MATARIN CAPITAL

Investing with Insight and Integrity

The Good, the Bad, and the Speculative

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Eighty years ago Ben Graham opined on differentiating between investments and speculations when he said, "An investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return. Operations not meeting these requirements are speculative."

At Matarin, we think speculations can be defined as those companies that are both money losing (negative earnings) and cash burning (negative cash flow). Stocks of these companies are typically not priced based on what they have produced in terms of sales, earnings, or cash flows, but rather on what they may produce in the future. A company cannot survive as an ongoing entity, though, if it continues to lose money and burn cash. We think that there is strong future investment merit in the notion that these companies will underperform the market over time as actual results fall short of optimistic expectations. In fact, over the past 22 years, the stocks of these speculative companies have underperformed the stocks of money making, cash generating companies by an impressive 12% per year, on average.

Investors can ignore the speculative nature of some companies by focusing on earnings rather than cash flow. Generally accepted accounting principles can enable companies to report higher earnings than are supported by underlying cash flow. But again, these poor earnings quality stocks (those with positive earnings and negative cash flows) also tend to underperform the broad market by over 7% per year. At Matarin, we do not focus on reported earnings as history shows that earnings are easily manipulated, and not an especially reliable metric. As demonstrated in the upper table below, typically it pays to “follow the cash.”

Universe of 3000 Largest US Stocks, 1990 –2012 (12-month average returns)

	Cash Flow Negative Companies	Cash Flow Positive Companies	Whole Universe
Earnings Positive Companies	*Poor Earnings Quality* 3.5%	*Investment Grade* 12.3%	12.0%
Earnings Negative Companies	0.1% *Speculative*	9.6% *High Earnings Quality*	5.0%
Whole Universe	1.0%	12.1%	11.0%

Clearly, in the long run, it is beneficial to avoid owning both poor earnings quality and speculative stocks. However, there are shorter periods of time when these types of stocks will outperform: During the technology bubble of 1998 and 1999, speculative stocks dramatically outperformed the rest of the stock market as investors valued companies on inflated expectations for future earnings. Remember when eToys was going to dominate the toy business and AOL was going to rule the internet?

During post-recession bull markets, lower quality stocks have outperformed, as was the case after the last three recessions (as defined by the National Bureau of Economic Research): 1990 to 1991; 2001; and 2008 to 2009. Those recoveries led investors to believe the earnings of poor quality or speculative companies would improve, which propped up stock prices and led to outperformance in the short term during 1991, 2003, and 2009.

Beginning in August of 2012, supported by hopes of a move toward Eurozone crisis resolution and further stimulus from the Federal Reserve, many speculative and poor quality stocks led a market rally. At Matarin, we define these companies with the greatest risk of disappointment in future sales and cash flows in the face of continued economic uncertainty as “bad businesses.”

These are typically less efficient businesses with weak cash flow generation. While this concept is only one of the four concepts we use to evaluate the excess return a stock is likely to deliver, it is the one on which we place the greatest emphasis, given the consistent and dramatic out-performance of “good businesses” in the market over time. As you can see in the lower table on the right, companies burning cash significantly outperformed in August/September. Interestingly, companies generating negative cash flow but positive earnings (weak earnings quality) were the top performers, and likely helped those managers following earnings and ignoring the cash. While the type of “speculative rally” currently occurring can continue over short periods of time, we suggest that in the long run it is much more profitable to invest in good businesses that make money and generate positive cash flow rather than poor businesses that lose money, burn cash, and have poor earnings quality. Even if they outperformed in August/September, Ben Graham would be reminding investors that “in the short run the market is a voting machine, but in the long run it is a weighing machine.”

Universe of 3000 Largest US Stocks, August-September 2012

	Cash Flow Negative Companies	Cash Flow Positive Companies	Whole Universe
Earnings Positive Companies	*Poor Earnings Quality* 11.0%	*Investment Grade* 6.3%	6.4%
Earnings Negative Companies	9.7% *Speculative*	7.5% *High Earnings Quality*	8.5%
Whole Universe	10.3%	6.7%	7.1%

Data as of September 30, 2012. Sources: Compustat, FactSet