MATARIN CAPITAL

Investing with Insight and Integrity

U.S. Small Cap Equity Benchmarks: The S&P 600 vs. The Russell 2000

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Introduction

At Matarin Capital Management we seek to add value for clients, not only as a result of our diligent and passionate dedication to delivering excellent investment returns through active management (the “alpha” for which we are compensated), but also by analyzing and selecting the most appropriate benchmark against which to measure that alpha.

In the case of Small Cap Equities, we have found that the S&P 600 has modestly outperformed the Russell 2000 index over time (see chart below), primarily due to the differences in the providers’ basic index construction methodologies. This outperformance creates an opportunity for better peer group relative returns from small-cap for investors who use it. As Investment Managers, we prefer to measure our returns relative to this benchmark, rather than the Russell because it will provide greater reward for our clients, even though it is harder for us to beat.

Comparison of Index Construction Methodologies

Russell Investments creates its U.S. Stock Indexes by identifying a broad universe of eligible securities based on where they are domiciled and traded, as well as their market cap, closing price, float and structure. Within the top 3,000 stocks by market capitalization, the 1,000 largest securities as of May 31st each year are assigned to the Russell 1000 Large Cap Index, and the next 2,000 securities are assigned to the Russell 2000 Small Cap Index.

Standard and Poor’s creates its U.S. Stock indexes by defining a universe of eligible stocks based upon market capitalization, liquidity, public float, sector classifications, and financial viability. An important difference between Russell Investments’ and Standard and Poor’s’ eligibility standards is that S&P’s criterion for financial viability usually requires four consecutive quarters of positive as-reported earnings. This gives the S&P Index a positive valuation bias relative to the Russell index, as it means that the S&P Index tends to contain fewer money-losing companies.

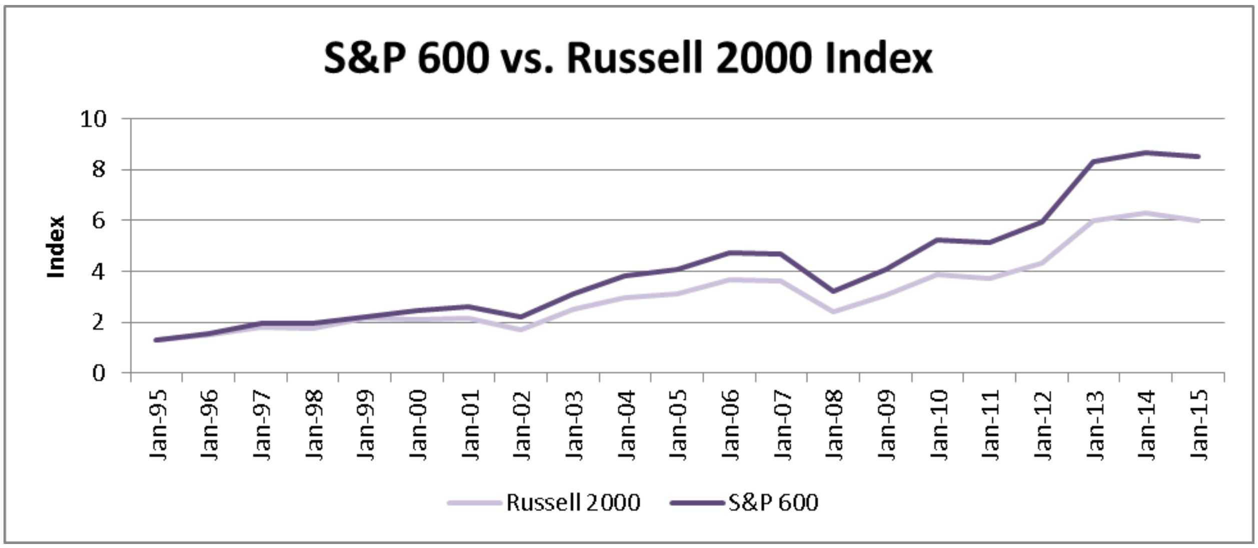
We believe an important source of outperformance by the S&P 600 Index vs. the Russell 2000 Index is this exclusion of money-losing companies, which tend to be poor relative performers over time.

Index Turnover

While not a negative to index returns, the methodology used to rebalance the Russell 2000 Index can further negatively impact investor results. The Russell 2000 Index is fully rebalanced once a year often resulting in excessive (and therefore costly) turnover for investors. The S&P, on the other hand, rebalances the 600 Index on an as-needed basis as stocks move in and out of eligibility. Turnover in the S&P Index tends to be meaningfully lower, resulting in lower transactions costs for investors due to rebalancing.

The Numbers

The S&P 600 Index has outperformed the Russell 2000 in 15 of the past 21 years and by an average of 2% per year. Matarin believes this is primarily due to the different methods, as described above, used to construct the two indices. Based on our own calculations, using an annually rebalanced universe of the 3,000 largest equities, we found that companies which lost money underperformed those which were profitable by an average of over 4% per year. The exclusion of stocks which have not reported four quarters of positive earnings is likely a key reason that the S&P 600 Index has demonstrated cumulative outperformance relative to the Russell 2000 Index overtime. (Please refer to the chart below.)



In conclusion, the risk exposures of our North American Small-Cap Equities portfolios are constructed around the S&P 600 Index. While this is a more challenging benchmark to beat, we believe it is the appropriate benchmark for our clients. If, as in the past, the S&P 600 Index continues to outperform the competing benchmark of the Russell 2000 Index, our objective of providing annualized excess returns of 2-4%, on average over a market cycle, should result in superior results for our clients.