MONONGAHELA CAPITAL MANAGEMENT

PERCEPTIONS

1st Quarter, March 31, 2014			
	3/31/14	**% Change 1st Quarter**	**% Change Year**
Dow Jones Industrials	16,457.66	- 0.15 % *	- 0.15 % *
S & P 500	1,872.34	1.81 % *	1.81 % *
Russell 2000	1,173.04	1.12 % *	1.12 % *
BC Aggregate BD Index		1.84 %	1.84 %
10 YR Treasury Yield	2.726%		
30 YR Treasury Yield	3.561 %		

**** Includes reinvested dividends***

Flash Boys

Michael Lewis recently proclaimed on CBS's *60 Minutes* "The United States stock market, the most iconic market in global capitalism, is rigged." What followed was an exposé on High Frequency Trading (HFT) as described in Lewis' latest book *Flash Boys, a Wall Street Revolt*. Brad Katsuyama, a former RBC trader, emerges as the central heroic figure in this well told story. With equal measure of poetic license and hyperbole, Lewis spins a yarn of what he considers the insidious world of High Frequency Trading.

By way of definition, HFT uses computer driven models to exploit small price discrepancies on various stock exchanges. HFT firms develop proprietary trading strategies that allow them to move in and out of positions in milliseconds, aiming to capture a fraction of a cent on each short-term trade. They typically avoid leverage and holding positions overnight: profits are generated by voluminous trading. High frequency traders most often compete against other HFT firms, and thrive on volume, not fundamentals.

The rise in HFT coincides with a regulation passed in 2005 that was designed to open the market and provide investors with trading options other than the New York Stock Exchange and the Nasdaq. The theory was that more exchanges would mean greater competition and better pricing. In reality, more exchanges meant more opportunities to exploit small pricing anomalies among the markets. Today there are 16 registered stock exchanges and numerous dark pools (dark pools are in-house markets maintained by the larger firms). The key to successfully exploiting minute price discrepancies in these exchanges is speed. In a world measured in milliseconds, being the first to see order flow gives one a tremendous advantage over the

competition. Lewis notes "Someone out there was using the fact that stock market orders arrived at different times at different exchanges to front-run orders." The predatory behavior of HFT traders adds no value to the investment or trading process. The combination of high frequency trading, dark pools and payment for order flow exaggerates volume but adds zero liquidity.

To put the need for speed in HFT in perspective, the earliest chapters of the book describe the unfathomable expenditures of time and money that HFT firms will deploy in order to gain an advantage measured in milliseconds in seeing market orders. Mr. Lewis estimates that Spread Networks, a start-up firm, spent over $300 million to lay a secret fiber optic cable between Chicago and New Jersey, bypassing the conventional telecom carriers to gain time. The newer, faster optic line could then be leased to HFT firms at astronomical prices.

Another HFT strategy involved the payment of hundreds of millions of dollars each year to physically locate computer servers close to stock exchanges so that trades could be executed milliseconds ahead of others. Mr. Lewis argues that HFT systems glean critical information from the stream of trading data flowing into their systems: this allows them to see which stocks other investors want to buy before the investors' orders are executed. These systems and pricing tiers are designed specifically for high-speed trading. They are charging higher rates for faster speeds and more data for select clients. The more you pay, the faster you trade. In theory, the faster you trade, the more money you make.

The remainder of the narrative details the struggles of a small group of individuals to create an exchange that eliminates the advantages offered to HFT. Theoretically, the new electronic exchange (IEX) envisioned and developed by Brad Katsuyama will allow all investors the ability to trade at the same time, no matter what superfast fiber-optic cable others build to gain an advantage.

While trading is an important component of portfolio management, it pales in comparison to the significance of solid fundamental research. Successful value investing at its core is a slow process, requiring exhaustive research and the patience to buy at discounted value. To support our research and portfolio management, we have developed and built our proprietary trading desk for one and only one purpose; best execution for clients.

We applaud the efforts of Brad Katsuyama and as part of our continued due diligence, we are examining the potential use of the IEX exchange.