

ARETE INSIGHTS

Welcome

Because I am an analyst at heart, I am better at providing a long list of things that Arete does differently from the mass of other investment offerings than I am at articulating a single idea that captures the essence. After a lot of consideration though, I have found the essential difference is that before all else, I am an investor.

What I mean by this is that Arete is purely and simply a representation of what I consider to be best practices for investing. My top priority has always been to generate superior investment returns.

Being the inquisitive sort, I wanted to better understand the source of this tendency. I believe it mostly derived from when I was growing up in Iowa. I had a problem in that I was ambitious and driven by intellectual challenge. I knew early on I probably had to go to college to fulfill my intellectual pursuits, but I also knew I probably couldn't afford it. For better or worse, I felt that doing nothing was a terrible option.

I worked all the odd jobs I could find, saved my money, did well in school, and through several scholarships, loans, work-study, and grants, I was able to attend Grinnell College. The education and experience made my life immeasurably better. This was my first really big investment, and it worked.

My investment experience since has been similar. My circumstances have largely been such that I could not afford to do nothing. Going nowhere was not an attractive option. Nor did I have the luxury of taking extravagant risks because I did not have a safety net to catch me if I fell. I have had opportunities though, and this is actually what Arete is all about.

Arete is about carefully managing risk and seizing attractive opportunities. It is designed to be extremely functional - to be long on things that actually help make investors better off, and short on costly peripheral items that do not. It was designed to be a very fair value. In short, it was designed as a solution to my investment problem. I believe it can serve as a solution for many others as well.

I never thought this "investment" attribute was particularly unique until I worked in some large, complex, investment organizations. What I found was that the possibility of making a great deal of money in the business attracted a great number of ambitious people. I also discovered that a good number of them did not know how to invest. Many of them even knew it, or at least suspected.

While there have been bad actors in the money management business, as in any other, the more pernicious truth is that there have been an lot of people getting paid quite a bit of money and not helping investors earn better returns. I don't believe these people are bad people, at all. I do think many of them have been

primarily motivated by preserving lucrative careers.

As a result, of the thousands and thousands of “professional” investors, many are not primarily motivated by, and capable of, producing superior investment returns. In this respect, Arete is quite clearly different. Neither I, nor Arete, has any vested interest in mediocre returns. The only way we get ahead is if our clients do.

Finally, since the Thanksgiving holiday is rapidly approaching, I would like to thank all of the people who read my letters and have spent some of their valuable time learning more about Arete Asset Management. I also would like extend special appreciation to Arete’s clients. Without your effort to learn about Arete, and ultimately to trust in me and in Arete’s mission, none of this would be possible. Thank you!

Best regards,

David Robertson, CFA
CEO, Portfolio Manager

Insights

We have been thinking a lot lately about professional trust. In short, there has been a great deal of “bad behavior” in the investment management business and it has markedly tainted the entire industry. In various ways, from excessive fees, poor transparency, avoidance or abrogation of fiduciary duty, individuals and organizations in the investment management business have taken advantage of the very people they are supposed to help. The full impact of such behavior is greater yet because it tarnishes

the industry and creates suspicion of everyone, including even the best actors. Suspicion prevents many investors from actively seeking the services they need.

In order to better understand the character of misdeeds, to better equip ourselves to avoid problems, and simply to satisfy our curiosity, we studied the nature of dishonesty in people. One of the best sources on the subject is *Predictably Irrational*, by Dan Ariely, who is one of the foremost experts in behavioral economics.

Ariely begins his investigation by differentiating forms of dishonesty. The first form is a deliberate and aggressive act such as an individual planning to rob a store and then executing the plan. Such acts are considered significant violations of social codes and typically receive harsh treatment in America’s penal system.

The second type of dishonesty is, “the kind committed by people who generally consider themselves honest.” These acts involve things like taking a pen from the supply closet, exaggerating an insurance claim, and the like. Such acts are fairly common and in some cultures, even rampant.

Through a series of clever experiments, Ariely revealed a great deal more about the nature of dishonesty. For example, he found, “when given the opportunity, many honest people will cheat. In fact, rather than finding that a few bad apples weighted the averages, we discovered that the majority of people cheated, and that they cheated just a little bit.”

He explains that people don’t become wildly dishonest because they fear violating social norms. Large-scale dishonesty would

surely invoke negative opinions from our peers which would be costly. “The problem is that our internal honesty monitor is active only when we contemplate big transgressions.” In other words, most mild acts of dishonesty fly under our ethics radar.

This is interesting, but what really is the harm of a few mild acts of dishonesty? For a baseline figure, Ariely reports a proxy for the cost of the first type of dishonesty. At the time of his study, “the total cost of all robberies in the United States was \$550 million.” In contrast, as a representation of the second type of dishonesty, “employees’ theft and fraud at the workplace are estimated at about \$600 billion.” In other words, the “mild” form of dishonesty costs the economy more than one thousand times as much as the “severe” form.

Those are the measurable costs. Perhaps even greater are the costs associated with erosion of professional trust. Originally, “individuals who had mastered esoteric knowledge, it was said, not only had a monopoly on the practice of that knowledge, but had an obligation to use their power wisely and honestly.”

