MATARIN CAPITAL

Investing with Insight and Integrity

2013 Year-End 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.

Commentary: Unlikely Winners of 2013

2013 has been a challenging year for short sellers. With the major market indices up between 30 and 40%, the most profitable hedging strategy last year was not to hedge at all.

At Matarin, our quantitative tools allow us to easily review and analyze what is working in the marketplace at any point in time. Based on this work, on the long side, stocks with strong price momentum and relatively inexpensive valuations delivered well above market returns. However, neither of these concepts worked great as shorting strategies, as the lowest rated names posted near market returns. In the following table, we present some additional investing themes, with data on how they performed in 2013.

Compared with the 34% return of the average stock, the 10% of the universe that was most levered coming into 2013 outperformed by 17% for the year. It is also notable that the stocks rated “C” by S&P coming into 2013 outperformed the average stock by 15% for the year. In addition, the bottom 10% of the universe as measured by the Altman Z-Score, which quantifies a company’s risk of bankruptcy, outperformed the average stock by 14% for the year. Given that short sellers often target these fundamentally weak companies, it is not surprising that the most heavily shorted names coming into 2013 outperformed the market average by 10%.

Factor Performance

Universe of 3000 Largest U.S. Listed Stocks Jan-Dec 2013

Factor	Top Decile	Bottom Decile
Short interest	44% (most shorted)	28% (least shorted)
Leverage Ratio	51% (most levered)	29% (least levered)
Altman Z-Score	48% (highest bankruptcy risk)	25% (lowest bankruptcy risk)
S&P Debt Ratings	49% (stocks rated 'C')	33% (stocks rated 'A')

Average Stock Returned 34%

While it is certainly not the case that these types of fundamentally weak stocks consistently outperform their peers, it is also not the case that they consistently underperform. In fact, these companies tend to fare better in periods when investors are more generous in spirit and sentiments are high. This is certainly the situation today, when according to Investors Intelligence, bears among market newsletter writers recently fell to lows not seen since March of 1987. In this type of environment, credit spreads are narrow and risky companies can borrow at lower rates, and thanks to the Federal Reserve this time around, low high-yield spreads are reinforced by a zero short-term interest rate policy. Also in the current environment, rising stock prices are supporting otherwise weak balance sheets, and after repeated rebuffs, shorts have become chastened, which opens the door to headier share prices. The most likely catalyst of a change in fate for these companies will be a reversion in animal spirits. At some point, the market will move from a “tell me” mode, to a “show me” mode and when that occurs, these financially weak companies may suffer and the shorts may thrive.

Sources: Bloomberg, FactSet and Compustat

Commentary: When Active Managers Stop Policing the Market

Over the past few decades, stock market investors have learned the hard way that active management is not easy, as few active managers have beaten the market over time. At Matarin, we acknowledge that markets are dynamic, so we spend a significant amount of time scrutinizing our process and thinking about our “edge.” Essentially, we believe that the opportunity for us to thrive as stock pickers is greatest when factors that cause mispricing abound. We believe we can win if we try to identify when and why mispricings occur, and design and implement a unique systematic approach to capitalize on them when they do.

Active management has been described as a “loser’s game.” When taken as a whole, investment managers must provide the market return. Additionally, that return comes only before their fees, expenses, and transaction costs are deducted. Therefore, the zero-sum game before costs becomes a loser’s game after costs. Investors perceive this to be especially true in the U.S. large-cap space, and as a result have moved aggressively into passive funds. In fact, of late, we have heard time and time again that large cap active management is “dead.” Whether the underperformance of active large-cap managers is attributable to flawed stock selection tactics, inadequate risk controls, excessive turnover, or high fees, it has become the widely accepted belief that spending one’s risk budget in the large-cap space is not justified. Given this trend, it is not surprising that the passively managed Vanguard Total Stock Market Fund has become the world’s largest mutual fund with over $250 billion in assets.

This shift into passive strategies has us pondering what this means for all active large-cap managers, and for own large core strategy, Matarin Large Cap Core (LCC). We ask ourselves, “What should happen as passive strategies dominate? Is it possible that as more and more money goes passive the large-cap benchmarks will become ‘dumber’? Does this broad acceptance of large-cap market efficiency actually create inefficiency or increased opportunity, and make it easier for active managers to outperform? Does the increase in passive investing increase the quantity of mispriced securities?”

Consider a simple scenario in which all large-cap assets move into index funds. In this (albeit unlikely) situation, the market would become rich with highly mispriced securities. We like the example offered by University of Chicago professor Lubos Pastor, “For an analogy, think of active managers as police officers and of mispricing as a crime. If there were no officers patrolling the streets, there would probably be some crime. But as the number of officers increases, the amount of crime is likely to decline.”

In a world where all large-cap assets were managed passively, companies which are underpriced relative to their underlying fundamentals would be common. There would be no differentiation by investors between companies with good fundamentals and companies with poor fundamentals. The market would no longer reward well managed, profitable, and growing companies. Companies would be excessively rewarded just for being large. The stocks of all companies (in the index) would exhibit the same return.

But this dystopian future will never come into being. The forces of rational investing that keep the markets efficient always prevail in the end. Strong but undervalued companies would become the targets for buyouts, acquisitions, and arbitrage. Poor companies would be subject to shorting and bankruptcy. As such, the mispricings that are being created by passive management are only broadening the field of return opportunities for the few police who remain on the street. As a result, we expect that if we, at Matarin, continue to focus on the true drivers of long-term shareholder value, then the move toward ever more passive management will provide an ever greater opportunity for our clients.