# Q2 2013 Newsletter

MATARIN CAPITAL

Investing with Insight and Integrity

*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.*

## Commentary: U.S. Markets

Matarin's stock selection process evaluates potential investments using four broad "concepts": Business, People, Price and Catalyst. While the Business, People and Price concepts tend to be longer-term indicators, the Catalyst concept is intended to provide insight regarding the nearer-term direction of future stock prices.

While our investing style is far from "technical analysis," we do believe that trends in stock prices and changes in trading volumes can be informational, and have strong "future investment merit" underpinned by behavioral finance. In addition to our unique application of momentum factors and sales trends, we also monitor stock trading volumes in efforts to quantify changes in popularity across stocks. Generally, by monitoring changes in speculative activity we can avoid the "hot" stocks where sentiment has gotten ahead of fundamentals. As the oft quoted oracle Warren Buffett once said, "The time to get interested is when no one else is. You can't buy what is popular and do well." Interestingly, over the past several quarters, the names with increasing trading volumes have done quite well; we think this speaks to a higher than normal level of speculative activity currently in the market.

Over the past few months, perhaps the most talked about stock has been electric car maker Tesla Motors (TSLA). It is the classic "story stock" and has gained over 200% YTD. Perhaps more amazing is the frenzied trading volume in company shares. For example, in the month of May 2013, the trading volume in TSLA was just over 331 million shares. When compared to the 118 million shares the company has outstanding, one can conclude that each share of TSLA stock changed hands almost three times during the month! Wow. This does NOT include the fact that TSLA shares are close to 25% insider owned (by co-founder and CEO Elon Musk), and are therefore not turning over. To put this 280% monthly share turnover in context, the median monthly share turnover for Exxon Mobil is 7.5%, for Amazon is 23%, for Apple is 44%, and for Bank of America is 45%. While we concede that "buy and hold" may no longer apply, the trading volume in Tesla in May appears staggering.

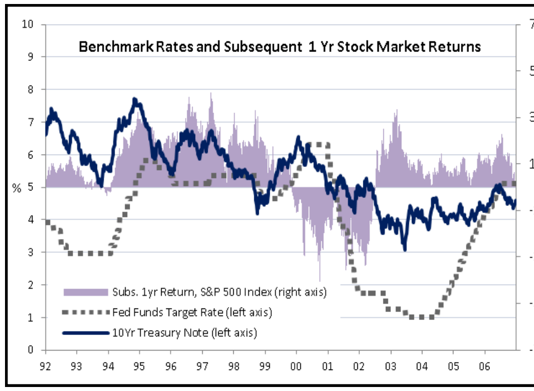
We decided to take a look at how story stocks have tended to perform historically in the month(s) following a month where share turnover was greater than 200%. On average, there are just over three names per month where share turnover is greater than 200%. The list includes many "blasts from the past": stocks like Palm, Ask Jeeves, Lycos, QLogic, and Rambus. In addition to TSLA, in recent months the list includes names like First Solar, JC Penney, Blackberry, and of course, Netflix (Netflix is actually on the list 25 times!). As you can see in the table, it does appear that at the extreme, the highest share turnover names tend to subsequently perform poorly. While we do not use share turnover as an input into our stock selection models, our return forecasts tend to be negatively correlated with popularity. At Matarin, we like a good story as much as the next guy or gal. However, when it comes to stock selection we prefer to focus on the fundamentals.

| 3000 Largest U.S. Listed Stocks Jan. 1994 to May 2013 Subsequent Period | Prior Month Share Turnover > 200% | Prior Month Share Turnover < 200% | "Story" Stocks Under-performance |
|---|---|---|---|
| 1 month return | -2% | 1% | -3% |
| 3 month return | -6% | 3% | -9% |
| 6 month return | -10% | 5% | -15% |
| 12 month return | -23% | 11% | -34% |

## Commentary: Monetary Policy

Between May 2 and June 30 of this year, the 10-Year U.S. Treasury yield rose precipitously from 1.63% to 2.49%, pushing down U.S. bond prices, a trend which was mirrored around the world. The rise is anticipatory of a potential decrease in monetary stimulus from the Federal Reserve later in 2013. It is generally thought that rising interest rates and contractionary monetary policy are bad for the stock market. However, the stock market can often remain strong even in the face of rising yields, from the time when the bond market begins to anticipate Fed action through the beginning of a period of central bank contraction. To illustrate this, let's look at some examples. You will recall that the Fed began to raise rates in both 2004 and 1994, and rising Treasury rates anticipated this as early as 2003 and 1993, however, in both cases the stock market continued on its upward path for several years.

The impact of rates on the stock market often only takes on force once a policy and rate environment has had some room to run. True, there tends to be a meaningful negative correlation between the direction of interest rates and subsequent market returns – rising rates are correlated with falling markets, and vice versa – but when we look over longer periods of time, this observation really has the most strength after Fed policy has become quite tight or quite easy, and the more extreme readings affect the overall correlation. In a periodic analysis of longer-term returns, we see that when the multi-year trend in rates turns from negative to positive, the stock market continues to deliver *above* average returns in the immediately subsequent period, on average. The negative effects occur with a lag. Consider the table below, in which we show the subsequent 1st, 2nd, and 3rd year returns for the S&P 500, in periods after which the long-term (smoothed 4-year) trends in Fed Funds and Treasury rates have turned from negative to positive. This study runs from 1963 to present, and the average annual return for the index in this period was 7.8%.




So, is the market's recent nervousness about the beginnings of a change in the direction of monetary policy and interest rates potentially overdone -- or at least early?

The nature of the contraction and policy tools are different today than they have been in the past, of course. Rather than a change in the Fed Funds rate, we are facing an exit from quantitative easing (QE). The Fed's previous attempts to end QE did indeed lead to disappointment in the stock market, because the underlying real economy remained weak. It is unknown whether the economic expansion can now stand on its own two feet with less underpinning from Federal Reserve capital, although the recent economic data is encouraging. If indeed the economy is finally turning a corner, then the market should be able to continue on its upward path for some time, even if rates continue to rise.

**Impact of Initial Interest Rate Change on Stock Returns**

| Subsequent Year | S&P 500 Return After Fed Funds Change Turns from Negative to Positive | S&P 500 Return After 10 Year T-Note Change Turns from Negative to Positive |
|---|---|---|
| 1st Year | 11.6% | 10.3% |
| 2nd Year | 8.5% | 8.7% |
| 3rd Year | 2.2% | 6.9% |

*Sources: Bloomberg, FactSet and Compustat*