MONONGAHELA CAPITAL MANAGEMENT

PERCEPTIONS

3rd Quarter, September 30, 2018			
	9/30/18	**% Change 3rd Quarter**	**% Change Year to date**
Dow Jones Industrials	26,458.31	9.63 % *	8.83 % *
S & P 500	2,913.98	7.71 % *	10.56 % *
Russell 2000	1,696.57	3.58 % *	11.51 % *
BC Aggregate BD Index		0.02 %	- 1.06 %
10 YR Treasury Yield	3.05 %		
30 YR Treasury Yield	3.19 %		

* *Includes reinvested dividends*

The Pendulum

Howard Marks, Co-Founder and Co-Chairman of Oaktree Capital Management released his latest book on October 2, 2018, titled *Mastering the Market: Getting the Odds on Your Side.* His investment acumen, honed over fifty years as a value oriented manager, has allowed Marks to observe various market cycles and analyze their workings. In his study of historical patterns, he looks for opportunities that are created by the "mood swings of the securities markets."

> In business, financial and market cycles, most excesses on the upside- and the inevitable reactions to the downside, which also tend to overshoot- are the result of exaggerated swings of the pendulum of psychology. Thus understanding and being alert to excessive swings is an entry-level requirement for avoiding harm from cyclical extremes, and hopefully for profiting from them. (Howard Marks, p 82)

Before we can gauge how far the pendulum has swung, we first identify intrinsic value through various quantitative measures. Once we understand the inherent value of a security, it takes a Herculean effort to avoid the "Call of the Sirens." As Marks notes,

> The difficulty of understanding events, their significance and their potential ramifications comes in good part from the kinks in investors' psyches, and it contributes to –and feeds back to exacerbate - investors' responses. Thus investors tend to emphasize just the positives or the negatives much more often than they take a balanced, objective approach. And they tend to become

> optimistic and eager to buy when good news, positively interpreted, has forced prices up … and vice versa. All of this is obvious (especially in retrospect.) Thus, equally obviously, understanding and dealing with it presents a potential way to improve results. (Howard Marks, p 93)

Procter & Gamble illustrates the tendency to extrapolate negative trends ad infinitum, resulting in mispricing. By early May of 2018, Procter & Gamble had fallen approximately 20% to $73 per share from its year end price of $91.88. As expected, a cacophony of negative commentary and sell recommendations accompanied the decline. There were fears of margin pressure, concerns about the impact of Amazon, lack of pricing power, low organic growth as well as a myriad of other ills. The forces of forecasting pessimism pulled the pendulum far to the left of equilibrium. From that oversold position, the stock began to rally. The rally culminated today (October 19th) with a one day 8.38% gain after reporting healthy organic demands for many of its core brands, like Old Spice, Pantene, Olay and Head and Shoulders. From its May bottom, Procter &Gamble has rallied 19% while yielding almost 4% in dividends. We of course could not forecast the future in May; however the excessive selling lowered the risk to the point where the risk/reward was stacked in our favor. The down cycle created extreme pessimism resulting in an opportunity to buy a blue chip Dow stock at a significant discount to intrinsic value.

Like Howard Marks, we have spent a considerable number of years observing and understanding cycles. For consumer staples like Procter & Gamble, Colgate Palmolive, General Mills and Walgreens Boots Alliance the psychological pendulum has begun to swing back from pessimistic extremes. Excessive risk aversion in the Consumer Staple sector has lowered prices and presents a long term opportunity for above average total returns. Understanding behavioral tendencies along with the study of cycles significantly enhances return potential.

Marks, Howard. Mastering the Market Cycle: Getting the Odds on Your Side. New York: Houghton Mifflin Harcourt, 2018.