Matarin Capital

Investing with Insight and Integrity

Successful Investing in 2014: What's Working?

April 2014

2014 has been an interesting year so far for asset managers. Given Matarin's ability to analyze and interpret the salient drivers of stock price performance, we've received some inquiries from our clients about what we are seeing in the markets, particularly during the past several weeks. As a result, we thought we would write down some thoughts on the environment for investing as we see it now.

Over the last 6 weeks, there has been a pronounced shift in what types of stocks are faring well or poorly in the market. It is always difficult to pinpoint exactly why markets behave as they do, but one clear driver occurred on 3/19/14. Federal Reserve Chairwoman Yellen surprised the market by shifting the criteria for future interest rate hikes and suggesting the first rate increase could come sooner than expected. This may have been the trigger for a change in sentiment, and in what is being rewarded or punished in the market.

Here are some of the drivers of return that we see as being important in distinguishing winners from losers since then:

FUNDAMENTAL DRIVERS OF RETURN Matarin's approach evaluates potential investments using four broad "concepts." In the table below, we show performance for those concepts so far this year. We are looking to purchase efficient, growing, cash flow generative businesses (Business), trading at cheap valuations (Price), with shareholder-focused management (People), and catalysts for near-term value realization in place (Catalysts). In our hedge fund, we are looking to short the opposite. The data support several conclusions regarding the fundamental drivers of return that have been working so far this year, before and after 3/19.

	December 31, 2013 - March 19, 2014			March 20, 2014 - April 28, 2014		
	Highest Rated	Lowest Rated	Performance Spread	Highest Rated	Lowest Rated	Performance Spread
Business	3.3	5.4	-2.1	-3.3	-5.3	1.9
Price	3.2	7.1	-3.9	-1.1	-9.2	8.2
People	4.2	4.1	0.1	-3.3	-6.8	3.4
Catalyst	6.4	1.2	5.3	-6.1	-4.0	-2.0

The numbers plainly show that there has been a huge shift into value and "quality." The Price concept reveals that while the most expensively valued stocks had been outperforming the cheapest names by 3.9% through 3/19, we have recently seen valuation metrics working quite well and the most expensively valued names selling off. In fact, subsequent to 3/19 the most expensive names are now underperforming the cheapest by 8.2%. The Catalyst concept reveals that the performance of momentum strategies has also shifted somewhat. The names with the strongest momentum outperformed weak momentum names by 5.3% through mid-March, but have reversed course and underperformed since then, with the strongest momentum names returning -6.1% over the course of the past six weeks. Interestingly, weak momentum has continued to be a reasonably *good* indicator for picking future underperformers, as the weakest momentum names pre-March 19th have continued to modestly underperform the market as well, with a return of -4.0% over the past six weeks. In the current environment, it is not surprising to see the Business and People concepts adding value, as the market has adopted a more cautious and selective stance, with an increased eye on fundamentals. In that context, the highest rated businesses in our Business concept, underperformed the lowest rated by 2.1% through 3/19, but they have gone on to outperform by 1.9% since then. While the companies with the most shareholder-friendly management in the People concept outperformed by only 0.1% through 3/19, they have outperformed by 3.4% since then. Overall, the current environment is characterized by a bit of a "return to sanity," and typically this is the kind of environment in which Matarin's preference for good businesses and good management at a good price is well-rewarded.

SIZE As you can see in the total returns of the S&P 500 (large cap) index and the return of the Russell 2000 (small cap) index, both before and after 3/19 presented to the right, while smaller-cap stocks got off to a strong start in 2014, the S&P 500 is now outperforming the Russell 2000 by 5.4% YTD. There are times in the market when exposure to size (whether large or small cap) becomes so risky that it trumps the returns that investors would generate from pure stock selection alone. For asset managers with smaller-cap size bias, that bias would have hurt returns post 3/19. On the other hand, one element of Matarin's strategies which has benefitted our investors recently is that we are size neutral. It's understandable that small stocks are sensitive to emerging concerns about the potential for rising interest rates. Smaller stocks tend to rely more heavily on borrowed capital for survival than large stocks do, which is one reason that small stocks have thrived in the ultra-low interest rate environment of the past several years.

	Russell 2000	S&P 500
Dec 31, 2013 - Mar 19, 2014	3.3	1.1
Mar 20, 2014 - Apr 28, 2014	-6.5	0.7
2014 YTD	-3.6	1.8

SECTORS There has also been a leadership shift at the sector level, which was most pronounced within Health Care stocks. The sector went from the top performer pre-3/19 to the worst performer post-3/19. Technology names were also notably weak in the later period. In general, the higher growth, higher beta, and more speculative stocks which had done so well in 2013 and early in 2014 turned down most sharply. (High expectation stocks are more prone to suffer with rising interest rates, because of the sensitivity of the valuation of their future cashflows to the level of the discount rate. In this sense they are very similar to zero coupon bonds). By contrast, Utilities are now one of the top performers YTD. Similar to the observations made about size risk, for managers with large sector tilts - especially into higher beta sectors - this may have dragged down results. At Matarin, we find sector bets to be quite risky, and have found that we are rewarded in the long run for staying pretty balanced on sector exposures at all times.

	Dec 31, 2013 - Mar 19, 2014	Mar 20, 2014 - Apr 28, 2014
Cons Disc	-0.6	-4.7
Cons Staples	-0.5	0.8
Energy	1.7	7.8
Financials	2.3	-2.7
Health Care	14.1	-11.8
Industrials	2.1	-2.5
Info Tech	3.9	-9.8
Materials	6.1	-1.9
Telecom	-0.6	-3.8
Utilities	4.8	4.5

FOR THE LONG RUN As we have observed in past writings, at Matarin we believe in general that we will find the greatest long-term reward for taking investment risk that is focused as much as possible on stock picking – investing in fundamentally good companies and shorting the opposite. We believe that the risk/reward tradeoffs that come from exposure to risk factors such as market cap and sectors are less rewarding by comparison. The market environment in 2014 thus far has served to reinforce these views.

Sources: S&P, Compustat, Russell 2000 iShares Index Fund, FactSet, Northfield