Quarterly Letter from: October 12, 2015
Five Mile River Investment Management LLC
3rd Quarter 2015

PERFORMANCE

	FMR* *Taxable*	FMR* *Retirement*	S&P 500 *With Dividends*	Dow Jones	Russell 2000
1Q2014	-1.16%	+2.54%	+0.95%	-0.26%	+4.32%
2Q2014	-3.82%	-3.31%	-0.28%	-0.88%	+0.42%
3Q2014	-13.09%	-8.01%	-7.11%	-7.58%	-11.92%
9 Months	-17.38%	-8.80%	-5.27%	-8.64%	-7.72%

Average Annual Rate of Return**	**Combined FMR**	**S&P 500**	**Dow Jones**	**Russell 2000**
	9.96%	11.62%	10.25%	13.22%

Because the market lows and this reporting period coincided (9/30/2015), we wanted to provide perspective on the markets over the first two weeks of October. September's decline in the S&P 500 entered formal correction territory (greater than 10%) and was the worst monthly decline in well over a year. We discuss below the reasons why we believe this correction was healthy, that **the correction is probably over**, and importantly the first two weeks of October have produced a rally that has already regained much of the lost ground from September. Specifically, commodity, energy, and industrial stocks staged one of the strongest rallies of any two week period this year. FMR portfolios have risen between 10% to 14%, in just the last two weeks.

Normally our Five Mile River Investment Management quarterly communication does not devote a great deal of time focused on headline macro topics. But the third quarter's volatile stock market performance dictates that we discuss, in some detail and with some facts, a number of these issues that were headwinds this past quarter. We will cover **the 10% correction, a normal and healthy market event**, and that the S&P 500 is now selling at a price earnings ratio of 15 times forward earnings, instead of the overvalued 18 times that it was selling for at the end of 2Q. Also, the abnormal flash crash on August 24th needs to be discussed as it was precipitated by multiple quantitative risk and hedging strategies and made the market's downturn seem like something disastrous. Additionally, this letter will also address the events in the energy sector which represent a once in a generation price decline, that had a particular effect on our MLP holdings, held in taxable accounts.

The Current Correction: Why it is Normal and Why it is Probably Over

The current correction is the third since the market bottom in March of 2009. It was not a surprise, as the stock market has been fairly valued to over-valued in some sectors since the summer of 2014. What was a surprise

was the Dow Jones Average sudden drop of 1089 points in virtually a straight line on August 24th, with a surge in volatility and numerous trading halts on the New York Stock Exchange. The S&P index rebounded in early September and, as expected, retested the August low of 1867 as the quarter ended. **A "retesting" of the bottom is typical and importantly often signals the end of the correction.** The S&P 500 closed the quarter at 1920 down 7.11% for the third quarter. After a correction in a non-recession bull market, the S&P 500 typically rallies anywhere from 15% to 20% over the following six to twelve months. The market's volatility in the third quarter (often expressed as the number of days the market moves up or down more than 2%) was a precursor for the correction, and often signals a shift in the industry groups that will lead the market forward.

After the first flash crash and quick recovery in 2010 (Dow Jones down 1000 points and recovered in 30 minutes), how could it happen again five years later when supposedly the trading rules were changed to reduce volatility? Following the first flash crash in 2010, the stock exchanges created "market circuit breakers" that pause trading for individual stocks if their price changes too much in a short period of time. These rules were supposed to make trading more orderly during severe volatility in the markets. However, there had not been a real-time test of these new "circuit breaker" rules since adopted, and as it turned out, on this past August 24th, these rules were tested for the first time and failed miserably!

The new rules actually exacerbated trading problems and created spasms and trading halts in many stocks and Exchange Traded Funds (ETFs). ETFs are baskets of securities that trade throughout the day and emulate a specific index or sector (technology, as an example). They have proliferated over the past five years and now hold over $4 trillion dollars of investor money. Many of the ETF's could not be priced correctly on August 24th, because the underlying stocks were halted, or had delayed openings. This only exacerbated ETF holders' frustration, which induced more ETF selling that contributed to the markets' sharp sell-off. The fragility of these exchange rules and the worrisome liquidity problems with many of the ETFs were clearly exposed. Another change in these dysfunctional trading rules will be needed. Five Mile River portfolios do not own any ETF's, as we only own specific companies we have fundamentally researched.

