# MONONGAHELA CAPITAL MANAGEMENT

# PERCEPTIONS

| 2nd Quarter, June 30, 2018 | 6/30/18 | % Change 2nd Quarter | % Change Year to date |
|---|---|---|---|
| Dow Jones Industrials | 24,271.41 | 1.26 % * | (0.73) % * |
| S & P 500 | 2,718.37 | 3.43 % * | 2.65 % * |
| Russell 2000 | 1,643.07 | 7.75 % * | 7.66 % * |
| BC Aggregate BD Index | | (0.16) % | (1.62) % |
| 10 YR Treasury Yield | 2.85 % | | |
| 30 YR Treasury Yield | 2.98 % | | |

* *Includes reinvested dividends*

## Value in Aisle 6

Stocks continued their divergent path in the second quarter with industrials and consumer staples moving lower while large technology companies surged. For the first six months of the year, Netflix was up 103.9%; Amazon surged 45.35%; Facebook moved up 10.12%; Apple was up 9.38%. Momentum investing continued to drive the market as relatively easy monetary policy and low yielding alternatives pushed investors further out on the risk curve. In contrast, in the same six months of the year, General Mills was down 25.35%; Walgreen Boots Alliance declined 17.36%; Procter & Gamble was down 15.04%; Kimberly-Clark pulled back 12.7%. While we establish intrinsic value for specific securities, the compilation process from a bottom up perspective can reveal interesting sector patterns.

As portfolio managers, we categorize stocks into eleven sectors, listed below.

| Sector Industry | Market Cap (Trillions USD) | % Change as of 6/30/18 |
|---|---|---|
| Consumer Discretionary | 5.73 | 11.5 |
| Consumer Staples | 3.05 | -8.6 |
| Energy | 3.97 | 6.8 |
| Financials | 7.25 | -4.1 |
| Health Care | 5.22 | 1.8 |
| Industrials | 4.05 | -4.7 |
| Information Technology | 9.55 | 10.9 |
| Materials | 2.09 | -3.1 |
| Real Estate | 1.22 | 0.8 |
| Telecommunication | 1.64 | -8.4 |
| Utilities | 1.21 | 0.3 |

Sectors, much like individual equities, tend to vacillate between undervalued and overvalued levels. Our risk management process (again from a bottom up perspective) looks for levels of extreme deviation from intrinsic value. The Information Technology sector, now the largest sector, is dominated by the mega capitalization stocks like Apple, Facebook, Alphabet (Google), Microsoft, Nvidia, Intel and Oracle. The Consumer Discretionary sector is dominated by Netflix and Amazon (although we would consider Amazon more of a hybrid technology/consumer company.) These two sectors were up approximately 11% in the first half of the year.

Our valuation models and the market's historical performance suggest caution when sectors move rapidly towards extreme valuations at the same time that the broader markets are flat. We saw this play out in the sixties and seventies with the Nifty Fifty. Names like Polaroid, Xerox, Burroughs, and International Telephone and Telegraph were the rage and then underperformed for a quarter of a century. We saw the technology bubble burst in 2000. Names like Cisco, AOL, Sun Microsystems, Oracle, Nortel and EMC all traded above 100 times earnings and then proceeded to fall dramatically. More recently, the banking sector, after reaching extreme valuations in 2007, collapsed as the financial crisis unfolded.

Jeremy Siegel, professor of finance at the Wharton School was prescient with his caution in early March, 2000. He noted:

> Our bifurcated market has been driven to an extreme not justified by any history. The excitement generated by the technology and communications revolution is fully justified, and there is no question that the firms leading the way are superior enterprises. But this doesn't automatically translate into increased shareholder value… In a competitive economy, no profitable firm will go unchallenged. Margins must erode as others chase the profits that seem so easy to come by now. There is a limit to the value of any asset, however promising.

Siegel's comments are equally relevant today. The mega cap technology sector's meteoric rise has left valuations at historically high levels. While these are great enterprises, equity valuations now carry significant risk. At the same time, the pessimism surrounding the consumer staples sector has valued these great enterprises at steeply discounted prices and the risk/reward balance is favorable. We have been steadfast in our search for value for forty years, whether old economy or new economy, whether laser wafers or yogurt. Our research suggests that walking down aisle 6 in the local supermarket or strolling through Walgreens and observing the steady product placement from names like General Mills (Cheerios, Blue Buffalo Pet Food, Annie's), Procter and Gamble (Tide and Crest), and Kimberly- Clark (Scott Tissues, Kleenex and Huggies) should provide a safe haven, dividend premiums, and above average total returns for the next decade.