Quarterly Letter January 14, 2016
Five Mile River Investment Management LLC
4th Quarter 2015

PERFORMANCE

	FMR Performance	FMR	FMR Benchmark*	Russell 1000 Value**	Dow Jones	S&P 500***
	Taxable	*Retirement*	*Taxable Index*			
1Q2015	1-1.16%	2.54%	-2.31%	-1.26%	-0.26%	0.95%
2Q2015	--3.82%	--3.31%	-2.01%	0.55%	-0.88%	0.28%
3Q2015	-13.09%	-8.01%	-13.25%	-10.01%	-7.58%	-7.11%
4Q2015	1.62%	1.59%	2.71%	4.91%	7.01%	6.94%
Full Year	-16.04%	-7.34%	-14.70%	-6.26%	-2.23%	1.30%

The market started 2015 with the **S&P 500 at 2059,** and closed a very bumpy year with this index at **2044** off **-0.7%** (the S&P with dividends was +1.3% for the year). The high was 2130 in May and the low was 1867 in August, the second 10% correction in six years. This coming March 12th will mark the 7th anniversary of this Bull Market from the Great Recession low of 666. Over the past seven years the economic expansion has averaged only 2% per year, far lower than any recovery from a recession in the past 50 years. Such a slow pace of economic expansion has at times seemed vulnerable to macro shocks, which is what is currently handicapping the market. However weak this recovery has been, it continues, and probably strengthens as the U.S. consumer, who represents two thirds of the economy (GDP), is benefiting from higher employment, rising income, and improving confidence. Fears of an imminent recession are exaggerated.

As early as the summer of 2014, the valuations of most equities (P/E ratios) were fully priced, and over the past 18 months some momentum sectors clearly reached overvaluation as the list of what was "working" in the stock market got significantly smaller. The catch acronym for what was working in the past year was dubbed the "FANG" stocks (Facebook, Amazon, Netflix, & Google), clearly dominant growth stocks, some of which defied gravity as far as valuation metrics.

Last year was not a good year for value or income oriented investors as most value indices were down for the year, and even the high growth tech NASDAQ index was only up 5.7% for the year, its weakest

performance in four years. Of the 500 S&P companies, 267 were up and 233 were down for the year**.** Piling on this volatile and difficult market, the oil price decline of 46% in 2014, and 30% in 2015, brought down all segments of the energy space whether or not their profits were directly correlated to the price of oil and gas. FMR's selective energy infrastructure master limited partnership positions have businesses that are uncorrelated to the price of oil, nevertheless, they were dragged lower by across the board energy liquidations. We will update our outlook for this sector later in this letter.

2016 Outlook: Transition and Volatility

The New Year started off with a 6% market decline in the first five trading days. This decline now represents a 9% drop for the S&P 500 from the May 2015 high. The overriding issue for the equity market continues to be valuation. We are not in a "bubble" environment like 2007, but the stock market is expensive. The price earnings multiple on the S&P 500 is 16.5, while the historical 80 year average is 15. In all likelihood the market is completing another 10% correction as short-term investors and high frequency traders panic over "macro" issues. **Calm, not panic, and focus on the fundamentals are the guideposts for 2016.** These have been, and will remain to be, our values at Five Mile River.

We commented extensively in our third quarter letter on "macro" problems, and what not to worry about as long-term investors. 2015 was a volatile transition year, and 2016 is very likely to be another volatile transition year as the number of "macro" concerns has continued to grow. Not until there is greater certainty regarding corporate earnings, and some abatement of macro concerns will 2016 escape from being another transition year. Forecasting the stock market in the short-term is a "losers" game for long-term investors. While stock market annual returns are likely to be **+6 to +8%** over the next few years, predicting any one year is not a productive use of our financial planning time. **Portfolios need to stay invested with long-term assets in order to come out ahead of inflation and to meet individual investment objectives.** While most investors know that the annualized total return from equities has averaged 10% over the past 90 years, achieving that result in any one year has been a low probability occurrence. Only three times since 1926 has the S&P 500 produced a total return between +9% and +11% (1968, 1993, and 2004).

