

# ARETE INSIGHTS

## Welcome

Shortly after I graduated from college, I had the good fortune of being able to stay with a good friend in Chicago while I looked for a job and started career. Coming from Iowa, the idea of living in the big city of Chicago was a daunting, but exciting prospect. I ended up having an extremely positive experience — largely due to the gracious efforts of my friend to serve as a “tour guide”. He went out of his way to show me the ropes of living in the landscape of a major metropolitan area.

When I hear people discuss their challenges with investing, I see many parallels with my experience in moving to Chicago. There is usually a lot of action and a lot of noise and it can be overwhelming. It’s easy to get distracted and to make mistakes. I think what many investors could really use is a good tour guide to help them navigate the investment landscape.

A good, native, guide can make a lot of things easier. For example, a guide can show you the bad areas of town to avoid. This is extremely helpful because seedy or dangerous areas don’t always look that way on a map or a guidebook. In the same vein, a guide can also sidestep the tourist traps. Plus, things change and a guide can keep you apprised.

In addition, a good tour guide can help distinguish real threats from perceived ones. For those people who don’t spend a lot of time in large, urban environments,

there are a lot of people and behaviors that will seem strange and unsettling. This is unfortunate because it prevents a lot of people from enjoying the many charms of the city as much as they could. A native can quickly distinguish between normal city behaviors and real threats.

On the positive side, a good tour guide can navigate ably and efficiently through the city to really showcase a city’s unique charms and to allow one to get the most out of the experience. By going to the iconic attractions at the right times, big crowds and long wait lines can be avoided. A good tour guide knows lots of little tidbits of history and landmarks that won’t show up on maps or in books. And finally, a good tour guide can show you where the locals go to eat, drink, and socialize — all of which capture the unique flavor of the city.

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Most investors do not “live” in the capital markets so investing really is a lot like being in a new city. There is a wide array of options for taking in the experience, and the best option for any particular person depends on what he or she wants to get out of it.

Investing with index funds, for example, is a very passive experience, like riding a bus on an expressway through the city. Sure, you get “exposed” to the city, but you miss out on a lot too. Buying a mutual fund might be more like a hop-on, hop-off bus tour of a city. These tours can give you a nice general impression of what a city is like, but are still fairly superficial.

In addition, visitors can always organize their own trip. This arrangement allows for greater flexibility, but also requires much greater effort and is fraught with risks. Almost everything is harder than it needs to be and it is all too easy to get lost while figuring out directions and paying attention to strange traffic patterns. It is also all too easy to end up somewhere you don't want to be, and to miss what you do want to see.

For those who are investing over a long time horizon (e.g., for retirement) and who want to learn and take things in along the way, there are surprisingly few good options. Many providers are accessible, but lack intimate knowledge of the terrain. Other providers have strong local knowledge, but distribute it only indirectly through "products". Very few bring the knowledge and expertise of reading piles and piles of 10ks and proxy statements and listening to conference calls and analyzing financial statements and other models — AND — can translate that expertise into insights and answers to help YOU.

When I moved to Chicago, I did take in all the major attractions, but I learned a lot more than just that. I also learned several safety lessons which gave me confidence to be in the city. I learned the rhythms of the city and how to get around. And I embraced all of the great neighborhoods and cultures and architecture that make cities like Chicago so dynamic. I enjoyed the experience so much that after having never spent more than a few hours in a major city, I have lived in one ever since.

Now, with Arete, I am trying to provide the same type of experience for investors. I want Arete to provide the type of experience that is far more than just a neat visit and more like the one I had in moving

to Chicago. I want Arete's investors to use me as a resource, to learn more about investing, and to learn about the great attractions in the mid cap universe. Hopefully, some will even develop the same lifelong appreciation I have. If you, or someone you know, ever has an interest, I would love to be able to show you around the landscape of mid cap stocks!

Best regards,

David Robertson, CFA  
CEO, Portfolio Manager

## Insights

Warren Buffett once said, "There is so much that's false and nutty in modern investing practice and modern investment banking . . . If you just reduced the nonsense, that's a goal you should reasonably hope for." Many investors intuit such nonsense; they feel they are not being well-served but are either resigned to the fact, don't know who is responsible, or don't know what to do. Where does the nonsense come from?

