

# THE ARETE QUARTERLY

## Welcome

As a continued reminder, the text content of this and future editions will be considerably shorter than in past letters. This change will allow the *Arete Quarterly* to be more focused on portfolio analysis and will also facilitate much more regular publication of general commentary through the Arete blog. If you haven't visited [www.areteteam.com/blog](http://www.areteteam.com/blog) yet, please take a look when you get a chance.

## Business Update

First and foremost, I'm extremely pleased to announce the official launch of Arete's personalized CIO (chief investment officer) service! This service combines our approach of helping investors to invest better with what we see as a gaping hole in investment services: personal access to high level investment expertise.

I've noted many times in the past that despite experiencing an exceptionally difficult environment for active management over the last several years, we have remained focused on continuing to do good research and finding ways to help investors. These efforts spawned the Arete Research Wiki among other things. Although the wiki did not end up being as helpful to investors as I had hoped, I did find that the wiki format was enormously useful for managing information internally and set us on a path for much better knowledge management.

### Inside This Issue

Welcome	1
Business Update	1
Portfolio Characteristics	2
Transactions Review	4
Performance Review	4
Investment Philosophy	5
Arete Mid Cap Core Composite	7

I also gained some additional insights into the delivery of investment services from this exercise. For certain, I became more convinced, not less, that investors need something that largely does not exist yet in the current services landscape. A big part of that something, I believe, is greater interaction regarding high level investment issues and strategy.

Because so much investment information is delivered through a "broadcast" model, investors have precious few opportunities to follow up, question, or challenge statements. In addition, broadcast messages too often incorporate a narrative that fulfills a corporate objective, omits important details or possibilities, or avoids a thorough disclosure of underlying assumptions. In short, while investors have access to lots of information, it can be hard to put that information into context.

What would really help, it seems, is a way to better link high level investment insights with an investor's particular situation. Surprisingly, people have access to doctors and lawyers in the fields of healthcare and law for exactly these purposes. We should have access to this common and useful

functionality for investing too. If you, or someone you know might have an interest, please take a look here [[link](#)] for more information. I'd love to hear what you think!

I also wanted to mention that I moved Arete's office space in the first quarter to the Betamore facility at 1111 Light St. For those unfamiliar with it, Betamore is a technology incubator that also has community space for solo entrepreneurs and freelancers. While I also work out of the home office, maintain records there, and use that as Arete's official mailing address, you can find me at Betamore a good chunk of the time.

In addition to being a wonderful space in which to work, Betamore offers a lot of networking and education opportunities, and provides a friendly and dynamic environment in which many answers are just a brief conversation away. It also engenders the concepts of community and collaboration in a way that is sorely needed in the investment business. As Arete's business has evolved, these characteristics have become increasingly important.

Thanks for your interest and take care!

David Robertson, CFA  
CEO, Portfolio Manager

## Portfolio Characteristics – Arete Mid Cap Core

A key proposition for Arete's Mid Cap Core strategy is that it is a truly representative mid cap portfolio. In general, this suggests that over time, you can expect to see the aggregate characteristics and sector

exposures of the strategy migrate to those of the Russell Midcap Index®. During intervening periods, however, sector exposures and other characteristics will reflect the opportunities we find in the market at that point in time.

We believe maintaining a truly representative mid cap portfolio is important for two reasons. First, a truly mid cap portfolio faithfully plays its role in a broader asset allocation scheme. Second, it allows for accurate assessment of performance. Without an appropriate benchmark it is difficult, if not impossible, to judge whether performance differentials are due to skill or luck, and are sustainable or transient.

For example, many fund managers attempt to beat their benchmark by timing the market and/or migrating style. These tactics rarely generate sustainable out-performance. To us, such activities usually just serve to obfuscate the underlying inability of the manager to add value through a coherent and disciplined investment process.

