

# ARETE INSIGHTS

## Welcome

One of the debates that most investors confront at some point is whether to pursue active or passive investing. As an investor myself, I have always been fascinated by the tradeoffs in seeking to do the best I can with what I have. In this pursuit, I have come to see the active/passive decision significantly influenced by two under-reported factors: 1) Understanding and appreciating the symbiotic relationship between active and passive investing, and 2) Understanding and managing one's emotions relative to these decisions.

A recent article in the *Financial Times* highlights the symbiotic relationship nicely. In "Passive parasites do not cure all financial ills," David Smith describes that, "Passive management is, inevitably, a parasitic industry ... and every smart parasite knows a healthy host is crucial." He elaborates, and accurately in my opinion, that passive investing works best when the markets are broadly efficient.

This insight introduces the notion that the active/passive decision is not a black and white, either/or decision. Rather, it is contingent on the health of the market. In turn, the market's "health" is determined by the concentration and diversity of active investors. When there are a lot of different investors, none of which holds commanding positions in the market, buying and selling, haggling over prices,

those prices tend to be fairly accurate representations of underlying value. This creates an attractive environment for passive investing.

Conversely, when market diversity breaks down and becomes dominated by similar strategies, prices can drift far, far away from their intrinsic values. As assets under management of index funds and exchange-traded funds (ETFs) have exploded over the last several years, it is distinctly possible this has occurred. Somewhat ironically, the great success of passive investing may be sowing the seeds of its own destruction.

The balance, or lack thereof, in the market's ecosystem is also affected by behavioral tendencies. As Smith describes in his article, "Humans mostly suffer the same behavioral biases, so they compound each other rather than offset each other." So as indexes go up, they attract more interest, and on and on ... until something bad happens. At the end of the day, passive investing is a good idea, but in moderation.

The behavioral dynamic is one that influences the active/passive debate in another interesting way. In "Hello passive, goodbye active: fund investors make the switch" (*Financial Times*), Owen Walker describes "The trend for savers to turn their backs on active funds and favour low-cost passive investment funds is mainly due to feelings of dissatisfaction with active fund managers."

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While I wouldn't be surprised if much of this dissatisfaction was well deserved, there are some very interesting insights into that dissatisfaction. Walker reports, "Another advantage that passive products have over their active counterparts is they do not attract the same feelings of blame from unfortunate investors. In a recent study ... academics at the University of Southern California found that investors are far more likely to blame and pull out of active funds following poor performance than with passive funds."

Really! Now that sounds to me like there are some serious trust issues between investors and active managers — and I'm sure that's the case in many instances. Nonetheless, it also suggests that many investors are much more willing to accept losses in index funds than in active funds. Of course anywhere there is potential for investors to willingly accept losses, Wall Street can't be far behind. I have no doubts this at least partly explains the wild proliferation of index funds.

In summary, both passive and active investing can make sense depending on one's particular circumstances, the balance between passive and active management in the market, and one's level of trust with his or her manager. Given the prominent levels of passively managed assets, I suspect the scales will be tipped toward active management for some time.

If you decide to pursue active investing, though, it is very important to develop a strong relationship of trust. If an active manager does not provide substantial disclosure and transparency and is not easy to work with, it will be hard to maintain trust in the tough times (which will always happen).

Finally, the industry and the market constantly change and adapt. Arete was formed to lead change by creating a better package of active management for investors. If you are disappointed with a manager, but still believe in the prospect for active management, or are increasingly leery of index funds, please let me know. I suspect you may be surprised by how much more you can get.

Best regards,

David Robertson, CFA  
CEO, Portfolio Manager

## Insights

Every once in a while a big transformation occurs that disrupts old ways of doing things and demands new ways of thinking. Right before the millennium the internet was the big story. The story of information and mobility has dovetailed into one of power being disrupted across the world. More specifically: Size is rapidly losing its prominence as a key determinant of power.

The dimension of size was discussed in the [Q1 13 edition of \*The Arete Quarterly\*](#) with the illustration of "generals fighting the last war". It is afforded much greater attention in Moises Naim's new book, *The End of Power: From Boardrooms to Battlefields and Churches to States, Why Being in Charge Isn't What it Used to Be*. As Naim describes, "Power ... is undergoing a historic and world-changing transformation."

Size became equated with power for good reasons. Early businesses, for example, were typically very small and specialized. As such, they typically paid a relatively

high percentage of revenues for materials and for skilled job functions.

