# 2017 Year End Newsletter

*Matarin Capital Management, LLC 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.*
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MATARIN CAPITAL
Investing with Insight and Integrity

# The Parable of the Boiling Frog

## A Steady Climb

The S&P 500® Index delivered positive total returns during every single month of 2017 – a record that had not been achieved in the prior 90+ years of index history. In fact, the index has now risen for 14 months in a row, handily besting the second-longest record of 11 months. There are a lot of theories about what has allowed this steady climb. Some that we favor at Matarin include the rising prevalence of investment strategies that are programmed to buy dips (for example, all-weather strategies, lifestyle target-date funds, high-frequency and machine trading, and short volatility). The rise of passive investing also slows the market's price discovery process.

## Get Uncomfortable With Being Comfortable

In June 2016, Matarin published a piece about behavioral investing, entitled "Get Comfortable with Being Uncomfortable." The inverse advice also holds true -- an extended period of rising markets and low volatility has the potential to numb investors into complacency and at some point, investors will have to "get uncomfortable with being comfortable." Learning from the lesson in the parable of the boiling frog, rather than being lulled into complacency by easy gains as the markets begin to boil, investors should remain ever-aware of their surroundings, because at some unpredictable point in the future it will be time to jump out of the pot.

We believe that the behavioral heuristics that drive cycles of complacency are similar to those that drive environments of fear:

*Herd Behavior & Confirmation Bias*: The tendency to believe in the wisdom of the crowd and to follow it can lead to an excess of complacency in bull markets. Add to this the tendency to seek out news that confirms one's own expectations, compounded by the ease of finding such information as a bull market picks up steam.

*Recency Bias & Anchoring*: The tendency to "anchor" expectations for the future on recent market prices and to assume that recent trends will continue in the future means that many investors will assume that 2018 will look a lot like 2017 – steadily rising markets, low volatility – and put too little weight on lessons that we've learned in earlier, riskier market environments. The assumption that the future will look like the recent past helps to create the conditions for bubbles and crashes.

*Overconfidence*: Bull markets and bubbles may lead to overconfidence if investors assume that their own skill and insight have enabled their outsized returns. This feeling of control also encourages excessive risk tolerance.

Some texts even consider the simple *Thirst for Excitement* as a behavioral bias.

## The Price of a Lottery Ticket

With the widely-tracked VIX index of market volatility sitting near lows throughout 2017, the volatility of many individual stocks has been low as well. This environment has led many investors to look for volatility wherever it can be found. As such, some of the most storied stocks in the market right now are also the most volatile. But highly volatile stocks tend to underperform over time, and volatility goes both ways -- investors should be cautious of volatile stocks with positive *and* negative price momentum.

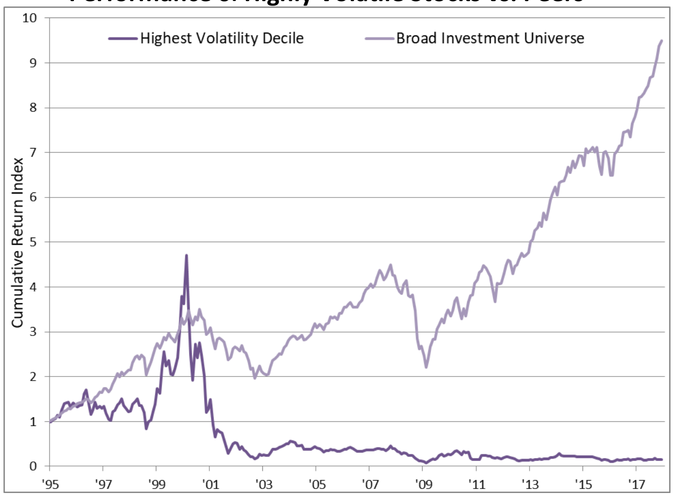
The stocks shown in the table on the right are the best and worst 2017 performers within our selected universe of highly volatile, liquid, US stocks. (You may not be surprised to read that two of the top performing names are related to blockchain – Riot Blockchain and MGT Capital.)

| Company | 2017 Return (%) |
|---|---|
| Riot Blockchain | 666 |
| MGT Capital | 552 |
| Ignyta | 404 |
| JC Penney | -62 |
| Rite Aid | -76 |
| Frontier Comm | -80 |

Matarin completed a study of the 5,000 largest stocks each year from 1995 to present and found that the top decile of stocks by volatility has underperformed the bottom by 17% per year on average. Even during 2017, despite prominent outliers, the most volatile stocks coming into the year have underperformed by 8%.

So our advice is to be careful what you wish for when you look for excitement in investing, and remain aware of the waters as they boil.

**Performance of Highly Volatile Stocks vs. Peers**




*Data Sources: Compustat, S&P, FactSet, Northfield. Data as of 12/31/17.*