Five Mile River Investment Management, LLC April 19, 2017

Quarterly News letter

1st Quarter 2017

PERFORMANCE

	FMR Performance		Russell 1000	Dow Jones	S&P 500
	Taxable	**Retirement**	**Value**	**Industrial**	**Dividends**
2017 Q1	4.49%	3.82%	5.51%	4.56%	6.06%

The stock market's positive momentum from the fourth quarter of 2016 carried over to the first quarter of 2017, with new highs across all the major indices. For the first quarter of 2017 Five Mile River Investment Management taxable accounts performed at +4.49%, and Five Mile River retirement accounts were +3.82%.

The S&P 500 had one **3%** correction in the first quarter, as the market had already discounted slower than expected progress in major tax and healthcare reforms, as well as the Federal Reserve's (FED) **¼%** increase in the Fed Funds rate in March. In the Five Mile River 2016 year-end Newsletter (January 25, 2017), we said that in virtually all long bull markets, corrections are inevitable and healthy. Most investors well understand that narrowly defined bull markets that boom and then bust (e.g. the Dot-Com internet bubble of 1999/2000), are inherently unstable and unsustainable. Conversely, this bull market from the March 2009 bottom has been broad with many different sectors, industries, company sizes, with both value and growth styles having their day in the sun.

Given the relatively weak U.S. economic expansion, Five Mile River is constantly looking to invest in companies that can grow at an accelerating rate and still pay a healthy and growing dividend. Over the last several quarters FMR portfolios have added a number of growth stocks that also possess attractive, growing dividends. High-yield stocks continue to be the bulwark for Five Mile accounts in which maximizing current income for monthly distributions is required or imminent.

The FED, the Fed Funds Rate, Unemployment Data and Implications

As expected by most investors, the FED raised the Fed Funds Rate of interest on March 15, 2017 from .75% to 1.0%. The Fed Funds Rate is the interest rate banks charge for overnight lending of excess reserve balances to other banks or depository institutions. This rate is established by the Federal Open Market Committee (FOMC) lead by Chairman Janet Yellen. The FED pegged the short-term Fed Funds Rate at nearly **0%** from 2009 to 2015 to stimulate employment, inflation and economic growth. Because of simultaneous dysfunctional regulatory, fiscal and corporate tax policies, the FED's aggressive monetary policy of low interest rates had little effect on stimulating the economy. Thus, real GDP growth never got above the sluggish annual rate of 2% post the Great Recession. Remember, real growth only comes from increasing productivity and increasing the labor force. Since capital spending on plant and equipment has been below average for several years, the older equipment has contributed to low employee productivity. This, coupled with a shrinking labor participation rate ensures low economic growth.

Has Anything Changed? Possibly, However the Jury is Still Out.

Over the last six months, Chairman Yellen and the FOMC have recognized that employment has gradually improved to the point where the number of employed workers has finally reached pre-recession levels after ten years. The recent report of household unemployment at **4.5%** is the lowest rate since March 2007 (**4.4%**). However, the U.S. is not yet at full employment, as the U.S. labor participation rate is 63% versus 67.3% at its peak in 2000. In addition, the underemployment rate is still high at **8.9%**. This is labeled U6 and includes: discouraged workers, workers who have stopped looking for jobs, and part-time workers who want full-time jobs. Full employment would be signaled by the U6 rate dropping below **8%**.

Conclusion: The U.S. needs capital investment, a worldwide competitive corporate tax code, and a lower corporate tax rate (the U.S. has the highest corporate tax rate in the developed world) to incentivize and encourage new infrastructure investment from capital returning to the U.S. which has been stranded off shore. Prospects for these changes are promising under the new administration. However, polarization of the political landscape will likely result in delays of pro-growth policies, and benefits of new policies are not likely to be effective until 2018.

Implication: Gradual normalization of both interest rates and pro-growth fiscal and tax policies are currently priced into our **FAIRLY VALUED EQUITY MARKET.** Continued market volatility, exacerbated by high-speed computer trading, causes individual stocks, and sometimes whole industries, to become miss-priced. These selective corrections create opportunities in stock selection for Five Mile River active management. While the "market" may be fairly valued, bottom up research over extended periods of time can uncover undervalued stocks that will **likely add value to FMR portfolios in 2017.** The 2.2% yield on 10-year Treasury Bonds is not competitive or compelling for either individual or institutional investors. Stating the obvious, Treasury Bond coupons and interest paid do not grow, versus the average S&P 500 dividend yield at 2%, growing at 3% to 4% a year. FMR portfolio stocks weighted average yield is 3.5%, growing at 5% to 6% a year.

The FED members on the FOMC committee finally feel comfortable enough to telegraph a plan for a gradual increase in the short-term funds rate, most likely two more times this year. The panel also indicated that it is appropriate to begin reducing the FED's $4.3 trillion balance sheet in a **"PASSIVE AND PREDICATABLE MANNER."** In other words, they will not be flooding the bond market with huge quantities of government bonds and mortgage-backed securities. The FED will not reinvest the interest paid on these bonds, and will let the maturing bonds just run off their balance sheet. Their forecasts for Fed Funds rates at year-end are: 2017: **1.4%,** 2018: **2.1%,** and 2019: **2.9%**.

The implications of more predictable rising interest rates, and inflation rates that remain in a tight band between 1.5% to 2.5%, are NOT negatives for stocks. A normalization of interest rates and more supportive fiscal and tax policies should provide (if enacted) faster economic growth, higher corporate profits, rising incomes, and rising "absolute" equity returns of at least **+6% to +8% annually over the next three years.** While the logic of rising interest rates should make fixed-income securities more attractive on a relative basis, Five Mile River is not interested in bonds in a rising interest rate environment because holding bonds while this FED action is unfolding will decrease the value of the bonds. It is an important reminder to point out that rising interest rates (steepening yield curve) is a positive Leading Economic Indicator for stocks.

Five Mile's goal for client portfolios is ABSOLUTE, not RELATIVE returns. FMR's investment philosophy for diversified portfolio construction starts with dominant number #1 or #2 companies in their industry that possess **"sustainable" FREE CASH FLOW, DIVIDEND GROWTH, AND SHARE REPURCHASES**. The stock market value of these companies will increase over a long-term investment horizon, irrespective of whether the market says a particular stock is suddenly worth more or less. FMR's playbook for investing is the preservation of capital coupled with growth of dividend income and capital appreciation. It is NOT about speculation, nor is it about the short-term relative performance game against market indices. Five Mile River's investment objective is to protect and grow client assets by generating consistent and growing income from FMR portfolios today or for future needs, and for capital appreciation over the long-term.

Earlier in this letter we referenced searching out higher growth stocks that also grow their dividends. Recently Five Mile River portfolios purchased a dominant company in the telecommunications/cloud technology sector that has produced 30% growth in free cash flow, and has above average dividend growth. Long-term prospects for companies such as this are promising given the U.S. is at an inflection point for acceleration in corporate cloud deployment.

We welcome your questions, and are available for a conference call to discuss Five Mile River's investment strategy and market outlook. Wishing you a pleasant spring season.

Lee Todd Martha

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