MONONGAHELA CAPITAL MANAGEMENT

PERCEPTIONS

3rd Quarter, September 30, 2014	9/30/14	% Change 3rd Quarter	% Change Year
Dow Jones Industrials	17,042.90	1.87 % *	4.60 % *
S & P 500	1,972.29	1.13 % *	8.34 % *
Russell 2000	1,101.68	-7.36 % *	-4.41 % *
BC Aggregate BD Index		0.17 %	4.10 %
10 YR Treasury Yield	2.509 %		
30 YR Treasury Yield	3.212 %		

*** Includes reinvested dividends**

Capital Flows

Since the financial crisis of 2008, the Federal Reserve and central bankers have maintained a very relaxed and accommodating monetary policy, translating into artificially low interest rates. The historical tsunami of easy money washed over trading rooms, indirectly leading to highly correlated market returns. The term highly correlated markets refers to market conditions in which various classes of securities (i.e. large cap stocks and small cap stocks) move in the same direction regardless of the inherent merits of the underlying individual securities.

In a highly correlated market, the importance and use of individual equity and bond analysis is minimized. With trading dominated by aggressive high frequency traders, hedge funds, ETFs and futures trading (they love those S&P 500 minis!), indexes, baskets and futures are bought and sold with little research being done on the individual components. Interestingly, in the bond market, the thirst for yield has been so great that investors are treating lower grade sovereign risk, like Italy and Spain, as the quality and risk equivalents of US Treasuries. While the US ten year Treasury closed the September quarter at 2.5% yield, Spain's ten year bond yielded 2.17% and the Italian ten year bond yielded 2.3%. Both the Italian and Spanish bonds traded at a premium to the US Treasury equivalent. Remarkable!

A guiding principle in Graham and Dodd Value Investing is that financial markets are often inefficient. Through security analysis, individual stocks can be identified that are worth more than their current price. Over time, the markets will discover the actual value of the security, and the stock price will appreciate towards its true value. As long as markets are highly correlated, however, this process of discovery is put on hold. In general, equities go up together and down together in these periods.

In the 3rd quarter, as noted in the introduction, the market was bifurcated and the correlation began to decline. In periods of transition from high correlation to low correlation, securities become mispriced. As capital flow changes, particularly with lower volume securities, the rush for the exit causes exaggerated swings. Positions that took years to build are dismantled overnight and the laws of supply and demand dictate price declines to clear supply. A good example is the distribution of II-VI over the last three months.

Distribution

Over the last four years, institutions began aggressively accumulating II-VI and by the end of 2013 were the dominant shareholders. Most institutions had a momentum or growth profile and some were High Frequency Traders and ETF Funds. As II-VI struggled in digesting the *Oclara* acquisition, the institutions and fast money began leaving the stock en masse. In the second quarter, 13 institutions sold their entire position of 3,732,276 shares while 11 new institutions acquired 300,736 shares: a 12:1 sell ratio. As the Russell 2000 began to slide, the process accelerated in the 3rd quarter with the stock sliding towards $11 per share. Institutions continued to accelerate their selling in the 3rd quarter and that extended into early October. Simply put, the selling overwhelmed patient and price sensitive buyers.

Ultimately, the underlying fair value of a stock is based on its current and future earnings power. However, short term, stock price is often determined by capital flow and distribution. We met with II-VI on October 6, 2014 to discuss and review future earnings growth. While we only discussed and reviewed information that was public, we are comfortable that earnings are at a cyclical trough and we should see growth in net earnings going forward. At the same time, short term distribution trends that exaggerated the decline appear to be exhausted.

We remain positive on the long term prospects for II-VI and believe the short term negative distribution trends have turned. In a footnote, the company recently announced a $50 million share buyback.

As the market transitions from a highly correlated to less correlated one, opportunities for out-performance for value investors will be enhanced. Lower market correlation will provide opportunistic entry points for high quality value stocks.