Five Mile River's Strategy

Our Five Mile River value focus since the Great Recession of 2008-2009 has been to research and invest in companies with a dominant market share whose services or products produce free cash flow, have strong balance sheets, and management that returns capital to their shareholders with generous and growing dividends. This is a time-tested strategy that reduces volatility and generates favorable long-term returns.

A focus on free cash flow is effective because it imposes a serious discipline on management. Companies that grow dividends typically are rewarded over time with rising stock prices. Investors can reinvest the dividends in more dividend growth companies, thereby creating additional compounding of income which has been, and will continue to be, one of the strongest wealth creators for FMR client portfolios. Or the dividend payout can be used to support investor retirement needs. This is clearly a value strategy with growth characteristics, but it is not a pure growth stock strategy where no dividends are paid. The difference is that in the young, hyper-growth companies, managements are spending excess cash and borrowings to fund very fast growth.

Managements that are incentivized to create value for shareholders are typically significant shareholders themselves, either directly owning shares, and or stock options to purchase shares. Free cash flow permits managements to fund growth capital expenditures, pay down debt, make acquisitions, grow their dividend, and fund share repurchases. Top performing managements increasingly do some combination of all of these five growth and value-creating strategies. **Five Mile River's dividend growth strategy focuses almost exclusively on dividend paying and dividend growth companies.** Ninety-five percent of the companies in Five Mile River's portfolios pay dividends that on average are growing **7% to 8%** annually. The total return this provides investors is far more attractive than fixed income returns where the 10-year Treasury Note still only yields between 2.1% and 2.3%.

Dividends and Growing Payouts

While the major stock market averages produced small to negative returns for 2015, dividends paid in 2015 for the S&P 500 companies are estimated at $380 to $390 billion, the fourth consecutive annual record. S&P 500 operating earnings were down about 5% in 2015 caused by the strong dollar marking down the value of foreign earnings, and the recession in energy. However, dividends per share grew +9%. Why? The majority of the 500 companies generated growth in cash flow, even though reported operating earnings were negative. Interestingly, corporations are cautious to raise dividends, and disciplined and reluctant to cut them when profits are flat to down because dividend cuts cause a multi-year distrust of management. Managements typically reduce share buybacks before they cut dividends. There were 341 out of 500 companies in the S&P 500 that raised their dividends last year. Even the energy sector raised dividends 3% despite the painful cuts experienced with Kinder Morgan. S&P 500 dividends are expected to grow slower in 2016 but still rise +7%.

The dividend payout ratio (dividends paid as % of earnings per share) of the S&P 500 reached 38% in July 2015, the highest level since November 2009. The historical average for the S&P 500 payout ratio going back to 1936 was 51%, as dividends accounted for most of the cash returned to shareholders prior to 1980. Despite the flattening of corporate profits in 2015 and possibly continuing into 2016, the rise in the payout ratio is likely to continue as a number of managements understand the increased value that shareholders attach to companies which can demonstrate consistent growth in their dividends. With an expansion of price/earnings multiples unlikely, the cash returned via dividends is far more meaningful now than it was when the stock market was rising 10% or more per year. Five Mile River accounts have an average yield of 3.5% to 4% which generates half of the 2016 likely FMR total return of +6% to +8%.

