Matarin Capital

Investing with Insight and Integrity

Q2 2016 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.

Technically Speaking...

Why do momentum strategies work?

In the article "Use Your Edge," legendary investor Peter Lynch wrote "One of the oldest sayings on Wall Street is 'Let your winners run, and cut your losers.' It's easy to make a mistake and do the opposite, pulling out the flowers and watering the weeds." Momentum investing works because investors are biased gardeners. The bias is to sell strong stocks too soon and hold on to weak stocks for too long. This bias, called "the Disposition Effect," prolongs the price discovery process and can make following price trends rewarding.

What's happened in 2016?

2016 got off to a rough start for stocks with the average stock in the US market down over 13%. During the first six weeks of the year, the bottom performers of late 2015 continued to do very poorly, led by the strong selloff in energy stocks. So, momentum-based strategies may have been a strong driver of performance on the short side of certain hedge fund portfolios, as it was in Matarin's. However, on the long side, momentum strategies which wagered that health care stocks would continue their strength from the prior year were horribly disappointed, as health care went on to become the poorest performing sector in the market.

As is often the case, buying begets more buying, or selling begets more selling to the point that prices overshoot. And indeed, when investors returned to their desks on February 16th, they witnessed a dramatic reversal as momentum strategies got smoked, with prior losers bouncing hugely and past winners underperforming. This persisted through the end of the second quarter.

What can we learn from this?

Momentum is All Relative All momentum is not created equal. Sector momentum did particularly poorly after the February turnaround, so indicators which considered performance of stocks within sectors fared better than those which just consider the top and bottom performers within the overall investment universe. Measures which consider momentum within the broad investment universe would have been more exposed to the market's sharp reversal, as some specific sectors, including energy and materials stocks, were abundant in the negative tail. At Matarin, we compare the momentum of stocks within industries, rather than within the broad investment universe to avoid this risk.

Returns of Top vs. Bottom 20% (2/16 - 6/30/2016)	
Pure 12-Month Momentum	-19%
Industry-Relative 12-Month Momentum	-12%

Time Horizon Matters Shorter-term trend following is focused on price changes over a brief period – perhaps a month, weeks or days. These momentum indicators would have more quickly offered positive performance after the mid-February about-face, as information about the turnaround in prices was reflected more quickly in short-term windows. Once they had adjusted to the new information, these indicators would have rightly predicted that the turnaround would continue. Of course the risk of focusing on time horizons which are too short-term, is that these fast-moving indicators may offer too much "noise" as opposed to reliable "signals" over time. At Matarin we approach these nuances by including information about multiple periods' returns in our measures.

Find a Way to Stay Cool By April, the performance of momentum factors had gotten so bad that some investors may have been tempted to capitulate and remove momentum indicators from their processes entirely. However, it would have been a bad decision to throw this indicator out of the processes after the February experience. By May, momentum indicators in Matarin's process turned around and started working again. Momentum investing is, in general, prone to sharp drawdowns. So, it is important to find a way to use it which eases drawdown experiences, and avoids loss positions in which investors "just can't take it anymore."

Momentum in Sheep's Clothing Factor risks which are not traditionally correlated with momentum may become correlated with it as those factors gain or lose in performance. Momentum will reflect what's moving in the market, so a manager who's had strong recent performance and low turnover is likely to own a positive momentum portfolio, while a manager who's had weak performance will own a negative momentum portfolio — even if the managers have no explicit momentum component in their investment processes.

The data on positive vs. negative earners reveals that measures of quality have demonstrated a meaningful correlation with momentum in 2016. In fact, it was exposure to measures of quality rather than momentum which was most challenging for Matarin's performance during Q2'16.

Coming into Q2 2016...

Trailing 1-Year Earnings	Prior 1-Year Return	Q2 2016 Return
Positive Earners	-4%	3%
Negative Earners	-26%	8%
All Stocks	-7%	4%

One Strategy, Many Tactics

For Matarin, investing unemotionally, targeting the use of momentum in certain types of stocks, looking at momentum on an industry-neutral basis, and pairing momentum with several perspectives on valuation has led to portfolios which were less dramatically impacted by the sharp losses for momentum. This investment process was designed with an aim of avoiding situations which would inspire the emotional response of dramatic revisionist changes to investment approach in the heat of the moment. These tactics enable us to stick with strategies for the long run.

Source: FactSet
Data reflects Matarin's 2700+ All-Cap U.S. Stock Universe

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