All of that said, our overarching goal is to provide attractive returns to investors on an *absolute* basis. During most times, the stock market provides an attractive vehicle through which to realize those returns. In unique periods of significant overvaluation, however, when our valuation and other analyses suggest attractive returns are less likely, we may allow the cash portion of the portfolio to increase so as to preserve investors' capital and retain the option to buy cheaper in the future.

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Portfolio characteristics for the quarter continue to confirm that the equity portion of AMCC is a very representative mid cap portfolio. Market caps for AMCC are fairly similar to the mid cap index although the median is now considerably smaller. AMCC is considerably cheaper on the bases of Price-book and Price-sales which tend to be more stable metrics. Notably, Price-book still compares well despite a substantial rise from the inclusion of an anomalously high figure from GLPI.

#### Portfolio Characteristics (3/31/15)

	Arete MCC*	Midcap Index**
<u>Size</u>		
Average Market Cap (\$ mil.)	8,101	8,739
Median Market Cap (\$ mil.)	4,309	6,531
Minimum Market Cap (\$ mil.)	74	212
Maximum Market Cap (\$ mil.)***	28,905	37,257
Number of holdings	26	840
<u>Valuation</u>		
P/E current year	23.4	23.7
P/E forecast Y1	21.0	21.2
P/B	2.6	4.8
P/S	1.6	1.9
Yield (%)	1.8	2.5
<u>Valuation drivers</u>		
ROE (%)****	12.5	12.8
LT eps growth forecast (%)	10.2	11.5

Source: The Applied Finance Group™

\*Note: Excludes positions which are less than 0.1% weights.

\*\*Note: Arete currently does not subscribe to the Russell Indexes and therefore the statistics presented here represent approximations of the Russell Midcap® Index.

\*\*\*Note: Stocks with low floats are excluded

\*\*\*\*Note: The measure of ROE was changed from the average to the median as of 3/31/14.

As a note, we changed the calculation of ROE from an average to a median some time ago. As it was, this particular measure was volatile and provided little information content. Indeed, as the markets have run

up under the Fed's policy of quantitative easing, the benchmark's average ROE has become increasingly biased by a relatively small number of extremely high returns.

#### Sector exposure (percent of assets on 3/31/15)

Economic sector***	Arete MCC*	Midcap Index**	Percentage Comparison
Consumer Discretionary	3.8	17.2	22.0%
Consumer Staples	0.0	5.8	0.0%
Energy	0.1	4.2	2.4%
Financials	18.9	20.8	90.7%
Health Care	7.6	12.6	60.5%
Industrials	5.5	12.7	43.4%
Information Technology	6.7	14.8	45.3%
Materials	2.4	5.6	42.6%
Telecommunications	0.0	0.7	0.0%
Utilities	3.0	5.6	53.4%
Equity exposure	48.0	100.0	
Cash and equivalent	52.0	0.0	

Source: The Applied Finance Group™

\*Note: Arete Mid Cap Core is represented by the aggregate of all assets in the composite at the given date.

\*\*Note: Arete currently does not subscribe to the Russell Indexes and therefore the sector weights presented here represent approximations of the Russell Midcap® Index.

\*\*\*Note: Economic sector classifications were changed from Russell to GICS beginning Q414.

Sector exposures are all below benchmark weights due to the high cash position. As we have continued to raise cash, partly through sales of overvalued positions, and partly by not redeploying cash from acquisitions, several sectors are now below our normal guidelines of 50% - 150% of benchmark weights.

#### Active share\* (3/31/15)

Period	Percent**
Q115	94.2
Q414	93.5
Q314	93.1
Q214	94.1
Q114	93.5

\*Note: Computed for AMCC composite

\*\*Note: Active share > 80% is considered "very active"

As a quick reminder, active share highlights the degree to which a portfolio's holdings

differ from its benchmark. A portfolio must differ significantly from its benchmark in order to significantly outperform it – and therefore to justify charging active management fees. Arete's Mid Cap Core portfolio consistently exhibits active share well above the 80% level considered to be very active.