However, in the 1960s, Ariely describes, cultural trends moved to deregulate professions in order to reduce elitism. While perhaps well-intended, the unfortunate outcome was that “strict professionalism was replaced by flexibility, individual judgment, the laws of commerce, and the urge for wealth, and with it disappeared the bedrock of ethics and values on which professions have been built.” Professionals felt freer to engage in

mild acts of dishonesty such as padding hours and inflating fees.

These trends were brought into perspective a couple of weeks ago when we heard Thomas Friedman speak. Friedman, the *New York Times* columnist and author of *The World is Flat*, was concerned that we (the U.S.) have lost our direction by trading “situational for sustainable values.” More specifically, he lamented, we have “underpriced risk, privatized gains, and socialized losses.” We believe too many CEOs, professionals, and other leaders have been the worst offenders.

To his great credit, Ariely does more than discuss research, he also offers several prescriptions. For example, he says,

“If we recognize this weakness [our ability to ‘bend’ reality to suit our self-interest], we can try to avoid such situations from the outset.”

“Another path [to honesty] is to first recognize that when we get into situations where our personal benefit stands in opposition to our moral standards, we are able to ‘bend’ reality, see

the world in terms compatible with our selfish interest, and become dishonest. What is the answer, then? If we recognize this weakness, we can try to avoid such situations from the outset.”

His suggestion of identifying and avoiding potential conflicts of interest sounds simple enough, but is itself subject to reality ‘bending’. After all, for those so motivated, what constitutes a conflict? Certainly, it might be argued, just because some activities are extremely profitable for a firm does not ensure such activities are not also valuable for its clients. One large financial firm provided an extreme example of this vulnerability when it “actively and

consciously embraced conflicts of interest”.

As readers of the latest *Arete Quarterly* know, one of the best ways to avoid decision making errors is to add perspective by applying the “outside view”. In other words, what works in other comparable situations?

This is exactly the approach we apply at Arete. We ask which situations could involve a conflict of interest, and then we challenge that further by asking where there may even be the *appearance* of a conflict. Then, to the extent possible, we structurally eliminate the possibility of conflicts. This is why we have no soft dollar arrangements, why we have a simple product and business model, and why we provide all clients full time visibility to all of their holdings.

We aren't going to claim we are more honest than everyone else. But we will claim that we try harder to understand human frailties in order to avoid behaviors that can cost clients a lot of money. This is the best way we know to restore professional trust, and perhaps even to replace situational with sustainable values.

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.

So many ideas and tips and experiences go into Arete’s research process that it is difficult to provide meaningful lessons without providing a great deal of context. I had the opportunity to do just that recently when I presented to an advanced finance class at the Johns Hopkins Carey Business School. Since these students had already covered accounting, finance, and investment theory, I had the luxury of jumping into some of the more interesting aspects of the process fairly quickly. I realize many *Insights* readers may not have the same background in financial theory, but I believe many of the lessons will be useful nonetheless.

In order to provide some context, it makes sense to reiterate Arete’s investment philosophy. In short, Arete’s research process is designed to find undervalued stocks. This is so important that we include it with each of our quarterly reports — everything else revolves around it. Alternatively, some investors pursue philosophies such as momentum trading and market timing.

Of course finding undervalued stocks only works when you have a way to accurately value stocks. Arete licenses a model from Applied Finance Group which is essentially a very long-term discounted cash flow model. Detailed discussion of the model would require an advanced finance class of its own and is well beyond the scope of this section. Suffice it to say, however, empirical evidence and finance theory both support the efficacy of the model.

There are many different ways in which stocks can be undervalued, but I normally begin analysis by running consensus expectations through the model. This allows me to see the economic profitability of the company, to see if return on investment (ROI) exceeds the cost of capital, and to see how ROIs are trending. Importantly, it provides me context from which to judge the quality of management. For example, if ROI is less than the cost of capital, efforts by the management team to grow company assets would result in destruction of value and would reflect a poor set of priorities.

It often happens that by simply plugging in consensus estimates to the model, I find a stock that appears undervalued. Often, this is just appearance. Frequently, the market may not believe the consensus estimates or it may be pricing in risk factors not captured by the estimates. Occasionally, though, for various reasons, the market just has something wrong. While this is very useful information, it also helps to have some understanding as to why the market may be wrong.

Because of the efficacy of the model, it also serves as a useful interpreter of market expectations. By creating combinations of inputs that generate a price target equal to current market price, I get a credible quantitative perspective of the market's expectations for fundamental variables. For example, based on some reasonable assumptions, I can often determine within a fairly narrow range the level of profitability the market is discounting for a firm. With this, I can then direct my research to confirm or disconfirm the market's expectations as viable.

Finally, by running various fundamental scenarios through the model, I can identify credible upside and downside risk to valuation. Of course that doesn't always mean market prices will obey, but they do provide a useful framework from which to better understand what can happen with the stock.

There is a lot of information conveyed by the market, but it is difficult to understand if you don't speak the language fluently. I spent nearly twenty years learning and practicing the language of valuation for various investment firms. Now, Arete can serve as an interpreter for both individuals and institutions who appreciate the value active management can provide them.

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.