Update on Energy Sector and Master Limited Partnerships

Four separate but linked events over the past 14 months have caused a "Perfect Storm" for energy investments that was hard to predict. First, in the 4th Quarter of 2014, Saudi Arabia changed their policy to maintain production output and market share, and not support the price of oil. Previously, Saudi Arabia aggressively adjusted production levels to maintain price stability. Their decision to let "the market" determine pricing never anticipated that this would instigate what would become a 65% drop in the price of crude oil. Commodity prices are set by futures trading predominately on the Commodity Exchange (COMEX) in New York, and to a lesser degree on the Chicago Mercantile Exchange, and the Chicago Board of Trade. Second, throughout 2015 trading in oil futures contracts was over whelmed by speculators, hedge funds, and other non-energy traders. Speculation-generated futures trading represented over 100 times the

actual quantity of oil produced, and was a significant force that contributed to the sharp drop in price. Third, because of this backdrop of falling oil prices, Exchange Traded Funds (ETF's) that focused on energy or MLP's or both, experienced major outflows of capital. The largest ETF for MLP's is the Alerian MLP ETF (AMLP). AMLP is a clear example of what unfolded for MLP stock prices. The asset size of AMLP was approximately $13 billion in the fall of 2014, and on December 8, 2015 (the low) its size was $6 billion. When ETF liquidations are made, the ETF manager sells all positions proportionally, which explains why all MLP's fell in lock step, the best and the worst. Tax motivated year-end selling was also a contributor to the ETF liquidations. Unanticipated was the fact that Five Mile River's investments in non-commodity MLP's were swept up in this decline. Lastly, on December 4th, Kinder Morgan shocked Wall Street in reducing its dividend by 75%, a major disappointment. Their board's decision was to insure that the company could internally finance its $20 billion backlog of growth projects without selling equity for the next two years.

Since inception of the MLPs in the late 1990s, there have been two similar price corrections, one in 2002 and the second in 2008. In both instances most MLP stocks doubled in the following 12 to 18 months after these corrections, and continued to appreciate thereafter.

The Perfect Storm, now described, is thankfully passing as the oil price decline coincided with a drop in wells drilled, which recently resulted in a 400,000 b/d decline in U.S. production. The marginal cost of U.S. production is north of $70/barrel, so U.S. production is estimated to decline further by at least an additional 1 million b/d before stabilizing at 8 to 8.5 million b/d by 2017. The continued drop in U.S. production is significant relative to world-wide supply, and therefore will be one of the catalysts for higher energy prices, and dwarf any potential supply increase from OPEC or, in particular, Iran. The onset of more seasonal (cold) weather in 2016 will finally start to reduce energy inventories, and therefore provide an additional impetus for a firming in the price of crude oil. Legislation passed at year-end now permits the U.S. to export oil for the first time in forty years! These events will tighten supply and demand, and therefore should reverse the bearish commodity futures speculation, and reverse the liquidations in the energy and MLP ETF's. We expect that the horrific price decline we have experienced over the past year will set the stage for a multi-year oil price rally, beginning in 2016 and lasting probably four to five years.

This was a most difficult year for value investing and Five Mile River's dividend growth strategy. The positive news is that the non-energy portfolio holdings were up 3% to 4% in 2015, performing handsomely in a flat to down market. The quality of the assets and balance sheets of the energy holdings in FMR portfolios are the best in the industry and the upside potential in both price appreciation, and distribution growth is excellent.

As always we welcome your thoughts and questions.

Sincerely,

Lee Todd Martha

*Five Mile River's investment strategy for taxable accounts, with its emphasis on value investing which includes MLPs, is best compared with a blend of a value style index, the Russell 1000 Value Index (weighted 70%) and the Alerian MLP ETF Index (weighted 30%). Comparing FMR's performance in taxable accounts with this blended index provides a more accurate benchmark.

**The Russell 1000 Value Index is a broader index than the S&P 500, and consists of no more than 1000 companies with low relative P/E's, and price-to-book value characteristics. It tends to have strong representation with financial and energy industries. Managers with a value style often use this benchmark for performance measurement comparisons.

***The S&P 500 Index is a market capitalized weighted index of 500 companies. It is a growth-biased index because the larger the capitalization of a company, the larger the weight it contributes to the S&P 500 Index performance. The index referenced includes the dividends issued by these 500 companies.

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