## Transactions review – Arete Mid Cap Core

The positions in XEL and POM were sold after a very good year in general for utilities in 2014. Both stocks have provided decent income and appreciation but became fairly expensive. Indeed, POM was sold within a few cents of its acquisition offer from EXC despite hurdles remaining to complete the deal. Further, at these levels, the downside risk to valuations from rising rates significantly outweighs future upside potential. As we have done with other dispositions, we will wait until we find purchase opportunities that provide attractive returns to deploy the cash.

In addition, we sold the remaining position in TOL during the quarter. The stock continued to rise despite deterioration in a number of home building indicators. As a result, we were more than happy to take advantage of this paradox as an attractive opportunity to complete the exit.

## Performance review – Arete Mid Cap Core

The Arete Mid Cap Core product is designed with the flexibility to invest in the most attractive mid cap stocks, regardless of any

particular “style” designation. With that context, the primary criterion for selecting a stock in the Mid Cap Core strategy is that market value is significantly less than our estimate of intrinsic value. In other words, we try to find situations in which our research generates expectations for a company's growth and profitability that justify substantially greater valuations than what the market discounts.

Our investment process is designed to discover, analyze, and assemble stocks into a diversified portfolio that consistently outperforms its benchmark over time. Specifically, our investment objective is to outperform the benchmark Russell Midcap® Index by 200-400 basis points per year, net of fees, over the course of a market cycle.

Our target of 200-400 basis points of outperformance is based upon our experience with the strategy and upon our judgment of value creation. Our goal is to outperform by a large enough margin relative to risk to clearly merit the cost in time and resources to evaluate investing with us.

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Arete's Mid Cap Core (AMCC) strategy returned 0.53% (net of fees) for the quarter versus 3.95% for the Russell Midcap Index® (RMC) (see pages 8 - 10 for performance and related disclosures). Once again, the portfolio simply could not keep up with the midcap index when it posted exceptionally strong returns in February but it did perform comparably to the S&P 500 through the first quarter.

Top performers for the quarter reflect an environment in which value ideas are starting to work again. ITG which long

suffered from declining trade volumes after the financial crisis, has nonetheless continued to generate cash and is now benefiting from operational leverage as both volume and volatility have been picking up. GLPI got a boost when it announced a hostile offer for PNK which demonstrated both opportunism as well as the potential for the REIT model for gaming assets.

#### **Stock performance\*** (12/31/14 - 3/31/15)

##### **Best performers**

Company	Return in quarter (%)
Investment Technology Group	45.6
Gaming & Leisure Properties	25.7
Sears Holdings	25.5
Spirit Aerosystems	21.3
Amdocs	16.6

##### **Worst performers**

Company	Return in quarter (%)
Dex Media	-53.3
Peabody Energy	-36.4
Lands End	-33.5
Seagate Technology	-21.8
Genworth Financial	-14.0

\*Note: Performance includes price changes only; it does not include dividend income in the quarter.

DOX has been a very steady performer for a long time, but the other top two performers, SHLD and SPR have frequently been on the bottom performer list. SHLD announced plans to form a REIT which should increasingly demonstrate the underlying value of its real estate assets and also alleviate short term concerns about its retail operations. SPR is recovering nicely under its new management team and is finally starting to generate the type of profitability it ought to as such a key supplier to Boeing.

Interestingly, the bottom performers seemed to be driven more by macro trends and momentum than by company specific developments. Both DXM and BTU have been clobbered ever since high yield spreads started increasing last summer despite making good headway with operational improvements. STX shares were under pressure from the beginning of the year based on increasing concerns about GDP growth in general and lower PC growth in particular. The decline in GNW was not large and seems to be related more to uncertainty than anything else: Until more specific plans coalesce for its long-term care business, the stock will be unattractive to a large swath of investors.

In contrast, the poor performance of LE can be traced directly to company specific events. Poor results for the important holiday quarter were pre-announced in January and were attributed to currency headwinds and poor performance of their cold weather apparel.

