Investing with Insight and Integrity

Q3 2011 Quarterly Letter

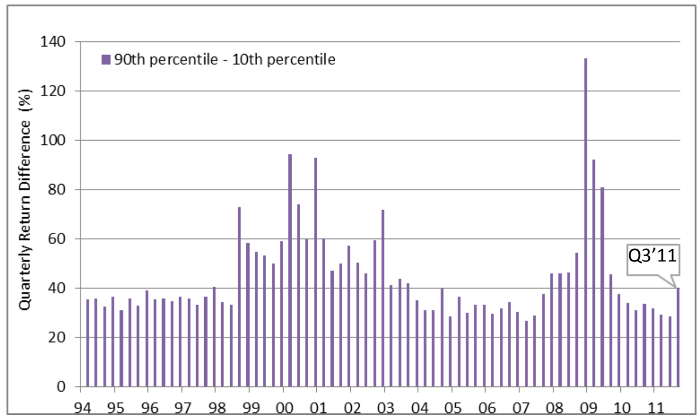
Matarin aspires to be an investment management firm that is a symbol of stewardship within our industry. We are dedicated to delivering excellent investment performance through insight, passion, and diligence. We aim to build strategic alliances with our clients based on the highest ethical standards.

Commentary: U.S. Markets

"The correlation of moves in individual stocks and the S&P 500 index is at a record, making the job of long-only mutual fund managers to differentiate from the benchmark virtually impossible," reported CNBC this quarter. "Elevated correlation is generally considered a poor environment for long-only fundamental investors. In highly correlated sell-offs the market does not discriminate based on company fundamentals, reducing the value of stock picking."

We've been dismayed to hear this and similar commentary spread throughout the quarter, because logically, the thinking is based on a completely false premise. What matters for active managers is not whether all stocks are moving in the same *direction* (as measured by correlations), but whether there is any difference in the *degree* of their movement. If some stocks are up a little and other stocks are up a lot, there is ample opportunity for stock pickers to beat their benchmarks by picking the stronger stocks. The same is true in environments where most stocks are down, if some are down much more than others. In general, the degree of opportunity for stock pickers can be defined as the spread in returns between the market's top and bottom performers.

Return Spread between Top and Bottom Performing Stocks



Sources: S&P, Compustat and IDC; Data as of September 30, 2011

The accompanying chart shows the return difference between the S&P 1500's 90th and 10th percentile performers, quarterly, from 1994 to present. While the opportunity for stock pickers was not as great as during the tech bubble of 1999-2000 or the financial meltdown of 2008-2009, it was about normal as is measured by the degree of difference in returns.

Commentary: Global Markets

This quarter, when interest rates on 10-Yr Government Bonds fell below the dividend yield on the S&P 500 for the second time since 1958, we asked ourselves how the observation should inform our market expectations, if at all. This relationship had been reversed for all of recorded history before 1958 – about 77 years, with the exception of the crash in '29 – until inverting again during the Financial Crisis in '08 and then again last month. Recently, these yields have also swapped places in other countries around the world: from Switzerland and Japan to UK, Germany Australia and Hong Kong.

Does this observation tell us anything important about future stock or bond returns? Our adjusted Dividend Discount Model presented at the right reveals that there are two possibilities worth considering: 1) the equity risk premium being priced into the market has risen; 2) the growth rate has declined. Another element that's not as clear in the formula is that any increase in the premium provided to "safe haven" currencies would also cause those countries' Treasury yields to fall, and dividend yields to appear relatively larger as a result. So in many emerging market countries which enjoy higher growth rates and/or no safe haven status – India, China, South Korea – the dividend yield remains below Treasury yields, as they were in the US for the past 53 years. But in the developing world: rising risk, falling real growth, and rising safe haven premiums… should investors run for the hills?

Adjusted Dividend Discount Model

Dividend Yield > *Treasury Yield* IF *Equity Risk Premium* > *Real Growth Rate*

Here's the good news for our readers: while Dividend/Treasury yield relationship is a helpful tool for explaining the current environment, it is not a particularly useful tool for predicting the future direction of the stock market overall. The indicators at work are driven largely by investor sentiment. When projections for growth and risk are at their most extreme, this indeed may be the time to discount them most heavily.