Q1 2018 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. Please refer to the last page for important disclaimers.

MATARIN CAPITAL

Investing with Insight and Integrity

Bucking the Conventional Wisdom

During the first quarter of 2018, many stock market investors received a rough wake-up call. After being lulled into a comfortable, nothing-but-up frame of mind, returning volatility and losses jolted investors back to reality. The S&P Composite 1500 Index ended the quarter down 7.8% from its January 26th high and returned -0.7% for the quarter. In this type of market environment – especially one that followed a historic period of complacency – one might have expected 'conventional' safety trades to be the winners. But this time around, there were some notable differences that caught our eyes:

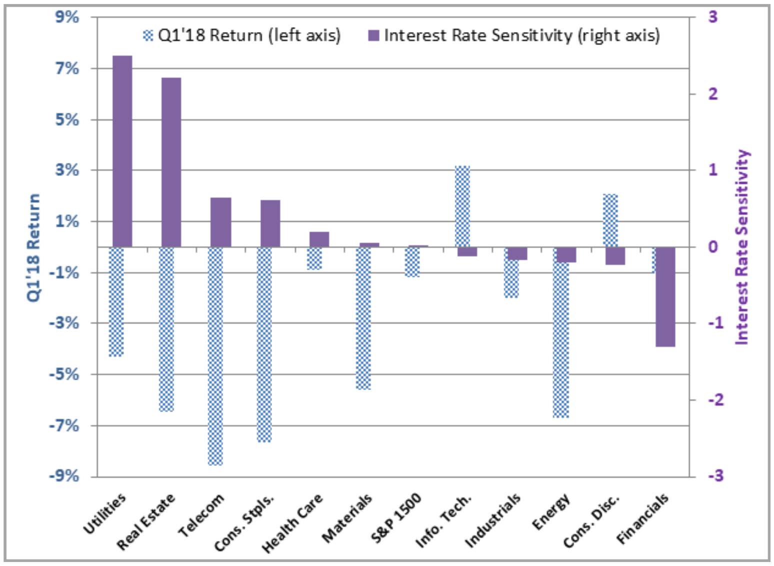
- 'Conventional' safety might have led us to expect large cap blue chip stocks to outperform, but during the first quarter it was microcaps that led the market. In fact, microcaps outperformed small caps, which outperformed midcaps, leaving large caps at the bottom of the pack.
- 'Conventional' safety might have led us to expect higher quality, free cash flow generative, inexpensive valuation stocks to outperform, but cash burners, expensive valuation, and higher momentum names led the market.
- 'Conventional' safety might have led us to expect defensive stocks and sectors to outperform the rest of the market as it declined, but traditionally defensive stocks went into decline as well, with the Russell 1000 Defensive® Index, the S&P 500 Low Volatility Index, and the MSCI USA Minimum Volatility Index all down by ~2% for the quarter.

Friends in Low Places

Another notable feature of the first quarter was that U.S. 10 Year Treasury yields rose from 2.40% to 2.74% and bond prices stumbled. This key feature of the quarter may help explain why the market did not follow the typical defense playbook, because while defensive stocks have tended to offer better performance during periods of market weakness, many do *not* perform well during periods of rising interest rates.

It appears the relationship between stocks and bonds may be changing, which could demand yet another refresh of conventional wisdom. Over the past several decades, interest rates have fallen when stock markets declined, so interest rate sensitive stocks have strengthened. Not so this time around. So what can investors do if both the equity bull market and the bond bull market end at the same time?

At Matarin, interest rate risk is one of the macroeconomic risk factors for which we control through our Northfield risk model. The chart at the right shows the average interest rate risk of each sector within the S&P 1500, as measured by Northfield, along with its price change for the quarter. This chart demonstrates the connection between interest rates and traditionally defensive stocks, such as REITs and utilities. At Matarin, another useful approach to managing portfolio sensitivity to interest rate risk is simply to avoid significant relative exposure to rate-sensitive sectors by remaining sector neutral.



In many cases, this connection between interest rates and defensive stocks arises from these stocks' high dividend yield. In the current low interest rate environment, investors have turned to high dividend stocks in search of the yield for which they would have traditionally bought bonds (the dividend yield on stocks is higher than many countries' sovereign bonds). As a result, the correlation between the prices of bonds and high dividend stocks has risen. And, as interest rates rise, there is a risk that the higher dividend yield interest-rate substitute stocks will begin to look less attractive, and along with bond prices their share prices may come under pressure too. This is exactly what we witnessed during the first quarter.

Relative Safety

When this period of growth and exuberance ends, for the first time in a long-time, we may experience a bear market that is fueled by rising interest rates and falling bond prices, rather than quelled by falling interest rates and rising bond prices. In this scenario, traditionally defensive sectors like real estate and utilities – and defensive strategies like low volatility -- may underperform during the downturn, just as they did in the first quarter. And we see it as unlikely that expensive growth stocks will continue to protect on the downside, as well.

Therefore, now as ever, in addition to focusing on alpha generation, we are emphasizing risk management-- measuring and managing the exposures of our portfolios to interest rate and stock market risk (beta) itself. Sound risk management will always be an important part of the conventional wisdom here at Matarin.

Data Sources: Compustat, S&P, FactSet, Northfield. Data as of 3/31/18.

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