The short answers are growth and complexity. As the industry has grown and specialized, many behaviors and incentives have evolved which can subvert the goal of serving the best interest of investors. This is not to say that there is a lot of malicious intent; that is not the case. It is to say that industry and organizational structure are often more important than the intent of individual professionals in determining the value investors receive. We provide the following commentary as a brief guide of some potential problems to beware of in protecting your interests.

The investment process starts for many investors with a plan to diversify assets by allocating to various asset classes. For institutions this often done by a consultant; for individuals it is often done by a financial planner. From a very high level, the allocation exercise makes perfect sense since diversification can lower portfolio risk without any cost to return.

The challenges normally come with implementation. Too often, asset allocations represent a very narrow responsibility in the form of merely establishing *exposure* to asset classes. This exercise can fall short of fulfilling client investment needs in many ways.

First, during times of extremely high cross-correlations among assets, such as the one we are in now, asset allocation provides very little diversifying benefit. When this happens, it is critical to redouble and re-evaluate efforts to improve diversification and to communicate the diminished value of the exercise to clients. If this is not done, clients may be taking on much greater risk than they realize.

Second, entire asset classes can be overvalued or undervalued for significant periods of time. Without significant valuation expertise, historical perspective, and strong analysis, it is quite possible for the allocation exercise to fail a very simple criterion: to generate returns commensurate with risk for investors.

Third, many times asset allocation schemes are implemented with index funds and ETFs (exchange traded funds). While these

vehicles can provide cheap access to a wide variety of assets, there are risks to be aware of. Most importantly, many indexes are weighted by market capitalizations. In these cases, overvalued assets get overweighted and undervalued ones get underweighted. Strange but true, these indexes *systematically* favor the least attractive investments. As long as new money pours into the same investment vehicles or asset types, their performance looks great. Once it leaves, look out: think NASDAQ 2000-2002.

Finally, the asset allocation exercise represents valuable real estate in the chain of communication with clients. Most clients prefer to work with one vendor and the asset allocator is in the best position to be the single contact. That position gives the allocator the ability to act as gatekeeper for all of the other managers.

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Many allocators take advantage of this role by emphasizing in-house, proprietary funds, by charging a toll on other providers for the privilege of gaining access to *their* clients, or by excluding access to a wide swath of managers altogether. Each activity happens at the expense of making the very best funds available to investors.

Investment managers, as a group, are no less guilty of perpetrating their own nonsense. Many managers, acutely aware that many clients, including asset allocators, are watching over their shoulder every day, become slavishly beholden to relative performance. As a result, many managers are more interested in guessing what other people are going to be buying tomorrow, rather than doing the real work

of figuring out what an investment is worth today. Effectively, managers subject themselves to a “game” of running short sprints when their ultimate investors want them to compete in the marathon.

This behavior is exacerbated by the fact the many performance bonuses are paid on an annual and even a quarterly basis. These periods are ridiculously short for most investors. Further, because so many analysts and portfolio managers are so far removed from their clients, often never meeting them, the idea of serving a client is an abstraction that does not motivate them.

It may seem odd to claim that for all of the knowledge and expertise in the investment management industry, the job of ensuring that clients end up with investments that leave them better off too often falls through the cracks. Yet it was our own encounters with such nonsense that led to the creation of Arete. Indeed, we continue to hear from other analysts and portfolio managers who corroborate our experiences that misspent resources and perverse incentives often prevent investors from deriving as much benefit from the process as they should. While many larger firms do have “superior access to resources”, too often those resources fail to generate incremental benefit for investors.

Arete was formed with the intent of providing an accessible alternative to much of the nonsense. In particular, we focus on creating a portfolio of investments and communicating our insights so as to improve the welfare of our clients. We believe this is a simple proposition most investors want, need, deserve – and too often cannot find elsewhere.

## 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. “Lessons from the Trenches” highlights 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.

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One of the many great aspects of investing in mid cap stocks is that there are so many interesting and growing businesses to learn about. In fact, we regularly run a screen of all US stocks with market caps between \$1B and \$20B (which produces about 1,500 companies) and we regularly review *Value Line* statements in order to stay apprised of the landscape.

In a recent review of *Value Line*, we looked through the food processing industry for ideas. In particular, we were wondering if we could find stable, defensive, dividend-paying companies that were still cheap. One company, Sensient Technologies (ticker SXT), stood out for the stability of its cash flows over time so we proceeded to qualify this idea with our valuation work.

