MONONGAHELA CAPITAL MANAGEMENT

PERCEPTIONS

3rd Quarter, September 30, 2016

	9/30/2016	**% Change 3rd Quarter**	**% Change Year to date**
Dow Jones Industrials	18,308.15	2.78 % *	7.21 % *
S & P 500	2,168.27	3.85 % *	7.84 % *
Russell 2000	1,251.65	9.05 % *	11.46 % *
BC Aggregate BD Index		0.46 %	5.80 %
10 YR Treasury Yield	1.605 %		
30 YR Treasury Yield	2.34 %		

* *Includes reinvested dividends*

"It is not necessary to change. Survival is not mandatory."
W. Edwards Deming

Although Deming was speaking of business management practices at the time, his observation holds true for any institution or organization, including cities. One of the best examples of adaptation can be found in the history of Pittsburgh, Pennsylvania. The city is well known for its deep industrial roots and in many regards was the quintessential American Industrial City. Andrew Carnegie built his industrial empire in Pittsburgh and also sowed the seeds of change by funding the Carnegie Technical School in 1900. The Carnegie Technical School evolved into Carnegie Mellon University. As domestic steel production declined in the latter part of the Twentieth Century, Carnegie Mellon emerged in many regards as the quintessential technological learning center in America, especially renown for work in the field of robotics.

In 1995, research scientist Dean Pomerleau and Ph.D. student Todd Jochem, from Carnegie Mellon University's Robotics Institute, drove from Washington D.C. to San Diego, California in a self-driving minivan. Their trip was dubbed "No Hands Across America" and demonstrated CMU's leadership in the field of self-driving cars. When Uber began to explore the use of driverless technology in late 2014, Uber CEO Travis Kalanick flew to Pittsburgh to tap into the deep knowledge base in robotic technology at Carnegie Mellon University.

In September of 2016, a few Uber customers in Pittsburgh were invited to test (ride) a self-driving car. Uber is a privately owned ride hailing service which debuted in San Francisco in 2011, now offering service in 507 cities worldwide. The selection of Pittsburgh for the driverless car pilot program was not random but the result of the evolution of technology. Pittsburgh is proud to claim both its steel title and its technology title. We note that Pittsburgh's survival is due to the ability of the city and its people to navigate change.

Navigating Change

Investing is never an absolute practice; it must adapt to the current environment and prepare for changes ahead. Recently, near zero interest rates levels have elevated equity prices, particularly dividend yielding defensive issues; because bond market alternatives are very limited. As value investors, we have benefited from the rising tide of cash generated by low interest rates. This stream of cash has been channeled into defensive industries like consumer non-durable, utilities, health care and safe haven assets.

Significant macro changes develop slowly and have a long shelf life. These are the changes on which we focus. While 2016 elections are grabbing the headlines 24/7, we are focused on the transition out of a thirty-five year bull market for bonds (declining interest rates); relative values will begin to change. Slowly, investors will leave the cocoon of defensive issues like Campbell Soup in search of higher relative yield and growth.

In the rush to safe haven assets, quality growth stocks like Hubbell Inc. and Rockwell Collins have been discarded by the market and left in the value bin. Buying quality growth stocks at value multiples should lead to strong growth. As an example, in December 2014, II-VI was being dumped by institutions into the "discarded" bin and closed the year at 13.65. Less than two years later, II-VI is trading at 25, up approximately 83% from the December 2014 levels.

We have avoided the banking sector for the better part of 35 years, but segments of the financial industry should benefit from slowly rising interest rates. MetLife (3.4% dividend) and Federated Investors (3.6% dividend) should see earning growth with modest increases in the Fed Fund rates. These positive trends should remain in place for many years.

It is our responsibility to search for value. Part of our success depends on recognizing significant changes in macro environments that will affect individual equity valuations.
From a bottom up value approach, our research suggests defensive issues and intermediate and long term fixed incomes assets are overvalued. Subtle macro changes in the interest rate environment provide the narrative to support that thesis. At the same time, the dislocation caused by extraordinary low interest rates has left certain sectors undervalued.

Pittsburgh's evolution from an industrial base to a balanced industrial / technological footprint was critical in its path to growth. Likewise, we look forward to adjusting your portfolio to the changes occurring in both the fixed income and equity markets.