MATARIN CAPITAL

Investing with Insight and Integrity

2014 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.

Active Management: Risky Business Not Mission Impossible

A year ago at this time, we wrote a piece reflecting on the market drivers we had seen for the year 2013. We had viewed that year as one in which unlikely winners led the stock market. With the broad market up 34%, the 'rising tide' truly did lift all boats as the stocks that typically underperform (speculative stocks, stocks with junk rated debt, bankruptcy candidates) did well, and stocks that showed more long-term promise lagged. In 2014, the market has risen again − although to a lesser extent − but something has changed. The characteristics of the stocks leading the market this year have been much more in keeping with long-term expectations. Perhaps a pullback in the 'throw caution to the wind' risk-seeking appetite that characterized the investment environment in 2013 has led the market 'back to its roots' in terms of common sense thinking about what types of businesses, and as a result what types of stocks, will win out in the long run. As you can see in this table, the returns to all four of the fundamental concepts which Matarin uses to invest have been positive, and the returns to some of the 'common sense' quality metrics which we presented at last year-end have normalized. A theme that came through clearly for us in generating returns for clients this year was cash flow generation. Top line sales were not enough to win in 2014. Converting sales through business efficiency into free cash, and then returning that cash to shareholders in a skillful manner, were all important drivers of winning returns.

MATARIN FUNDAMENTAL ALPHA CONCEPTS*	
Business (Good vs. Poor)	14.5%
People (Good vs. Poor Management)	13.1%
Price (Cheap vs. Expensive Value)	4.4%
Short-Term Catalysts (More vs. Less)	4.6%
COMMON SENSE QUALITY METRICS*	
Short Interest (Least vs. Most Shorted)	7.8%
Leverage Ratio (Low vs. High Leverage)	1.4%
S&P Debt Ratings (A vs. BBB & C Rated)	3.9%
NORTHFIELD RISK FACTORS*	
Stock Market Beta (High vs. Low Beta)	-17.1%
Bond Prices (Positive vs. Negative Exposure)	9.4%
Oil Prices (Positive vs. Negative Exposure)	-6.5%
Foreign Currencies (Positive vs. Negative)	-7.1%
ADDITIONAL METRICS	
S&P 500 Index vs. Cash	13.6%
S&P 500 Index vs. MSCI World	8.2%
S&P 500 vs. Russell 2000	8.8%
S&P 500 Utilities	28.8%
S&P 500 Health Care	25.4%
Russell 2000 Energy	-35.5%

*2014 Performance of the top vs. bottom quintiles

In the context of this 'normalization' of rewards for stocks that demonstrate traditionally gainful characteristics – and as a result tend to be favored by professional asset managers – one might have expected a banner year for active managers in beating their benchmarks. However, despite this we observe disappointing results being reported by many asset managers this year. As an illustration, we were surprised to see a recent *Fortune* magazine article which coined 2014 as "The Year That Nothing Worked," a direct contradiction to our own observation that many tools for stock selection worked well. But many active managers did underperform during 2014. Most notably, 82% of active large cap mutual fund managers lagged the S&P 500 Index. So what might be some of the reasons for this disparity? With drivers like sector performance, oil prices, interest rates, the US Dollar and large vs. small size as driving themes for the year, it may well be the case that many 'top down' managers whose focus is on macroeconomic trends simply got those bets wrong. However, for many of the more 'bottoms up' managers whose focus is on picking individual stocks, we think that underperformance may be less attributable to poorly performing stock selection criteria, and more about portfolio construction and risk control.

In the table we also show the performance of various risk factors during 2014. As you can see, many of the risk factors (to which our strategies at Matarin bear little exposure, by design) were indeed quite risky in 2014, and had the potential to greatly impact portfolio performance for those exposed. Some examples:

SECTORS – Health Care and Utility sector names were the top performers while Energy was a huge laggard. For managers positioned more aggressively - betting against traditionally defensive sectors like Health Care, Utilities, and Staples - this may have negatively impacted performance. In this vein, it is also noteworthy, especially in association with a rising market, that low-beta stocks outperformed high-beta stocks by over 17% during the year.

SIZE – Larger cap stocks were the top performers as the S&P 500 returned 14% versus a gain of only 5% for the Russell 2000 Index. Given the propensity for large cap managers to more equally weight portfolio holdings, and to be overweight mid- and smaller cap names, it is a safe assumption that many managers were not 'large cap enough'. Interestingly, this may be somewhat attributable to the recent push for higher active share which is often accomplished by straying from the index into smaller cap stocks.

CASH – Given the positive return for the stock market, cash that was not fully invested also created a drag on performance.

MACRO FACTORS – Sectors and industries that benefit from falling interest rates, such as Utilities and REITs, performed well in 2014. However, falling rates were a headwind for fund managers positioned in stocks poised to benefit from higher interest rates. In addition, given the strong US Dollar, companies with lower exposure to foreign currencies also outperformed. Companies that benefit from falling energy prices (Airlines, for example) also performed well for the year. Therefore, it was not only the obvious risks that could have impacted performance, but also these more nuanced risks that are not always obvious.

DOMESTIC vs. INTERNATIONAL – In 2014, the S&P 500 outperformed the MSCI World Index by 8%, so cash invested in non-U.S. names tended to negatively impact portfolio returns, on average.

All investors take a variety of risks to varying degrees, whether intentionally or unintentionally. At Matarin, we want to take risk where we think we have the most information, and where our risk taking will be most rewarded. Given our expertise in stock selection, we focus on taking stock-specific risk and closely monitor and control other sources of risk where we have less or no information. For example, we tightly control industry and sector risks, beta, size, macro factors, and other common risks amongst stocks. By closely aligning our RISK with our EDGE, we are able to hold on to the baby while neatly disposing of the bathwater.

Sources: Bloomberg, FactSet and Compustat