, we have been huge advocates of the vitality of the US economy and capital markets. We still are, and we remain very significantly invested in them. They aren't perfect, but they are very, very good.

A couple of things have changed recently though. One is that the magnitude and potential consequences of our current challenges are extremely serious. Further, we do not believe the seriousness of these challenges is appropriately discounted in market prices. Insofar as this is true, many people will likely have less for retirement than they think they do.

The second thing that has changed is public policy direction. It doesn't surprise us that our politicians are avoiding difficult problems. It absolutely concerns us that avoidance has continued for so long, even in light of such dire consequences. We do believe the US economy will pull through, but we will be watching policy responses

carefully as a guide for our path to recovery.

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.

Much like high quality raw materials are necessary to manufacture high quality products, so too is good information required for good investment results. As a result, an important part of our research effort at Arete focuses on filtering through the piles and piles of news, research, and data and refining it down to only the most useful elements.

It probably shouldn’t be too surprising that the most useful elements are not always those that make headlines in mainstream media. I heard a fascinating discussion of this phenomenon by Gillian Tett of the *Financial Times* at a presentation at the University of Baltimore about a year and half ago.

When Tett began reporting on US financial markets in 2004, she found, “there was a big discrepancy in how media was covering finance and what was happening.” Having

earned a Ph.D. in anthropology, she saw striking parallels with concepts outlined by French anthropologist/sociologist, Pierre Bourdieu (1930 - 2002).

Tett elaborated on Bourdieu’s ideas in a guest lecture at Princeton University in April 2010. Bourdieu believed that “an elite group [can] control society not just by controlling the physical means of production but also by influencing the cultural discourse. Crucially, influencing the way society talks about itself also influences what is left unsaid — i.e. that which is regarded as impolite, taboo, boring, or taken for granted.”

What is left unsaid creates a “social silence” that can be used to avoid difficult topics and can engender complicity. Tett believes, for example, social silence could have been an important factor in general acceptance of self-regulation of financial markets.

The influence of both what is discussed, as well as what is not discussed, shapes the “cognitive map” of a population. The recent discussion of the debt ceiling provides an excellent example. While the media focused on the rancorous debate and partisan politics, the hugely important policy issues of restructuring debt and improving job growth were conveniently “silenced.”

Since high grade information is enormously important to the manufacture of good investment results, we exercise great care in identifying pockets of social silence. This often allows us to “hear” things that other may not, with the goal of forming a more complete cognitive map.

To accomplish this, we implement several checks to ensure information quality. At the very least, we always leverage our experience with various information providers. We seek quality, sustained over time, and deliberately de-emphasize entertainment value (which often serves as a distraction). In addition, we vastly prefer providers who communicate clearly and honestly. The harder it is for us to understand them, and the more we have to adjust for their “spin,” the less valuable their services are to us.

Several other approaches also help to circumvent the limitations imposed on cognitive maps. For one, we seek multiple sources. As John Hussman, of the Hussman Funds, describes, “The only way to get at the ‘truth’ is to look for a convergence of signals that share common information components but whose ‘noise’ components aren’t terribly correlated with each other.” Multiple sources and multiple signals allow us to triangulate on important insights.

Closely related to the multiplicity of sources is diversity of those sources. Our goal is intellectual honesty and that is best achieved by finding sources and arguments that seriously challenge our own thinking and assumptions. Two of our primary media sources are based in the UK, *The Financial Times* and *The Economist*. In addition to being fantastic sources of information, both publications provide a perspective on US matters that is virtually unattainable for US-based publications.

Finally, part of the value of cognitive diversity is that it vastly increases the chances that a source may dare to be irreverent. Information or topics that are regarded as “impolite, taboo, boring, or

taken for granted,” in one cultural context, may be very fair game in another.

Corporate culture tends to have a lot of taboo topics which is why we generally prefer more independent sources. This is especially true of banks, investment companies, and other financial services firms. They have too much business riding on optimistic outlooks to allow much meaningful discussion of problems or challenges. It also explains why we get so much out of the CFA Annual Conference — because it’s not sponsored by a Wall Street firm which may have incentives to control the cognitive map.

Good information is important for any enterprise, and especially so for money management. In addition to providing insights into the underlying reality of investments, it also provides a clear view of the risks related to various investments. We spend a lot of time at Arete trying to understand the nature and magnitude of risks we take on behalf of our clients. Because we are so singularly focused on acting in their best interests, we want to be right. For that, we often need to explore what has been left unsaid.

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.