## Investment Philosophy

We firmly believe in the critical importance of a cogent investment philosophy for any investment operation. In order to emphasize this point, and to assist you in understanding how we work, we provide an abbreviated version of our investment philosophy here. The text of our investment philosophy is also provided, in its entirety, in our Form ADV, Part II which is available upon request at any time.

**Performance derives from exploiting mispriced securities.**

The key to investment performance is finding and exploiting market inefficiencies

in the form of mispriced securities. There are two components to this. One component involves determining the fair price of securities in the form of underlying intrinsic value, which we do primarily through calculating discounted cash flows.

The second component of exploiting mispriced securities is establishing a clear understanding as to the various mechanisms at work that allow mispricing to occur. By understanding the mechanisms and motivations of the marginal buyer and seller, we believe we can more accurately estimate the probabilities and expected values of investment opportunities.

#### **Nobody has perfect information.**

Competitive pressure and technological development have conspired over the years to make most data and analysis commodities which no longer provide a meaningful competitive advantage. What can provide an advantage, however, is *how* that information is used and *how* it gets interpreted in making investment decisions.

In order to convert the raw material of information into the useful output of a good investment decision, it is necessary to assimilate and synthesize the information into some meaningful form. We believe the most effective way to accomplish this is to thoughtfully deploy resources available according to the nature of the research tasks at hand.

Research culture and research prioritization are also important in relation to analyzing and synthesizing information. We believe that the best way to leverage the collective knowledge and experience of a research team is to encourage active and open dialogue designed to explore multiple

perspectives and to challenge individual assumptions, biases, and beliefs. Only by enduring such scrutiny do the best ideas rise to the top. Further, in order to fully leverage these ideas, we believe research efforts must be dynamic and flexible in allocating resources such that ideas receive attention in proportion to the expected benefit to the portfolio.

#### **Execution is crucial for investment success.**

In order to create value, an investment strategy needs to be implemented continuously and comprehensively. Actions speak louder than words. We believe the most effective efforts focus on a few simple, but key concepts that work to ensure proper execution of a firm's investment strategy.

The first key to execution is structural in nature and involves a firm's independence. By maintaining independent ownership, an investment firm eliminates agency effects which can present a conflict of interest between clients and certain of its ownership groups. Independent ownership ensures that client and manager interests are optimally aligned.

The second key to execution is temperament. The best investors tend to have a temperament that provides them the courage and initiative to act, often going against the grain, when opportunities arise. However, the same temperament provides balance such that decision-making is not simply a risk-taking activity, but a very conscious and targeted effort to engage in propositions with high risk-adjusted expected returns.

Finally, another important element of execution is simply doing what you say you do in your investment process. Too often, perfectly acceptable investment processes fail when actual investment activities bear little resemblance to the process described

in the marketing presentation. We call this the “marketing gap;” the difference between what is said and what is done. Execution is optimized when the marketing gap is minimized.

## Arete Mid Cap Core Composite

**Arete Asset Management, LLC**  
**Mid Cap Core Composite**  
**July 31, 2008 - March 31, 2015**

Period	Russell Midcap®			Number of Portfolios	Internal Dispersion (percent)	Total Composite Assets (\$)	Composite Assets With Bundled Fees (\$)	Percentage of Composite Assets With Bundled Fees	Total Firm Assets (\$)
	Gross-of-Fees Return (percent)	Net-of-Fees Return (percent)	Index Return (percent)						
2008*	-37.97	-38.16	-35.01	3	NA	207,031	207,031	100%	207,031
2009	48.63	47.83	40.48	3	NA	471,867	471,867	100%	673,806
2010	16.86	15.78	25.48	3	NA	546,315	546,315	100%	877,368
2011	-8.20	-8.88	-1.55	3	NA	497,767	497,767	100%	897,918
2012	15.20	13.84	17.28	4	NA	798,766	798,766	100%	897,341
2013	23.18	22.00	34.76	4	NA	974,605	974,605	100%	1,172,496
2014	4.01	2.99	13.22	4	NA	1,003,729	1,003,729	100%	1,200,564
2015									
January	-2.61	-2.61	-1.56	4	NA	977,504	977,504	100%	1,171,544
February	3.22	2.98	5.54	4	NA	1,006,595	1,006,595	100%	1,202,192
March	0.25	0.25	0.06	4	NA	1,009,084	1,009,084	100%	1,307,153
Q1	0.78	0.53	3.95	4	NA	1,009,084	1,009,084	100%	1,307,153
YTD	0.78	0.53	3.95	4	NA	1,009,084	1,009,084	100%	1,307,153

