Q3 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.

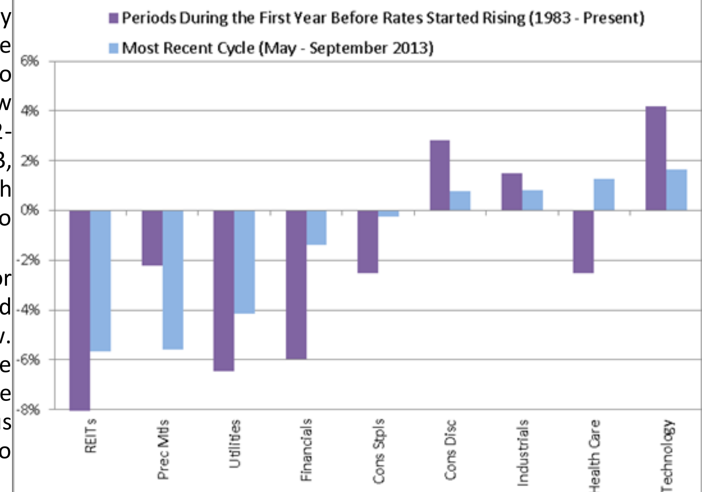
Commentary: U.S. Markets

Interest rate movements have become an important focus for investors over these past five months, as the 10-Year U.S. Treasury yield rose from 1.63% to 2.98% , settling at 2.62% on 9/30/13, signaling that investors expect the Federal Reserve to raise rates at some point in the foreseeable future. Equity investors should continue to consider how a continued rise in rates will affect their stock portfolios. There are obvious places to look for rate sensitivity in equity portfolios, and less obvious places as well. In fact, some companies, while overlooked, may experience significant indirect effects from rate increases.

Sectors & Industries

At the sector and industry levels, there are groups of stocks which investors intuitively expect to do well when rates are falling and poorly when rates are rising: Utilities and Real Estate, for example. These expectations have been substantiated over the long-run, and have also held up in the most recent period. In the chart on the right, we show selected sector and industry returns, net of market, during historical 12-month periods prior to the Fed's first policy rate increase ('83, '86, '93, '98 and '03). Next to it we show returns during the most recent 5-month period since May, when the Federal Reserve signaled that it may start to "taper" its quantitative easing program.

Sector Net Performance in Periods Prior to Rising Fed Funds Rates



When rates first start rising, the market will generally stay strong for some time and later-cycle names in sectors like Technology and Consumer Discretionary do well as product demand continues to grow. On the other hand, in periods of either actual or anticipated rate increases, interest-rate sensitive stocks like REITs, and stocks that are preferred by yield-seeking investors like Utilities, are punished. Precious Metals stocks may also begin to look relatively unattractive relative to bonds as yields on those assets start to rise.

Indirect Effects

Looking beyond the obvious, some companies are also exposed to interest rate sensitivity indirectly. Three areas which we are watching at Matarin are:

Exchange Rate Effects – Exchange rates are directly affected by short-term interest rates. If the U.S. Dollar (USD) is yielding more than a given foreign currency, investors should prefer to hold their money in USD, where they can earn a higher return. So all else being equal, the expectation of higher interest rates in the U.S. should attract outside capital, and cause strength in the dollar. Over the past decade, multinational companies which are heavily reliant upon sales abroad have had a tailwind (thanks to a weak and then range-bound dollar), which boosted corporate earnings. A rising dollar will have the opposite result. Beverage producers like Coca-Cola (KO) and Boston Beer (SAM) will respond differently to this catalyst. While KO, which derives roughly 50% of revenues from overseas markets, will be hurt by unhedged currency exposure, SAM, which generates most of its sales at home, will have little at risk. At Matarin, we utilize a customized Northfield Risk Model to monitor and control for this type of risk.

Pension Expense Effects – Companies with large underfunded pension liabilities could also be big beneficiaries if a period of higher interest rates emerges. Because the present value of future pension liabilities is calculated based on long-term bond yields, pension liability growth has been soaring in the past years' low interest rate environment, while pension assets have lagged. Today, the typical corporate plan is only 89% funded, according to the investment consulting firm Mercer. So all else being equal, if long-term rates continue to rise, companies like Unisys (UIS), which contributed $200 million to its underfunded pension fund in 2012, would be major beneficiaries as they would have more cash available to benefit shareholders.

Financial Engineering Effects – Historically low interest rates in recent years have also encouraged companies to issue new debt, engage in debt-funded mergers and acquisitions, and use proceeds from debt issuance to repurchase shares. While leverage is a great thing in good times, it can be highly problematic in weaker economic periods. Companies utilizing these techniques to grow profits have been rewarded in the market recently. However, these methods of growing profits are often not sustainable, especially when interest rates are rising. So investors may be better served by focusing on the underlying cash flow generation abilities of companies' core businesses at this time.

Timing

Some amount of investor concern over the effects of rising long-term interest rates on portfolios has dissipated since the Fed surprised the market by failing to taper on September 18th. At this point, it seems that a discussion of interest rate risk would be somewhat incomplete without turning to the question of timing. A more dovish Fed has actually been projected by Matarin's proprietary bond market forecasts throughout the recent cycle. Our 10-Year U.S. Treasury forecast is still favorable today, but the greatest area of risk to rising rates as we see it comes from our forecasts for inflation and real growth, each of which has been showing signs of life recently.

While equity investors may have some time to prepare their portfolios before interest rates move substantially higher, our advice would be to think about some of the less obvious ways in which rising rates affect corporate earnings, cash flows, asset values and subsequently, share prices.

Sources: Bloomberg, FactSet and Compustat

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