CNBC and Other News Providers Want Us to Worry About the Wrong Things

It is normal and healthy for 10% corrections in long running bull markets. The portfolios managed by Five Mile River are dominated by dividend-rich investments that will continue to prosper and provide a **growing** stream of dividends and distributions for re-investment to build your wealth base. The last day of September and the beginning of October saw many of the FMR Blue Chip holdings rise by over 5%. The important message we emphasize here is to neither agonize over these seemingly dire "macro" headlines nor the short-term 10%+ corrections in the value of individual stock holdings. This fast downside correction does not equal permanent losses unless you sell out at the bottom of these corrections. On the contrary, the best buying opportunities usually occur when a sector such as energy gets knocked down hard, or a crazy day like the flash crash temporarily drops all security prices for a few minutes or an hour to illogical levels. We are staying the course with FMR's investment strategy to grow and protect the portfolio assets with our dominant "moat" companies producing strong free cash flow and growing their cash dividends for shareholders.

FMR Portfolios and the MLPs that are in FMR Portfolios

The broad S&P energy sector has declined on average about 20% since the beginning of the year. The high yielding master limited partnerships (MLPs) that we own in taxable portfolios declined in sympathy with all energy sectors anywhere from 15% to 25%. MLP companies build, own and operate pipeline, storage and processing assets. The MLP's that FMR portfolios hold include: Magellan Midstream, Enterprise Products, Enlink

Midstream, Markwest Energy and Williams, and are all TOLL takers with only INDIRECT exposure to the energy commodities and their price. These companies transport, store and process oil and gas and petroleum liquids. They do NOT produce or OWN these commodities, and get paid a fee per barrel, or gallon, or mcf (thousand cubic feet) of natural gas through long term contracts. Our MLPs have long-term "take or pay" contracts with minimums and reservation fees that are PAID to these companies even if the capacity in the pipelines or storage terminals is not used! Those fees grow with additional contracts for increased volumes and usage of these energy "highways," which is the primary cause for the growing distributions we receive as owners of these MLP shares.

We own these MLP's because they are truly unique investments. They carry very high current yields that are tax deferred income distributions, and our stocks have the ability to grow distributions well in excess of inflation on average 5% to 10% per year. We believe these MLP's will be able to sustain this growth over the next several years even with this oil price cycle distress and some future projects deferred. One contributing reason is that our pipeline investments connect to the most prolific, low cost energy reservoirs in the U.S. that should be unaffected by the current pricing environment. Robust double-digit demand for NATURAL GAS for both industrial demand (chemical plants) and electric power generation (replacing coal), has created many new growth projects for these MLPs. Not to be overlooked, 80+% of these high yielding (4% to 8%) MLP distributions are tax deferred in taxable accounts and offer significant advantages in minimizing current taxable income and for estate planning purposes.

FMR MLPs have been core holdings in taxable accounts over the past 10+ years as they have provided double-digit compound annual returns as cornerstone businesses enabling the expansion of our nation's energy infrastructure. With our abundant shale oil and natural gas resources now being developed, the U.S. is rapidly decreasing its dependence on volatile and hostile countries in the Middle East, Africa and South America. The long-term outlook for this sector is positive. The indiscriminate market selling in these companies' stocks, and the discount from their underlying performance, provides a significant buying opportunity.

Energy Sector Turmoil and the Outlook for Oil Prices

Oil prices began to decline one year ago when Saudi Arabia (produces 10 million barrels a day) surprised oil markets by deciding it was not going to cut production to stabilize oil prices at $100/barrel. The reasons could include the fact that most other OPEC producers were cheating on their quotas, and the Saudis thought it was probable this action would force U.S. high cost shale producers to dramatically reduce their production growth. West Texas Intermediate (WTI), the North American benchmark for crude oil price traded down 60% to a low of $42/barrel in January of this year before rebounding this past spring to $60/barrel. A "double-dip" and test of the January oil price low occurred this summer when the WTI crude price hit $38/barrel on August 26th before rebounding quickly to $42.56/barrel the following day, the largest gain since March 12, 2009. As of quarter end, the WTI crude price was $45/barrel.

"**Nobody rings a bell at the bottom"** whether it is the stock market or the price of oil. As we all now know, at the darkest hour for the stock market in March 2009, the Dow made an important bottom and began its rise of 10,000 points over the ensuing six years. We believe a similar environment is setting up with oil prices. Large **supply** increases have largely been exhausted, whether OPEC or Non-OPEC. Importantly, exploration capital spending across the global oil industry has fallen 25% to 30% ($20 billion), and will fall again in 2016 given current oil prices. In a word, $45 or $50 or $60 per barrel is unsustainable to grow production given the current costs for new exploration and development projects. Earlier exploration pullbacks (in the late 1990s) led to subsequent tight markets and higher oil prices as supply declines and world demand rises. Active drilling rigs in the U.S. are down 50%, and the number of exploration wells drilled or planned this year around the world will be down 25% to 30%. Non-OPEC oil supply (including the U.S.) is estimated to decline next year by at least

500,000 barrels per day. OPEC's incremental supply above their current production is estimated at less than 2 million barrels per day assuming Iran is given a greenlight, and IF internal sabotage and fighting subside in Iraq, Syria and Libya. However, OPEC's spare output capacity has evaporated compared to previous oil commodity cycles. Global annual reservoir deletion for existing wells is 4.7 million barrels/day. This represents 5% of oil supplies which have to be replaced to hold production even! **Demand** has only fallen once in the past twenty years, during our self-induced 2008/2009 mortgage and banking crisis. Global oil demand is growing by 1.3 to 1.5 million barrels on top of the current 94 million barrels per day of official worldwide demand.

