

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

Matarin's stock selection criteria are grouped into four broad concepts: Business, Price, People, and Catalysts. Within our Catalysts concept, we employ a proprietary price momentum strategy that not just simply buys past winning stocks and sells losers, but also tactically adjusts our emphasis on price momentum onto those names where it should work best, and when it should work best.

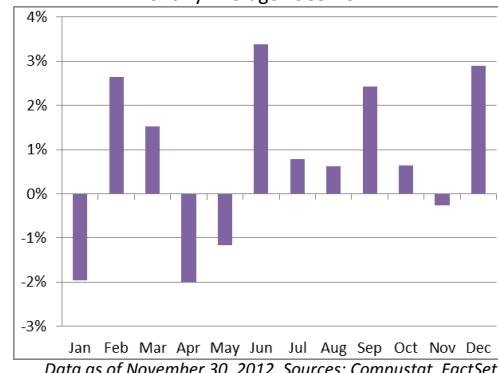
As is the case with all of our stock selection criteria, we are believers in the "future investment merit" for price momentum. Stock price momentum is a phenomenon that is largely driven by investor behavior. Generally, investors tend to sell winners too soon in an effort to lock in gains, and hold on to losers too long in hopes of avoiding losses and getting back to even. This "disposition effect" causes winners to remain underpriced for some time, and losers overpriced, which can lead to continued price momentum in the same direction. We think Peter Lynch said it well, when he compared this behavior to "pulling out the flowers and watering the weeds." Since 1985, a simple strategy of going long the best performing 20% of stocks over the prior year and shorting the worst performing 20% would have returned an average of just over +50 basis points per month, or over 6% per year.

Interestingly, as you can see in the chart below, momentum tends to work very well in the final month of each quarter (March, June, September and December) as money managers engage in the practice of "window dressing" — buying winners and discarding losers just before quarterly filings are prepared. December tends to be one of the strongest months for momentum thanks to window dressing and investors' typical year-end preference to harvest tax losses in losing stocks, and to delay realizing gains in winners in an effort to minimize current year's taxes. As you can also see in the chart below, January tends to be one of the worst months for momentum strategies as the "January effect" kicks in and the prior year's losing stocks tend to snap back in the start of a new tax year.

One impact of the "fiscal cliff" was the scheduled increase in capital gains tax rates. In anticipation of this tax hike, investors altered their typical December behavior of delaying capital gains, and instead accelerated the realization of capital gains into 2012. In fact, in December 2012 the top performing names over the past year *underperformed* the worst performers by 4%. Given this "non-informational" selling pressure in these names, we would not be surprised to see January 2013 behave unlike a typical January, as this selling pressure dissipates, investors' focus returns to fundamentals, and these longer-term winners snap back.

## Commentary: U.S. Economy

**Top-Bottom 20% Momentum Return Spreads**  
Monthly Average 1985-2012



On December 12th, the Federal Reserve adopted the "Evans' Rule" – to maintain its zero interest rate policy at least until the unemployment rate falls from its current rate of 7.7% to 6.5%, unless inflation forecasts exceed 2.5%. This is a step away from previous guidance, which had been calendar based, and the first time that the Fed has ever communicated specific economic targets in its policy making.

One presumes that a 6.5% unemployment rate represents the Fed's best estimate of our economy's current equilibrium or "structural" unemployment rate. The success of this new program hangs heavily on the accuracy of that estimate. If the Fed has underestimated the economy's equilibrium level of unemployment, then its new inflation limits may be reached well before its employment targets are. So in this context, we thought it would be worth taking a look at recent trends in structural unemployment in the US, to get a sense of how much room the Fed really has to move.

It's widely agreed that structural unemployment in the US has risen since the financial crisis of 2008-2009. The OECD's estimate of the structural rate of unemployment in the US has risen from an average of 5.5% from 1997-2007 to 6.1% today, as shown in "Previous update" vs. "New update" in the chart below. In fact, as you can also see, the upper end of the confidence interval for structural unemployment, which takes estimation error into account, is well above the Fed's 6.5% target, which means that the Fed's target may already be structurally unachievable in the long-run. What's more, the equilibrium structural unemployment rate may continue to rise. Enduringly high unemployment often becomes self-perpetuating, for example, as unemployed workers lose skills.

But this doesn't mean that the 6.5% target is completely out of reach. While monetary policy can sustainably lower the unemployment rate only to its natural equilibrium rate, fiscal policy can actually *move* the natural rate by changing incentives. Economist Edmund Phelps, the 2006 Nobel Prize winner, described certain catalysts which can lower the equilibrium rate over time, many of which can be affected by fiscal policy makers: investing in technological progress to develop new industries or eliminating capital market inefficiencies such as artificially high exchange rates or labor costs, for example, could all cause the structural rate of unemployment to actually fall over time.

The limitation of Fed policy is a topic which Chairman Bernanke himself has addressed with Congress. The Federal Reserve can only do so much in the absence of fiscal policy, while fiscal policy can effectively change the very structure of the labor market. We believe that in order for the Federal Reserve's new policy to be effective, fiscal policy must play its role.

**Structural Unemployment Estimates for the United States**

