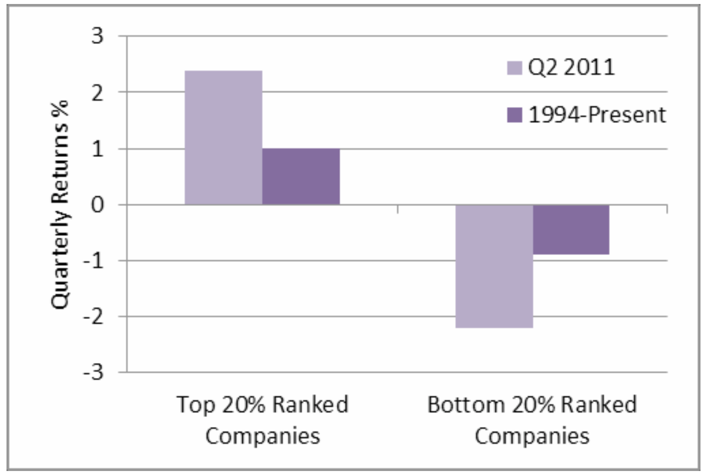
Q2 2011 Quarterly Letter

Matarin aspires to be an investment management firm that is a symbol of stewardship within our 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

The close of Quantitative Easing 2 (QE2) during the quarter heightened fears about a renewed economic slow-down. The change in sentiment led to falling Treasury Bond Yields (rising prices) and muted stock market performance, with the S&P Composite 1500 returning 0% for the quarter. Based upon business fundamentals, during the second quarter the top 20% of the index outperformed the market by over 2%, more than twice their typical rate of outperformance. Their polar opposite, worst rated 20%, underperformed the market by over 2%, which was more than twice their typical rate of underperformance, as shown in the graph at the right. While there is no single concept which outperforms all the time, we believe, on average, over time, it pays to own companies with good underlying business fundamentals.

Strong vs. Weak "Business Fundamentals"

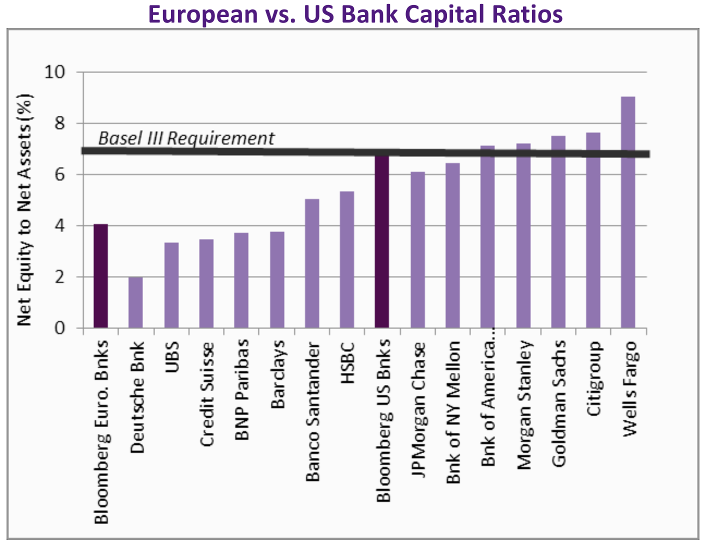


Commentary: Global Markets

We do not believe European bank stocks have fully discounted the inevitable risks of sovereign default on the European periphery. This comes at a time when the banks are exposed, because they have not yet taken the necessary steps to improve their leverage positions, as will be required by the new Basel III standards. They have lower equity to as- sets, and lower Tier 1 capital than the coming regulatory minimums will require, and comparably less than many of their global peers. Many have leverage ratios that are as high as Lehman at the beginning of the financial crisis. As European banks work to get their capital requirements in line, their stock prices may suffer as they may have to issue equity and take less risk. Even more importantly, as 95% of Greek debt *alone* is owned by European banks, they will be the main source of counterparty risk if international conta- gion from peripheral Europe's sovereign crisis becomes a concern.

The signs of strain are already there. In interbank money markets as reflected in LIBOR and T-Bill rates, Euro TED spreads are now about 1 standard deviation above average. This type of dampening in interbank lending was a main driver of the illiquidity that haunted markets during the financial crisis. Credit default swaps on European banks' bonds have also risen substantially, with CDS in the Bloomberg European Banks Index (BEBANKS) up over 135% since 3/11/10, when Moody's was the first major ratings agency to downgrade Greek debt. By comparison, average Bloomberg US Banks' (BUSBANKS) CDS prices have risen only about

European vs. US Bank Capital Ratios



11% in that time. CDS prices reflect that European banks face substantially higher risk now than they did 16 months ago, but surprisingly, stock prices tell a different story. European bank *stocks* are about even with the rest of the world's, depending on the index definition. What could explain this?

Ironically, banks may be benefitting from the self-same highly leveraged balance sheets that are bearishly risky. The average capital ratio of BEBANKS as of 6/30/11 was only 4.0%, as compared with 6.9% for BUSBANKS, and 7.0% required by Basel III. This means their stocks are being valued off of market caps that are too low, and they're benefitting by stretching less equity further. This is a risky game in a risky environment, and one which certainly can't last forever.

Sources: Compustat, IDC, and Bloomberg; Data as of June 30, 2011