Q1 2015 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.

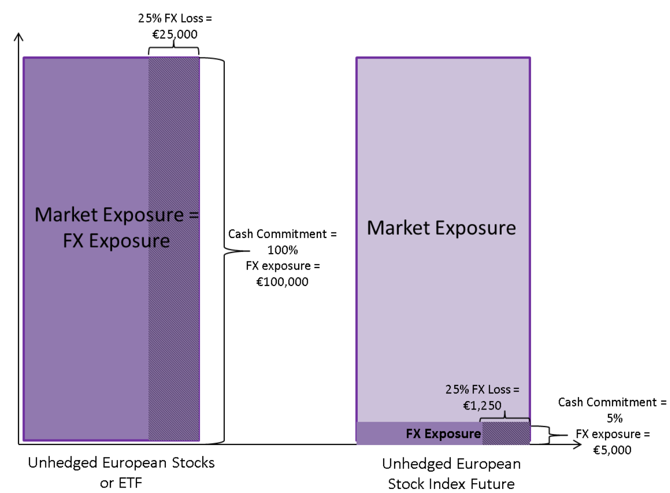
Matarin Capital

Investing with Insight and Integrity

Back to the Futures: Currency Exposures in International Investing

Bucking the conventional wisdom, U.S. stock markets have underperformed developed world indices (in local currencies) year to date. Matarin's forecasts for international developed stock markets (and the U.S.) remain moderately bullish, but for U.S. investors seeking to capture the attractive returns in international markets, it's become important to hedge out currency effects, as the dollar is up 25% on a trade-weighted basis from its July 2011 post-crisis low, and up 15% since June 2014.

Today many U.S. investors are considering whether to introduce a currency hedge with their international investments. At Matarin, we've recently introduced a Class B of our hedge fund called Market Neutral Beta$_{equity}$, which adds global equity exposure using futures. One nice benefit of the futures is that they offer an efficient and affordable way to hedge currency risk. International futures have an embedded ~95% currency hedge because of the way that futures positions are capitalized. In the simplified example shown here, you can see that if margin were exactly 5% on a €100,000 contract, a 25% decline in the Euro on a European stock index futures position would result in a loss of only €1,250 rather than the €25,000 loss that would come from a 25% FX loss in the outright purchase of unhedged European stocks or ETFs.



The impact of currency exposure in international equity returns in Q1'15 reminds us of how important it is to identify the exposures that are embedded in any investment, and to intently manage those exposures. At Matarin, we strive to bring a sharp focus in our alpha generation on the risks that we're best at taking. And one of the best ways to bring areas of skill into focus is by finding effective ways to hedge out the rest.

Value is in the Eye of the Beholder

The past few quarters have presented an interesting, and often challenging environment for value-biased equity investors. The Russell 1000 Value index has underperformed the Russell 1000 Growth index by over 4% YTD and by over 6% over the trailing 1-year period. Because Russell does not calculate its valuation criteria on an industry-neutral or sector-neutral basis, their indices will often have large sector biases relative to the core indices. For example, the Russell 1000 Value index has a nearly 30% weighting in financials, whereas the Growth index has a nearly 30% weighting in technology, compared with less than 20% for each of these sectors in the Russell 1000 Core index. At Matarin, we think it makes more sense to compare valuation across relevant groupings rather than simply comparing across all stocks, and we construct portfolios sector-neutral so we are not overly biased, for example, by the fact that financial companies tend to be consistently cheaper than technology companies. This will often cause Matarin's perspective on valuation to differ from what is reflected in Russell's growth and value benchmarks.

When considering valuation, our experience has also taught us that it is very important to look through several different lenses because relevant metrics vary across stocks based on industry, sector or company size. At Matarin our goal is to paint a unique picture for each stock in our forecasting universe by fully realizing that valuation (and stock selection in general) is not a "one size fits all" endeavor. Over the years we have performed research on dozens of valuation metrics and today we utilize a handful of metrics sourced from all three major financial statements, each of which contributes unique information to our "valuation mosaic." The most recent quarter provided a good example of the importance of using a diversified basket of value indicators, as "deeper value" metrics like sales-to-price and book-to-price struggled while the market showed a preference for higher quality businesses that are inexpensive relative to cash flow. The Russell Value indices, by contrast, use book-to-price (not earnings, sales, or cash flow-to-price) as a measure for valuation in index construction, which is another reason that the performance of their Value index relative to Growth was so poor during the first quarter, and another reason that the Russell 1000 Value will often not correlate with the performance of Matarin's valuation metrics.

In general, we are believers in value investing. We like to get more for less, and prefer stocks that are "on sale." As contrarians at heart, we believe that purchasing shares of lower expectation, inexpensively valued businesses (and shorting the opposite) is a winning strategy. As regular readers of this newsletter know by now, Matarin's stock picking style is neither solely growth nor value; but is rather "core" and, within that, opportunistic. Valuation is but one important component in our diversified approach.

Sources: Bloomberg, FactSet and Compustat