2014 Q1 Newsletter

Matarin Capital Management aspires to be a symbol of stewardship within the investment management industry. We are dedicated to delivering excellent investment performance through insight, passion, and diligence. We aim to build strategic alliances with our clients based on the highest ethical standards.

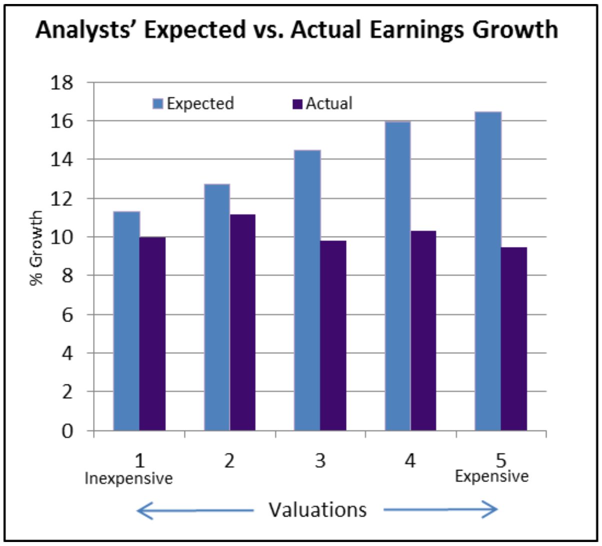
Matarin Capital

Investing with Insight and Integrity

The False Temptation of Growth

Many investors are emotionally attracted to stocks of higher growth companies, and it's easy to understand why. These stocks are sexy, high profile, fun to discuss at cocktail parties, and offer the potential for big gains. However, research shows that over the long run, simply buying those companies that have grown the fastest in the past has not paid off as a stock picking strategy. Further, following analysts' forecasts and buying the highest predicted growers is a losing strategy as well – especially for stocks whose business prospects are hard to forecast.

Often when emotion comes into play, growth expectations can get overdone and the future reality ends up being a disappointment. In the chart, we partition the S&P 1500 into five buckets based on valuation, and compare analysts' expected long-term earnings growth rates with realized 5-year earnings growth rates over the 1995-2008 period. It should come as no surprise that within the bucket of stocks that command expensive valuations ("the growth stocks") that growth expectations are significantly higher than for the more inexpensively priced stocks ("the value stocks"). Most interesting, the stocks within the "growth" bucket don't go on to grow any faster than the stocks within the "value" bucket over the subsequent 5 years. This shows that forecasting future longer-term growth is difficult, and analysts have a very high error rate.



Source: FactSet and Ed Reis

However, it is not merely because expectations for growth are often wrong that investing based upon strong forecasted growth is detrimental. It is also because those future expectations are already fully baked into the stock price today, so there is no potential for future upside from realizing those expectations, only from exceeding them. Another way of looking at the issue is that stocks with high growth expectations tend to be expensive specifically because of those expectations, and any small hiccup along the way is typically met with strong selling. This is the advantage of purchasing lower expectation, cheaper valuation companies; you only need them to modestly exceed low expectations to see significant price appreciation.

By way of further example, consider the recent environment for biotechnology stocks. After a strong 2013 in which biotechnology stocks returned over 65% for the year versus 39% for the Russell 2000 Index, the market entered 2014 in a "biotech boom." In the first 2 months of 2014 the average return of the 114 biotechnology industry names we follow was 23% versus a return of 2% for the Russell 2000 Index. Given this demand for biotechnology shares, we were not surprised to see a wave of IPOs within this space. In fact, 28 of 73 (38%) first quarter IPOs were in the biotechnology or pharmaceuticals industry, and a handful of names including Ultragenyx Pharmaceutical, Auspex Pharmaceuticals, and GlycoMimetics more than doubled from their IPO price. Interestingly, of these 28 that debuted in Q1, the companies have a TOTAL of $92M in trailing 1-year sales. When you compare this to the roughly $9B in total market capitalization awarded these names, it is obvious that investors have high expectations for future growth.

Given the high growth and high reward potential they offer, earlier stage biotechnology industry stocks inherently have a lottery ticket quality; some will win big, but most will lose. Case in point: in the first quarter of 2014, holders of Intercept Pharmaceuticals (ICPT) won the proverbial lottery. The stock was up close to 400% for the quarter on news that it had concluded a clinical trial for its drug to treat liver disease early because the drug worked so well. It was the top Russell 2000 performer (by far) for the quarter. (We are neutral on the stock and do not own ICPT shares.)

While the biotechnology stocks came into March like a lion, they went out like a lamb. They were extremely weak during the last few weeks of the month, when sentiment worsened as Federal Reserve Chairwoman Yellen shifted the criteria for future rate hikes. (High expectation stocks are more prone to suffer with rising interest rates, because of the sensitivity of the valuation of their *future* cashflows to the level of the discount rate. In this sense they are very similar to zero coupon bonds.) Another hit to biotech investor sentiment came when questions were raised in the U.S. Congress about the pricing of industry leader Gilead's newest drug at $1,000/pill. The reason for the shift in sentiment may, at the end of the day, be of little matter. Once sentiment shifted, selling brought more selling. As is often the case with momentum stocks, an investor wants to ride the wave of momentum until it comes crashing down, and then head for shore… quickly. For the full month of March, the average biotechnology stock was down 11%, and 10 names were down by greater than 30%. Easy come, easy go.

We are not suggesting that investors should completely shun growing companies, but analysts' estimated growth is really quite a poor predictor of future growth. At Matarin, we have found that rather than embracing expectations for growth, it is better to focus on companies that have already demonstrated an ability to consistently grow at above average rates, and whose stocks are still priced affordably.

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