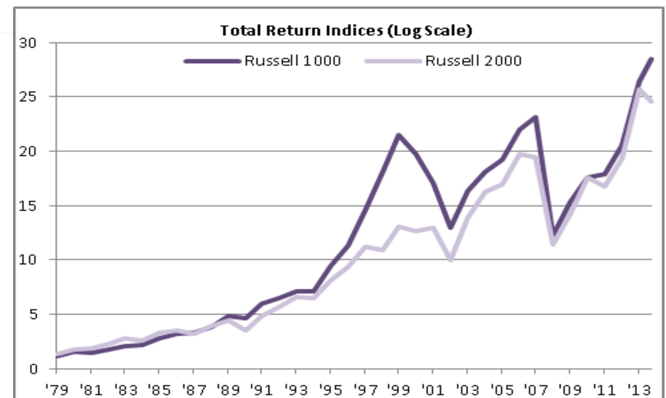
Q3 2014 Newsletter

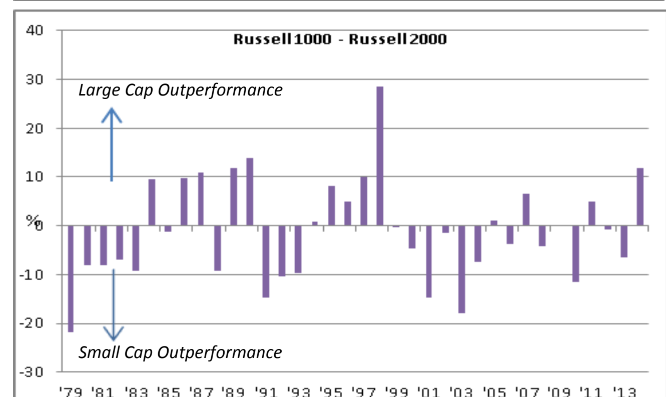
MATARIN CAPITAL

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.

Size Matters





Large stocks have outperformed small stocks by 12% in 2014, measured by the Russell 1000 vs. the Russell 2000, including 7% in the most recent quarter. This follows a long period over the past 15 years in which small has outperformed large by an annualized 3% per year. This change in leadership has called a couple of commonly-held fallacies about large vs. small cap return differences to attention.

First of all, the often discussed 'size premium' is not a constant phenomenon. In fact, as you can see in the upper chart on the right, over the past 35 years the cumulative returns earned from an investment in the large cap Russell 1000 index and the small cap Russell 2000 index have been about equal, with the large index most recently pulling ahead during 2014. Large stocks have seen periods of outperformance including multi-year trends from '84-'90 and '94-'98. Secondly, large stocks can outperform in 'risk on,' rising markets, as well as in bifurcated markets like this year. A period of large cap outperformance is not necessarily a bear market phenomenon. The large cap rally during the dot-com boom is a classic example, as large technology companies led the market. In the '80s, large multinational growth companies such as Coca-Cola, Pfizer, and Philip Morris led the charge. It is also important to note that during these periods both large *and* small stocks delivered positive returns.

At Matarin, we have recently developed a proprietary tool to forecast the return opportunity for larger vs. smaller stocks. In developing a methodology for forecasting the relative returns between large and small stocks, we focused our research on three areas of importance:

Price As is the case when selecting between individual stocks, it is also the case that it pays to purchase the more inexpensively priced, lower expectation size segment of the market. While a return opportunity in small vs. large, or the reverse, may be priced in too little by the market and undervalued early on in a cycle, once a 'size trend' gets on a run, it may eventually be priced in too *much* and overvalued. So traditional valuation analysis – in this case the valuation of size – may become quite relevant at extremes.

Fundamentals When it comes to fundamentals, smaller companies tend to have lower credit ratings on average and borrow at higher rates, so we expect small companies to do better when central bank policy is expansionary, credit spreads are narrow, and lending markets are active. The competitive landscape for international trade matters as well, since smaller companies tend to do more business at home while larger companies make more money overseas.

Catalysts While these drivers of relative return make a difference over time, the market tends to be inefficient in promptly discounting their importance. This is why small vs. large stock return trends will tend to persist for some time. Perhaps, for example, when small cap stocks are rallying, investors who have overweighted large caps will be slow to realize their losses and adjust their positions, so the upside in small cap returns is expressed over a protracted period. Or perhaps investors who have been profiting on the upswing take gains too early, which would have the same effect.

Larger stocks have already strongly outperformed smaller ones so far this year, but we still believe that this can continue. There are 3 key reasons for this: 1) Small stocks are looking richly valued relative to large, and after a multi-year period of small stock outperformance, it is reasonable to expect a reversal; 2) The cycle of cheap credit that favored smaller stocks for several years is looking 'long in the tooth'; 3) Intermediate term momentum now favors larger stocks. At the moment, our forecast is only modestly bullish on large vs. small, but one potential catalyst on the horizon that would lead to a more pronounced reading would be rising interest rates — a less favorable monetary environment would disfavor small stocks.

This perspective is important for investors to consider with regard to the large vs. small stock exposures that they have in their portfolios. Many large cap institutional investors tend to naturally, and often unintentionally, bear active exposure to smaller-sized stocks in their portfolios by roughly equally weighting, or conviction weighting, the stocks in their portfolios. These approaches ignore the large proportion of the overall market that that is comprised of megacap stocks -- for example, consider the fact that the weight of the 10 largest companies alone in the S&P 500 is 18%. So in order to keep up when megacaps are rallying, size risk must be taken into account. Portfolio construction approaches that are insensitive to size risk have likely begun to introduce a drag in performance as smaller stocks have lagged this year. Indeed, according to Morningstar as of September 30th over 80% of active large cap core mutual fund managers are trailing the S&P 500 in 2014. At Matarin, we believe that we will be able to benefit our investors in the current environment by avoiding this tendency to over-weight smaller stocks in our large cap portfolios and remaining disciplined about avoiding any unintentional size bias among our holdings.

Data as of September 30, 2014. Source: Bloomberg, Russell

One Dock Street, Suite 320 Stamford, CT 06902 203-998-0484 www.matarin.com