MONONGAHELA CAPITAL MANAGEMENT

PERCEPTIONS

3rd Quarter, September 30, 2017

	9/30/17	**% Change 3rd Quarter**	**% Change Year to date**
Dow Jones Industrials	22,405.09	5.58 % *	15.45 % *
S & P 500	2,519.36	4.58 % *	14.24 % *
Russell 2000	1,490.86	5.67 % *	10.94 % *
BC Aggregate BD Index		0.85 %	3.14 %
10 YR Treasury Yield	2.328 %		
30 YR Treasury Yield	2.857 %		

* *Includes reinvested dividends*

Isaac Newton and the Amazon Effect

Isaac Newton presented his three laws of motion in "Philosophiae Naturalis Principia Mathematica" in 1687. Paraphrasing Newton's first law of motion, an object at rest remains at rest, or if in motion remains in motion at a constant velocity unless acted on by an unbalanced force.

The stock market seems to be complying with Newton's law as the S&P 500 streamed 4.58% higher in the quarter and 14.24% higher in the first nine months of the year. With relatively low funding cost, expanding P/E multiples and profit margin expansion, the major averages are trading at all-time highs.

Newton noted that it is the natural tendency of objects to resist changes in their state of motion which he described as inertia. We have had devastating hurricanes, threats from an unstable Korean peninsula, political turmoil across the globe and hints from the Federal Reserve about tightening monetary policy … and the market has stayed in motion. While we do not make macro forecasts, it is reasonable to assume that there will be an "unbalanced force" at some point that disrupts and changes the market's direction.

When we analyze the current bull market which began March 9, 2009, quantitative investing with the accelerant of extraordinarily low interest rates have propelled the market to all-time highs. Quantitative passive investing tends to focus on growth and momentum and has led to historical gains in large cap stocks like Amazon, Facebook, Netflix, Tesla and Apple. Our portfolios have also benefited from extraordinary growth in II-VI, AbbVie, Badger Meter, Edwards Lifesciences and Honeywell.

As value investors we identify mispricing based on fundamentals like earnings growth, dividend yield, balance sheet strength and quality of management. Focusing on fundamentals helps us to properly re-allocate in extended bull markets and move into out-of-favor issues which should outperform in the next cycle. These stocks tend to be deeply discounted and more defensive in a flat or declining market.

In the process of re-allocating, we will be trimming some winners like II-VI, AbbVie, Badger Meter, Edwards Lifesciences and Honeywell. These stocks have performed so well that they are now overweighted in the portfolios. At the same time, the unpopular and out of favor sectors, many of them disrupted by Amazon, present value at current levels. Like Walmart before, Amazon is an incredibly efficient disrupter with access to an extremely low cost of capital. The thinking on Wall Street is that Amazon will become the behemoth that crushes all competition in all sectors of retailing, rendering all other distributors obsolete. Inefficient distributors like Sears will be put of business, but for others, the selling is overdone. Because of the fear of Amazon, these stocks are trading well below their intrinsic value, with a generous 3% dividend yield. Equities in this category would include:

	10/13/17 Price	52 week range	Dividend Yield
Walgreens	67.56	67.40 - 88.00	2.35 %
General Mills	57.53	50.13 – 64.00	3.80 %
Darden	79.42	60.97 – 95.00	3.10 %

Managing risk, particularly with our value style dictates that we make adjustments when stocks exceed our intrinsic value models. The surge in growth stocks and a corresponding devaluation in the "Amazon effect" equities have presented an opportunity to re-allocate growth profits into value oriented legacy positions. Buying Walgreens, General Mills and Darden Restaurants at deep discounts to core value allows us to look ahead and prepare for the eventual "unbalanced force."