MATARIN CAPITAL

Investing with Insight and Integrity

Q2 2017 Newsletter

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.

See general disclaimer on *last page.*

Less is More

In his book *The Map and the Territory*, Alan Greenspan reflects on his time as a young economist in the 1950s when the physical weight of goods produced was a useful measure for tracking U.S. economic growth. He observes that by this measure, the U.S. economy has not grown since the late 1970s, as we have substituted "ideas for physical volume," "intellectual for physical labor." As the physical weight of goods produced in the economy fell, so did fixed investment in the property, plant, and equipment used to produce them. Today, a sign of progress is that the goods that we are producing are getting smaller and lighter, and some of our most important assets are weightless.

In a similar vein, at this year's Berkshire Hathaway annual meeting, Warren Buffett said of the five largest American companies (by market capitalization) that you "could essentially run them with no equity capital at all….You really don't need any money to run these companies." It is remarkable to consider that these five companies, with $3 TRILLION in market value — roughly 10% of the total market capitalization of all U.S. listed names — require little in terms of capital assets. Like Alan Greenspan, Warren Buffett is pointing out how much things have changed. While our economy was largely built on tangible assets (property, plant, & equipment (PP&E)) in which additional capital spending was required to expand and grow (think railroads, steel mills, etc.), in today's economy intangible assets (intellectual property, patents, brands, networks, etc.) have increased in importance and value.

The table at the right shows how the capital intensiveness of the top 5 U.S. companies has evolved in the past 30 years. One unit of physical assets, as measured by net PP&E, supported 2 times its value in market cap in 1987. Today, the same amount of PP&E supports 28 times its value!

The top 5 today have a combined market capitalization of nearly $3 trillion but fixed assets of only $117 billion. These 5 names actually have more than twice as much CASH as fixed assets and trade at an average of 10 times book value now. Thirty years ago the 5 largest stocks traded at 2.4 times book value. It's also amazing that 3 of the 5 highest valued companies in America today were founded less than 25 years ago (Amazon in 1994, Alphabet in 1998, and Facebook in 2004). Ferris Bueller was spot on when he said, "Life moves pretty fast. If you don't stop and look around once in a while, you could miss it."

2017	Market Cap	Net PPE	Mkt Cap/PPE	Book Value	Price/Book
Apple	750	27	**28**	132	**5.7**
Alphabet	643	34	**19**	139	**4.6**
Microsoft	532	18	**29**	69	**7.7**
Amazon	463	29	**16**	19	**23.9**
Facebook	438	9	**51**	59	**7.4**
		Average	**28**		**9.9**
US Market			4		3.1

1987	Market Cap	Net PPE	Mkt Cap/PPE	Book Value	Price/Book
IBM	98	22	5	35	**2.8**
Exxon	66	50	1	33	**2.0**
GE	50	10	5	16	**3.1**
AT&T	30	20	1	14	**2.2**
Du Pont	29	16	2	13	**2.2**
		Average	2		**2.4**
US Market			2		**2.1**

At Matarin, all else equal, we prefer "asset light" companies with a limited need to spend heavily on capital expenditures. Within our Business concept, we favor efficient, long-term free cash flow generative businesses. In fact, we think each of today's top 5 — "FAAMA"— names has a better than average business. However, a good business is not enough for us, as we also want strong management, an inexpensive valuation, and catalysts on the horizon. In addition, within our Price concept, we think it makes sense to view valuation through a variety of lenses sourced from each of the 3 major financial statements that vary based on the type of stock we are analyzing. We would argue for the 5 largest names today that book value has little relevance. Across our strategies, we even own several companies with *negative* book value (which means more in liabilities than assets), which often occurs in businesses that are both asset efficient, and have track records of repurchasing shares at prices above book value per share.

As the economy continues to get more asset light, we offer 3 investment theses to investors regarding hard assets and book value:

1. Stocks can sometimes look expensive based upon book value, not because of overly optimistic expectations, but for accounting reasons or because they are asset light. Thus, shorting stocks based largely on price-to-book value ratios is a risky proposition.
2. Some industries are asset heavy, and some industries are asset light, so using book value to compare stocks in different industries can lead to consistent biases and invalid comparisons (think energy equipment versus computer software).
3. Take style index returns with a grain of salt. Through Q2,the Russell 1000 Growth index has outperformed the Russell 1000 Value Index by 9%. But Russell and others are using book value / market cap to compare stocks across the whole market. This means that companies like Apple, which are generating a lot of cash, but have relatively low book value are overlooked as value stocks. In fact, the Russell 1000 Value Index excludes Apple entirely, even though Apple trades at a cheaper cash flow multiple than the highest weighted name in the Value Index – Exxon Mobil. Therefore, our third piece of advice is to remember that "value" is in the eye of the beholder.