As Naim points out, “High transaction costs create strong incentives to bring critical activities ... inside the organization.” Size brought an ability to reduce transaction costs as well as to increase professional management (managers, marketers, accountants, etc.). For a long time, size became a virtuous cycle: Get bigger and proportional costs come down. Lower costs allow one to gain share and get bigger. All the while, this cycle progressively increases barriers to entry making it that much more difficult to be challenged.

Size has been especially influential in shaping the investment business. Because many costs are essentially fixed for an investment firm, their proportions become much smaller as assets grow. This created a mandate at many firms to do just that: Grow assets. In times of high commission costs, high computing costs, high data costs, high communications costs, high back office costs, and high marketing costs, it made sense to bring these functions in house and to amortize them over a large base.

There have always been challenges to size, though, and especially in the investment business. It is well documented that performance benefits tend to diminish rapidly with size. Further, smaller firms tend to have proprietors with more skin in the game and who care a great deal more about the performance of their clients.

In addition, times have changed – a lot. Now the costs of commissions, computing, data, communications, back office, and

marketing in most cases are tiny fractions of what they used to be. Technology has dramatically changed the economics of the investment business, vastly mitigating the economic justification for size.

Technology has changed much more than just the investment business; it has changed almost every facet of our lives. “Today ... what is changing the world has less to do with the competition between megaplayers than with the rise of micro powers and their ability to challenge megaplayers.” This ability to challenge has been wrought partly because technology reduces barriers to entry.

Importantly too though, technology also provides the tools by which to express discontent. Whether an underclass is frustrated with a political regime or a customer has had a bad experience with a product or service, it’s never been easier to get the word out on a global scale. The tides have changed and large players have never been so vulnerable.

Despite the countervailing evidence from virtually every part of our lives, many people still cling to equating size with power. While nostalgia and habit are likely factors behind this inertia, an objective assessment must also consider the advantages of being smaller. At the end of the day, the internet and digital revolutions are making things cheaper, better, and faster. This is absolutely true in the investment world and will be a great boon for those willing to consider smaller players that are trying to pass on these benefits to their investors.

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## 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 most sensitive variables in any long-term discounted cash flow model is the discount rate or cost of capital. This is so because it affects the calculations for each time period and therefore has a compounding effect.

Despite the critical importance of cost of capital to a valuation assessment, it is too often given inadequate consideration. Sometimes models employ formulaic derivations for the discount rate that have little resemblance to the real world. Sometimes cost of capital estimates are glossed over because they are so hard to quantify. Regardless, it's not uncommon for this critical variable to be wildly off the mark.

Arete addresses these important issues through its implementation of a long-term discounted cash flow valuation model licensed from the Applied Finance Group (AFG). AFG uses a market-derived cost of capital estimate which captures changes as the market moves. In this way, it avoids the risk inherent to static models of being slow to incorporate market changes and ultimately being seriously off the mark.

In order to provide greater insight into the cost of capital, it is also useful to consider different scenarios. Since stocks are long-term investments, it is likely that at some point over the life of the investment, capital costs will be different, and perhaps very different. This process was illustrated in the [Q1 12 edition of Arete Insights](#).

Henny Sender highlighted a very similar process in her article, "Fed's easy money has reined in M&A animal spirits," for the *Financial Times*. In it, she notes that the private equity world very explicitly incorporates the possibility of changing capital costs over the life of their investments:

"For some potential masters of the universe, the problem is precisely the artificially low cost of debt - despite almost \$1tn of dry powder. Every Monday, for example, when the private equity firms hold their weekly investment meetings and consider potential deals, one of the first data points they look at is where the 10-year rate is and where it will be in five years' time when the life cycle of private equity funds dictates that it is time to let go of companies bought now."

Not only does private equity address the potential for a change in cost of capital, but many important participants seem to view the likely change as an increase. "'Nobody wants to bet the ranch now because where the Fed is setting the 10-year today isn't going to be where the market sets it in the future,' says the head of buyouts at one important private equity company. 'Since I don't know what the long-term cost of capital is, I have to be conservative.'" In addition, another acclaimed private equity investor, Leon

Black, recently stated that his firm is "Selling everything that isn't nailed down."

Wow - very interesting! On one hand public markets are essentially saying that things have never looked so good and that the cost of capital may even decline from here. On the other, very accomplished private equity investors are more focused on selling than on buying.

While the theory of cost of capital is taught in every finance and investments textbook, the real world application often gets shortchanged. The fact is that capital markets have benefited from over thirty years of tailwinds from a declining cost of capital. Not only is this not likely to continue, but when the cost of capital starts rising, valuations may be severely impaired. Either way, it makes sense to consider the possibilities and one's exposure to 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."

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.

