MATARIN CAPITAL

Investing with Insight and Integrity

Q1 2012 Quarterly Letter

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.

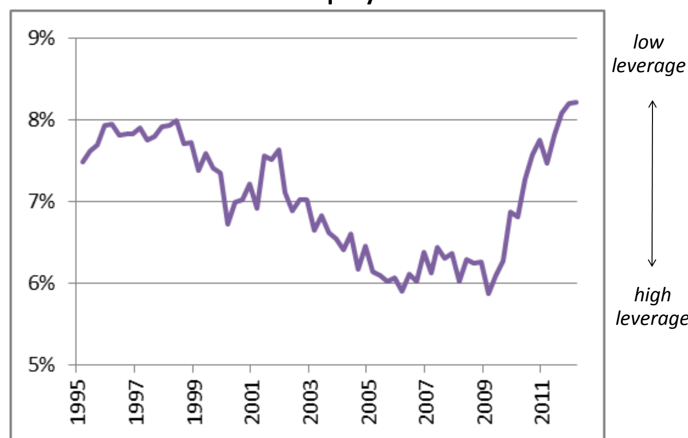
Commentary: U.S. Markets

It has often been said that banking has a simple business model: "Borrow at 3, lend at 6 and be on the golf course by 3pm." Given this small spread, commercial banks have typically leveraged their balance sheets to be able to deliver reasonable returns on equity. When the economy is on solid footing and banks are profitable, investors have been rewarded for taking this risk. Interestingly, the stock returns of commercial banks with the lowest 20% equity-to-asset ratios (essentially, those which are the most highly leveraged) have tended to outperform their peers by over 2% a year since 1995.

In the wake of the financial crisis however, it may seem insane for investors to think about taking advantage of this tendency by investing in the more levered US banks. While numerous concerns remain, many banks have greatly improved their capitalization ratios since 2008. The average tangible equity-to-assets ratio of U.S. commercial banks has improved to 8.2%, a 2% increase since the bottom of the financial meltdown. This successful recapitalization of US commercial banks was heralded energetically by investors in the first quarter of 2012, somewhat attributable to the release of the Federal Reserve's stress tests, as well as dividend increases from Wells Fargo and US Bancorp, among others. In fact, 1Q'12 revealed the second strongest outperformance of the more levered banks over their peers in the available data history (the only stronger outperformance quarter was 2Q'09, due the Treasury's bailout operation.)

At Matarin, we would not be surprised to see this trend continue. Subject to the condition of a continued recovery in the US economy, it is reasonable to expect that some banks will be able to achieve superior profit generation by effectively driving their balance sheets in the future, just as they have in the past. We may also see increased investor demand as dividend payouts continue to rise, feeding the income-hungry market place. While it is uncomfortable to over-weight the more leveraged banks because of their higher risk, investors often get paid for taking uncomfortable positions. As Warren Buffett once said, "If you wait for the robins, spring will be over."

US Commercial Banks' Equity-to-Assets Ratios



Commentary: Global Markets

The first quarter was very strong for global equities in general, but few markets outshined Japan, whose stock market ended 1Q'12 up by over 19% (local currency), making it the third strongest performer among all G-20 countries (only Saudi Arabia and Turkey fared slightly better). At Matarin, our forecasts suggest that the bullish case for Japanese markets has been overdone.

This strong start to 2012 marks a reversal from 2011 when Japanese stocks struggled, returning -17%. This weak performance last year was somewhat attributable to the dampening effects of the "triple tragedy" in March. In addition, Japanese stock underperformance was also attributable to the dramatic weakening of exports driven by an ongoing yen rally. We believe this yen rally was the result of: 1) Risk-averse capital moving out of the Swiss franc (into yen) beginning in August, after forceful exchange rate protection by the Swiss National Bank and 2) Yen carry trades became less attractive, with monetary and quantitative easing pushing short-term rates lower in several countries around the world. In particular, with US short-term rates hovering around zero, the value of the once popular Yen/US$ carry was eliminated entirely.

The 1Q'12 Japan bulls no doubt saw some of these negative circumstances beginning to reverse. Most notably during the quarter, the Bank of Japan announced an expansion of its asset purchase program, more than doubling its investment in shorter term Japanese government bonds. This led to a significant increase in the Yen/US$ of over 7%. At the same time, interest rates in the US began to rise in a trend which, if continued, could also make the yen carry trade (which puts negative pressure the yen) more attractive again. These effects would be positive for net exports, which are so crucial for the Japanese economy.

But there are several negatives for Japan, which we believe investors may be failing to discount. First, Japanese earnings have shown continued weakness in 2012, and it's not clear that an earnings recovery that would be sufficient to justify the recent rally is on the horizon. The Japanese government estimates that exporters require a Yen/US$ exchange rate below ≈82 Yen/US$ to be profitable. At the time of writing, the currency pair is struggling to hold at that level. A second negative is that Japan is a voracious consumer of energy with limited domestic production. High global energy prices such as Japan is experiencing now are essentially a big tax on the country's GDP. And while the weak yen may be a benefit to exporters, it only serves to further increase the country's effective energy import costs, which widens its already record-high trade deficit.

Bottom line: At these levels, a lot of good news for Japanese stocks has been priced into valuations and, in our opinion, perhaps not enough of the bad.