Matarin Capital

Investing with Insight and Integrity

2017 U.S. Tax Reform: A Case Study in Future Investment Merit

February 2018

The Tax Cut and Jobs Act of 2017

During December 2017, major U.S. tax reform was passed which will lower the corporate tax rate from 35% to 21%. Resultantly, as companies begin to announce first quarter 2018 cash flow and earnings in April 2018, these data items will not offer an easy apples-to-apples comparison with the same data items from 2017. Different companies will be impacted by the tax law change on different days, as they announce at different times, and in many cases, substantial one-time events have already been pushed into the 2017 fiscal year.

The Future Investment Merit of Tax Reform

At Matarin, although we are quantitative investors and benefit from being able to use backtests to evaluate our ideas, our investment process relies first and foremost on what we believe is the "future investment merit" of every idea. Therefore, when tax reform was passed, we immediately began to think about how the law would affect the items in our forecasting models going forward.

We focused immediately on earnings and operating cash flow data items. Earnings would be the most affected by far, but fortunately we tend to avoid the use of earnings in our process for the most part, because we believe that this data item is too easy to manipulate, and too widely followed by other investors. As a result of this thinking, Matarin's investment team decided to create a factor that would replace the operating cash flow yield factor that is included among the valuation factors in our "Price" concept.

Pre-Tax Yield

After some discussion and research, we settled on a factor which we are calling "**Pre-Tax Yield**." (This is not a standard accounting item, and so part of our research project included inventing a new name!) Pre-Tax Yield excludes items normally included as part of the net income calculation, such as income tax expense and deferred tax income (impacted by the tax law change), non-recurring special items, and non-operating income and expenses.

Historically, Pre-Tax Yield performed similarly to the operating cash flow yield factor, which it is replacing. And as the effects of tax reform flow through the market over the course of the next year, we have much higher confidence in Pre-Tax Yield's ability to predict future stock price performance during that period. More subtly, because Pre-Tax Yield is not a commonly-available factor for other investors to use, we are inclined to continue to use the factor in our investment process even after the effects of tax reform have waned, in the hopes of also benefiting from its relative uniqueness.

The Future Investment Merit of Matarin

We often like to tell our clients and prospects that they might consider feeling comfortable with their investments at Matarin, not mostly because of the returns that our strategies have delivered in the past, but much moreso because they have strong confidence in our ability and intention to continue to advance the process in the future. We view the latter as essential because the markets themselves will always continue to evolve. The Tax Cuts and Jobs Act of 2017 and Matarin's new Pre-Tax Yield factor offer just one real-time example of this commitment.

Disclaimer

The information in this document is confidential and proprietary and is neither an offer to sell nor a solicitation of any offer to buy any securities, investment product or investment advisory services. This document does not contain all of the information necessary to make an investment decision, including, but not limited to, the risks, fees and investment strategies of any fund or account managed by Matarin Capital Management, LLC ("Matarin") or its affiliates. Nothing herein is intended to constitute an offer or the solicitation of an offer, or an agreement as to the terms on which any account would be managed.

This document has been prepared at the request of the recipient, is not an advertisement, is not intended for public use or distribution, and is intended exclusively for the recipient's use. This document is not to be reproduced or redistributed to any other person without the prior consent of Matarin.

The views expressed herein are those of Matarin and are not intended as, nor should they be utilized as, investment advice or recommendations. In addition, nothing herein should be construed as tax or tax-related advice; any investor, client, or prospect is encouraged to discuss tax-related questions or concerns with a tax professional.