Q2 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

Post-IPO Returns 1997-2012, net of mkt.

	Number of IPOs	3Yr Returns
Pos. FCF IPOs	602	+23%
Neg. FCF IPOs	870	-26%
All IPOs	1472	-6%

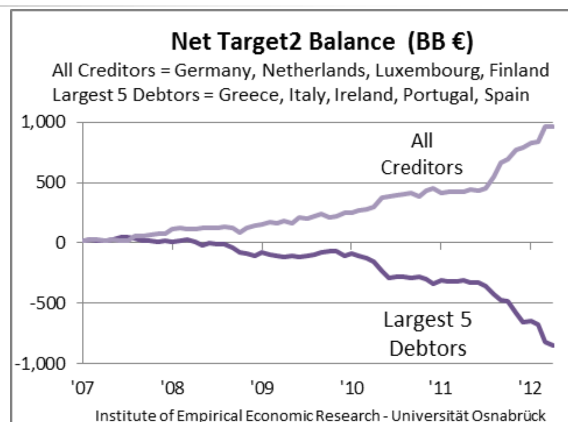
No news was bigger in the second quarter than the initial public offering (IPO) of Facebook. At Matarin, we do not invest in recent IPOs given the low quantity and quality of available fundamental data. Warren Buffett once said, "It's almost a mathematical impossibility to imagine that out of the thousands of things for sale on a given day, the most attractively priced is the one being sold by a knowledgeable seller to a less knowledgeable buyer." As is often the case, we tend to agree with Mr. Buffett.

Just to remind our readers, Facebook was priced at $38 on May 18th and briefly traded in the low $40s during that day. By month end, the share price had declined to $29.60. While IPOs tend to get a lot of publicity on their opening day of trading (when they tend to do quite well), the Facebook IPO got us thinking about the longer-term performance of IPOs. So, using data sourced from FactSet and Compustat covering IPOs issued from 1997 to 2009, we structured a simple test looking at the performance of positive free cash flow (FCF) generating IPOs, negative FCF IPOs, and all IPOs over the subsequent three year period starting at month-end following the IPO. We used FCF because we believe it is a reasonable measure of whether a company has a good business, and we chose a three year time period because it is a reasonable time horizon over which a long-term investor can judge the success of an investment, IPO or otherwise.

Mr. Buffett would be interested to know that what we found is consistent with his belief that investing in IPOs shortly after they are issued is not a profitable strategy. In fact, the pool of 1472 IPOs in our sample underperformed the small-cap market by an average of 6%. Interestingly, had you bought only the IPOs that generated positive FCF over the prior year, and held them for three years you would have outperformed the market by 23%. On the other hand, the negative FCF companies went on to underperform the market by 26%. This may be good news for Facebook, which is a positive FCF company.

This is one piece of good news for Facebook investors. While Facebook does not currently look cheap (based on the limited data available), it does appear to have a viable business model throwing off significant FCF. Bottom line: We are not invested in Facebook and are not recommending our readers invest, but we would not suggest avoiding it simply because it is an IPO.

Commentary: Global Markets



Many investors wonder why the Euro hasn't been weaker in the years since the Eurozone crisis began. Interestingly, while foreigners have been selling compromised European assets, European citizens and corporations have been repatriating assets in roughly equal amounts, creating offsetting demand which has kept the Euro somewhat stable. Where the imbalances really lie are *within* Europe, contained within a system called Target2. And today, any restructuring of the common currency which fails to address Target2 would pose a major problem for the Euro, and the European banking system.

In Target2, Europe's national central banks (NCBs) accrue claims and liabilities against one another in accounts held at the ECB. The accounts of the NCBs are, in turn, the rolled up credits and liabilities of each country's local commercial banks. In the design of Target2, the flow of capital between countries' local commercial banks is never actually cash settled. It is managed by the ECB through a fractional reserve system. For example, if a Greek person sells a risky Greek asset to buy a German bond, a Greek commercial bank will transfer reserves to a German bank via Target2. The reserves of the German bank in the Bundesbank account at the ECB will increase, and the reserves of the Greek bank in the Bank of Greece account at the ECB will decrease. At some point, the Greek bank may be required to post additional reserves, but given the lowered standards for collateral accepted at the ECB nowadays, the reserves posted to meet the new liability may indeed be questionable.

The Target2 system was designed to allow a free and frictionless flow of capital within the EMU. But in practice, some negative unintended consequences have emerged. The banks in troubled nations have amassed liabilities to those in wealthier nations which, if the system actually required it, could not be paid. As of the end of last month, the Target2 credit balance of the German Bundesbank alone was over €689 Billion, a number which was originally intended to average around zero. Because there is no cash settlement in Target2, this paper insolvency can be overlooked indefinitely, as it has been so far. But any solutions to the Eurozone crisis that do not address Target2 imbalances could be calamitous. In the event of dissolution of the Eurozone, all negative Target2 balances would finally need to be resolved (that's an - €861 Billion liability among the five most troubled countries alone). This could potentially be resolved by printing Euros, an inflationary force, which could seriously threaten the Euro.