The supply demand math demonstrates that the crude oil market should begin tightening in 2016, and persist over the next several years as demand exceeds supply. Equilibrium oil pricing to restore capital spending budgets and cancelled projects is at least $70/bbl. Energy equities will discount in advance a higher oil price from evidence of production flattening or declining. Volatility in oil prices on the upside can be quite rapid as the supply demand balance turns positive.

Laundry List of Macro Worries

The long laundry list of overblown macro concerns this quarter reads like a who's who list of big worries about the wrong things for long-term investors building wealth and preserving purchasing power: Greek debt default; Oil price volatility; Chinese stock market crash; China slow down; Devaluation of Chinese currency, the yuan; Brazilian, Australian, South African recessions; Federal Reserve's postponement of the first increase in the federal funds rate ("lift-off"); U.S. dollar's currency appreciation; Slowing U.S. exports; ISIS and Iran nuclear threat; Flash crash fallout for U.S. equity markets.

This list could easily be expanded, but our main point is that the U.S. economy is still the strongest major economy in the world (pedestrian but steady 2%+ GDP growth year over year). While this recovery has been slow, the U.S. is NOT in a recession and not about to begin a recession, and is NOT on the precipice of another financial crisis.

China is not collapsing and is still growing its economy, albeit it at a rate very likely below the government's official number of 7%. China is certainly struggling in trying to manipulate its volatile stock market, and its hands are full with dysfunctional and inexperienced central government control of their non-free market economy. Their transition to a consumer economy from an investment/export economy for one billion people will be rocky and take several years. The S&P 500 companies have only about 2% of their sales to China, and less than 1% of U.S. exports go to China. The Chinese stock market is not the Chinese economy, as they have many "SOEs" (state owned enterprises) with direct government control and intervention in the trading of their stocks. The Chinese currency was recently devalued only 3% versus the dollar, and it too is directly controlled by the government and their devaluation is not a cause for panic. They are a long way from having a free market economy or a free stock market, and recurring Chinese hiccups should be expected.

No Federal Funds Rate Increase

The Federal Reserve is **long overdue in normalizing short-term interest rates** by increasing the federal funds rate as it did NOT raise the ZIRP (0 rate) policy at their September meeting. They now run the risk of getting themselves "behind the curve" if future commodity prices (specifically energy prices) and wages unexpectedly rise faster than their subdued forecast. The unfortunate history of the FED, and its recent chairmen's forecasting abilities, is that it is littered with timing mistakes of being late in defending against inflation and impending bubbles. The FED has no room to respond by providing more liquidity and lower interest rates in a true crisis, and

the majority of the Fed's voting members know they are trapped, as they have purchased over $4 trillion of debt (Quantitative Easing) which probably won't be extended. At her recent press conference, Chairman Yellen seemed more worried about external international developments over which the FED has NO control, rather than any new specific worries about the U.S. economy. She has repeatedly said that normalizing interest rates would take longer, and that the normalized level would be lower than what we have experienced in the past. While that sounds very encouraging, she now acknowledged that she expects the first federal funds rate increase should occur at their December meeting. A gradual increase to a 2% to 3% federal funds rate from its current 0 to 0.25% is now likely by 2017/2018. This is not a disaster for the stock market, and the slow measured pace to normalization allows all investors, consumers and companies ample time to adjust.

The headline macro topics are issues we felt needed to be addressed in some detail. A 10% correction is healthy. The flash crash was abnormal, however, the results were not disastrous. The S&P 500 is now selling at a price earnings ratio that is in line with a "value" market. We remain confident about FMR's ability to continue to help create and build wealth, especially given the market's valuation and current yield.

We look forward to your questions or comments.

Sincerely,

Lee　　　　　　Todd　　　　　　Martha

**The performance information on page 1 is not audited and has not been otherwise reviewed or verified by any outside party. While Five Mile River Investment Management, LLC endeavors to furnish accurate information, investors should not rely upon the accuracy or completeness of this information.*

***Average Annual Rate of Return are presented in Form ADV Part 2. This is the consolidated rate of return from FMR Inception 3/31/03 to 12/31/14.*

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