We normally employ our valuation tools fairly early in the research process for a couple of reasons. First, the exercise gives us an idea as to whether valuation appears so compelling as to warrant accelerating the process, or whether it can be relegated to the “bullpen” and investigated more thoroughly later. Second, our valuation analysis allows us to identify the strategic

priorities of companies very clearly — which has profound implications for where and how the company's management should be trying to create value. This, in turn, allows us to prioritize research objectives quickly and efficiently.

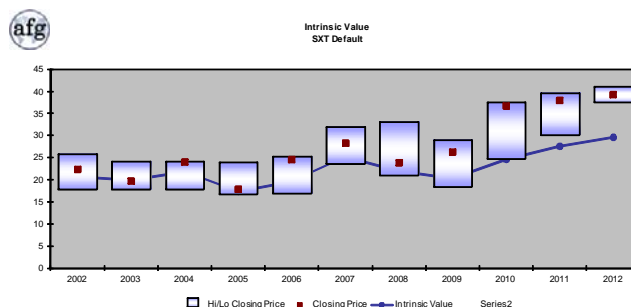
By way of background, we license the valuation model from Applied Finance Group (AFG). This particular model is essentially a very sophisticated discounted cash flow model. The great advantage of the model is that it makes a wide array of adjustments to reported accounting numbers such as earnings and capital so as to better reflect economic reality. The model has consistently outperformed competing approaches in accurately representing value over time.

As we often do, we started the valuation exercise by running current consensus estimates through the model. In addition, we reviewed several other financial numbers and relationships and made adjustments so as to most accurately reflect the performance of the business.

The result can be seen in the screenshot below. We found a very strong relationship between the warranted value of SXT (based on discounted cash flows and indicated by the dotted blue line) and its historical stock performance (indicated by the hi-lo-close bars). This result is testament to both the regularity of SXT's financial performance and to the incredibly powerful ability of the AFG model to capture economic reality.

The feature that really stood out to us was the divergence in the trajectories of warranted value and market prices beginning in 2010. Normally when peculiarities like this arise they signify the

need for further modifications to properly represent the business. In this case, we thoroughly reviewed our work and couldn't find any opportunities to improve the quality of the inputs.

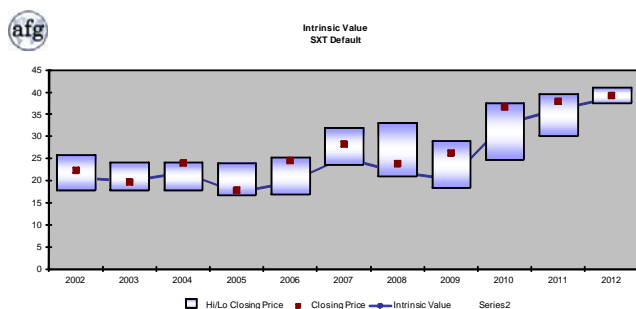


Why did SXT prices maintain such a tight relationship with warranted values for so many years and then break that relationship in 2010? One of the rewarding aspects of using a great model is that it allows the testing of a variety of "what if" scenarios.

In this case, we decided to test a hypothesis. When Bernanke first discussed quantitative easing in August 2010, the promise of low interest rates created a real challenge for savers and investors which induced incremental demand for safe, stable, dividend-paying stocks. What if that incremental liquidity did not help the entire market, but rather only a certain subset of stocks? We tested our hypothesis by reducing the cost of capital for SXT by 200 basis points beginning in 2010. The result is shown on the next page.

The model fits the price action with remarkable accuracy. While this is only anecdotal evidence, it provides some incredibly useful insight to market conditions. The SXT model suggests that the stock's price is artificially inflated due to monetary intervention. Insofar as this is the case, the implication is that SXT stock

price is at risk as soon as monetary policy changes or investors have reason to refocus on investments with better long-term return potential.



We aren't good at figuring out when trends begin and are even worse at guessing when they will end. What we are very good at doing, however, is figuring out what stocks are worth and buying them when they look exceptionally cheap. We will miss fads and busts, but we invest our clients' money in assets that make sense and with a long-term horizon. Rigorously applying the AFG valuation model is one of many tools we use to accomplish that goal.

## 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.