\*Note: Performance through 12/31/08 is from inception of composite on 7/31/08.

**Arete Asset Management Mid Cap Core performance composite disclosures follow:**

### Compliance statement

Arete Asset Management has prepared and presented this report in compliance with the Global Investment Performance Standards (GIPS®).

### Definition of the firm

Arete Asset Management, LLC (Arete) was established in 2008 and is registered as an investment adviser in the state of Maryland. Arete is defined as an independent investment management firm and is not affiliated with any parent organization. Arete currently manages one strategy, the U.S. equity mid cap core strategy, which it markets to individual and institutional clients.

Arete Asset Management Mid Cap Core performance composite disclosures continued:

### **Benchmark**

The benchmark is the Russell Midcap® Index and its performance is reported in U.S. dollars.

### **Calculation methodology**

Portfolio valuations are calculated as of calendar month-end and are computed in U.S. dollars and performance is also reported in U.S. dollars. Time-weighted rates of return are used which adjust for external cash flows. Our smaller, retail accounts contain fee structures in which one flat, per-transaction fee is charged for trading expenses and which embeds an implicit charge for custody. Since trading and custody charges cannot be directly segregated in these cases, they constitute “bundled fees”. Gross-of-fees performance returns are presented before management and custodial fees when custodial fees can be segregated from trading, but are presented before management fees and after bundled (trading and custodial) expenses for our retail accounts. Net-of-fees returns are presented after management fees, trading expenses, and custodial expenses are deducted or after management fees and bundled (trading and custodial) fees for retail accounts. There are no instances in which management fees are bundled with trading or custodial fees. Returns are presented net of nonreclaimable withholding taxes when applicable. Arete does not use leverage or derivatives in the management of portfolios. Additional information regarding policies for calculating and reporting returns is available upon request.

### **The composite**

This U.S. Equity Mid Cap Core composite was created in August, 2008 and includes all fee-paying, taxable and non-taxable, discretionary, long only, fully invested portfolios benchmarked to the Russell Midcap Index. Every new portfolio is added to the composite in the first complete calendar month that it is “fully invested”. For purposes of composite construction, a portfolio is “fully invested” if its equity composition is greater than 90% of the equity composition of the composite. Each portfolio will remain in the composite until its equity composition becomes less than 90% of that of the composite. A complete list and description of firm composites is available upon request.

\*As of March 31, 2012, the composite has been redefined in order to clarify policy in light of unusually high cash positions recently. Prior to March 31, 2012, a portfolio was considered to be “fully invested” if greater than 90% of portfolio assets were invested in equity securities which implicitly assumed a nearly 100% equity position in the composite.

### **Fee schedule**

The management fee schedule is as follows: 1% of AUM up to \$1 million, 0.75% on AUM greater than \$1 million, but less than \$5 million, and 0.65% on assets greater than \$5 million.

### **Minimum account size**

There is no minimum account size for inclusion in the composite. Please note, however, the minimum initial account size accepted is \$100,000.



Arete Asset Management Mid Cap Core performance composite disclosures continued:

**Dispersion**

Internal dispersion is currently not meaningful as there are five or fewer portfolios included in the composite. In the future, we plan to calculate dispersion using the dollar-weighted standard deviation of all portfolios included in the composite for each performance period.

**Verification**

Arete has not been verified by an independent verifier for its compliance with GIPS.