MONONGAHELA CAPITAL MANAGEMENT

PERCEPTIONS

3rd Quarter, September 30, 2023	09/30/2023	% Change 3rd Quarter	% Change Year to date
Dow Jones Industrials	33,507.50	-2.10 %*	2.73 %*
S & P 500	4,288.05	-3.27 %*	13.07 %*
Russell 2000	1,785.10	-5.13 %*	2.54 %*
BC Aggregate BD Index		-3.23 %	-1.21 %
10 YR. Treasury Yield	4.57 %		
30 YR. Treasury Yield	4.70 %		

** Includes reinvested dividend*

Center of Gravity

On August 10th, 1628, the world's most technologically advanced warship, the Vasa, set sail on its maiden voyage. Leaving the Stockholm harbor, the ship encountered a light wind less than 1,300 meters from the dock and within twenty minutes, the Vasa tragically sank with significant loss of lives. The ship lay in the shallow waters of the harbor until 1961, when the extraordinary well-preserved Vasa was raised and now rests in the Vasa Museum in Stockholm, Sweden.

The design failure of the Vasa has been intensely studied since the fatal mishap, but at the core, the design and construction contributed to the extreme instability of the vessel. King Gustav II Adolph of Sweden was very involved with the commission, design, and construction of the vessel. While Gustav was well educated and considered a brilliant military tactician, he had little expertise in ship design, particularly naval engineering. Under pressure from a war with Poland, Gustav pressed the upper limits of arming the Vasa and violated numerous "laws of physics." The King added a second cache of twenty-four cannons on the second deck, rendering the warship extremely top heavy and unstable. It was estimated that the Vasa was carrying 120 tons of ballast; woefully short of the amount needed to maintain the proper center of gravity. In a stability test performed right before launch in the presence of the ship's Captain Hannson and Navy Admiral Fleming, thirty men ran from side to side to test stability. After only three traverses, the ship was rocking so violently the test was halted for fear of heeling over. Not wanting to disappoint the King and miss a deadline, the results were never conveyed (or so the story is told) to the King. With a series of top-down change orders and a breakdown of communication between the original designer, the shipbuilders, and the King, the ship was delivered unseaworthy; failure was inevitable.

During the unprecedented era of ultralow/negative interest rates from 2008 to 2021, there was a great deal of unstable construction occurring on government and corporate balance sheets. With the temptation of low interest rates and the siren song of investment bankers, many companies piled on debt through acquisition binges and unbridled expansion plans. Unfortunately, a great deal of the debt was variable as opposed to fixed at low rates. Like the Vasa, when interest rates set sail at the end of 2021, the top-heavy debt-laden balance sheets began to expose the folly of growth-at-any-cost syndrome.

We have been writing about the risk of rising interest rates since our first quarter report of 2022, titled "The Punch Bowl." When we initially analyze an equity position, strength of balance sheet is the first hurdle and of course the liability side of the balance sheet is ground zero. While some debt is often warranted, it needs to be proportional to cash flow and stay within the boundaries of healthy debt ratios. An important tenant of our fundamental analysis is that the ability to service debt without disrupting current operations and future growth plans is critical for long term success.

As value investors, we expect the Captain Hannsons of the corporate world to stay the course and respect the sanctity of a strong balance sheet. Occasionally, we wake to the morning news that one of our companies is planning a major acquisition, one funded with debt. The scenario laid out by the Wall Street merger and acquisition advisors is always rosy, rarely discussing the draconian cost of significant debt in a rising interest rate environment. We save the official offering documents related to these acquisitions and of course as time goes on, they read like fiction. When acquisitions are made that are sizeable in relation to the buyer, our risk rises significantly. Those decisions are made without our input and as investors we can only react after the announcement, usually with the stock opening down. When appropriate, we will cull those stocks out of the portfolio.

While we have always tried to gauge management's risk appetite, it becomes even more relevant in the environment of higher interest rates. Our belief is that the higher rates we are experiencing are historically normal and management needs heightened respect for the risk associated with debt. As we continue to monitor and reduce risk in your portfolio, here are four companies we have added, or will be adding to your portfolio where appropriate. These are very well managed companies with minimum net debt, strong organic growth, and respect for the strength of their balance sheet.

Kulicke and Soffa Industries Inc (KLIC) $47.44 as of 10/11/23

KLIC designs, manufactures and distributes capital equipment and tools for assembling semiconductor devices. Niche products like ball bonders, wafer-level bonders, and wedge bonders drive the bulk of their capital equipment business. While the industry is cyclical, secular trends are positive and management has focused on research and development to drive future growth. Executives have reduced outstanding share count in the last 5 years from 70.4 million to 58 million, all from cash flow. The company remains net debt free and we have begun accumulating at opportune prices.

Lindsay Corporation (LNN) $117.58 as of 10/11/23

LNN, based in Omaha, Nebraska, provides proprietary water management systems and road infrastructure products and services. Irrigation systems represent approximately 85% of sales and innovative technology solutions are helping drive more efficient water usage, conserve natural resources, and increase crop yields. The long-term secular trends are positive for both divisions. The industry is cyclical and the stock is trading towards the low end of its 52-week range. Lindsay is a small capitalization stock with a market cap of approximately $1.3 billion dollars. A strong balance sheet and discounted price make LNN an addition to appropriate portfolios for exposure to the industrial and agricultural sectors.

Netscout Systems Inc (NTCT) $26.61 as of 10/11/23

NTCT is a provider of cybersecurity and service assurance for corporations and government networks. Their products and services help customers monitor and identify performance issues and defend against denial-of-service attacks and network threats. Like the companies mentioned above, NTCT has reduced share count from cash flow and maintained a net debt free balance sheet. The shares are currently on the low end of their 52-week range of $25.63 - $38.02 but appear attractive for our growth-oriented portfolios.

Williams-Sonoma Inc (WSM) $162.43 as of 10/11/23

WSM is a specialty retailer of high-quality home products. Brands include Pottery Barn, West Elm, Williams Sonoma, Rejuvenation, and Mark and Graham. Laura Alber, President and CEO since 2010, has provided excellent leadership with a focus on growth and innovation while maintaining a pristine balance sheet. Without incurring debt, WSM has purchased a significant amount of Treasury stock, reducing share count from 85.6 million shares in fiscal 2018 to 69.1 million shares in fiscal 2023. Year-to-date, the stock is up 41% despite a challenging retail environment. The private equity firm Leonard Green & Partners recently disclosed a 5% position in WSM. After years of accumulating this position, the stock has performed well, and at this price level is currently a hold for our portfolios.

Much like shipbuilders, Value Investors have numerous variables to consider when constructing a safe portfolio. In this interest rate environment, balancing your portfolio with net debt free companies is critical in establishing a strong center of gravity. At the same time, adding short term Treasury Bills yielding approximately 5.3% provides additional ballast.