Five Mile River Investment Management, LLC — October 20, 2017
Quarterly Newsletter
3rd Quarter 2017

PERFORMANCE ***

	FMR Performance		Russell 1000	Dow Jones	S&P 500**
	Taxable	Retirement	Value*	Industrial	Dividends
2017 Q1	4.49%	3.82%	2.60%	4.56%	6.06%
2017 Q2	0.73%	1.90%	1.03%	3.32%	3.09%
2017 Q3	1.03%	0.83%	1.79%	4.95%	4.36%
2017 YTD	6.35%	6.68%	5.78%	13.37%	12.97%

Five Mile River Investment Management – Happy 15!

This year marks Five Mile River Investment Management's (FMR) 15th year of financial management for clients. FMR's mission has been, and always will be, to meet FMR clients' specific investment goals (retirement, educational expenses, estate plans). FMR started investment advisement services in 2003 for friends and families, and it has grown organically from referrals due to the success of translating our clients' financial goals into portfolios of public common stocks that can be "tilted" towards growth or income. Five Mile River quarterly letters, dating back to 2003, discuss the "style" of investing employed for our clients (see all Five Mile River Quarterly Newsletters on www.fivemileriver.com). FMR dividend growth strategy has yielded a 15-year performance record compounding at an average annual growth of approximately 9%. This performance includes only two down years, 2008 and 2015, and serves as testimony to the durability of FMR's investment strategy. FMR invests for our clients using the same stocks that are purchased for our own families' accounts. FMR's fee of 1% per year is based on our clients' assets, so as our clients' assets grow, so does Five Mile River. There are no hidden fees.

New clients recently joining FMR, have left large Wall Street firms since those firms were directed to reveal all fees to their clients in anticipation of recent legislation called the "Fiduciary Rule" from the Department of Labor. Many traditional Wall Street firms were only held to the lower standard of "suitable for clients" and had not previously disclosed some fees to these clients. Frequently many "in-house" investment products sold to clients of Wall Street firms simply did not meet the new mandatory fiduciary standards to work in the "best interest" of the client. From the start and by contrast, Five Mile River has continually worked in the best interest of our clients and our Five Mile River team is dedicated to optimizing our client's financial success and to providing best-in-class services.

Five Mile River co-founder, Lee Garcia, CFA is a marquee name in the investment world, and Lee's leadership in formulating strategy and client portfolios has been key to Five Mile clients' asset growth. FMR's portfolio managers have on average over forty years of investment experience. Our goal is to grow client assets 6% to 8% per year using tax neutral strategies. We look enthusiastically to another 15 years and beyond to assist our clients in a bright financial future.

Synchronized Global Expansion and Markets

The domestic and global stock markets enjoyed another up quarter, this time in spite of nuclear missile threats from North Korea; gridlock in the Senate over healthcare and tax reform; and uncertainty about the next policy moves by the Federal Reserve to normalize interest rates. Global leading economic indicators (LEI) showed an acceleration in global growth from Japan to Europe to Brazil over the summer, a synchronized world-wide expansion rarely seen. The technology sector once again dominated the S&P 500 and rose **2%** during the quarter. Year-to-date performance of the S&P 500 now stands at **+12.97%.**

Our 2017 total return forecast for FMR portfolios remains unchanged at +6% to +8% with Five Mile River (FMR) portfolio company's dividend yield of 3.0% and weighted average dividend growth of +6%/year. The S&P's current yield is 1.8%, estimated to grow at 3% to 4%/year. Absolute total dividends paid by our portfolio companies continue to increase annually by an estimated six percent because of the large free cash flow from which these managements consistently distribute dividends to reward shareholders. In addition to growing dividends, most of our companies buy back shares from their free cash flow, which is emblematic of our "dividend growth" portfolio strategy.

The FED and "Get Out of Dodge"

"Get Out of Dodge" was the phrase initially popularized by Marshall Matt Dillion on the TV show, *Gunsmoke* in the 1960's, and again in the 1990's by Demi Moore in the Navy Seals movie, *G.I. Jane*. This phrase caught our attention in a July 2017 piece by John Mauldin, titled "Prepare for Turbulence" when referring to the Federal Reserve.

Fed Chairman, Janet Yellen, in testimony before Congress and in the Q&A after the Fed September meeting, admitted that she and the Fed Board are not sure about the root causes for persistent low inflation under their 2% target. She also said she "hoped" that there will never be another financial crisis in our lifetimes, and that she "thinks" we are much safer. The Chairman announced that the tapering (selling) of their $4 trillion bond balance sheet would begin in the fourth quarter. Their plan has the selling starting at $10 billion/month, rising to $50 billion/month, over time, subject to economic and market conditions. Further she announced that the majority of the Board expects to go ahead with another Fed Funds rate increase of 0.25% to get the rate to 1.5% in December.

Chairman Yellen's comments may be very comforting to some, but the Fed is and has been arguably "behind the curve", and too slow in moving away from Zero Interest Rate Policy (ZIRP), which led us to "There Is No Alternative" (TINA) for investors but stocks. Instead of **consumer price inflation,** the FED has given us **asset price inflation** (stocks and real estate). Investors have been forewarned and most fully understand that this "independent" monetary authority is and has been politicized, and must be closely watched. Bluntly put, the history of Fed policies and forecasts show numerous harmful blunders which created long-lasting dislocations.

What is unique is that starting in 2018, **six Fed governors will be leaving, including most likely Janet Yellen (term ends February 2018), and replaced by six newly appointed members.** John Mauldin's analogy to "Get Out of Dodge" is apropos of the Fed's governors finally making big monetary moves and then all leaving town, hoping their initiatives work out. Trump will have a historic opportunity by appointing a majority of Fed Board members that can re-shape policy with implications yet to be known.

Stock Market Valuations and Moving Away from ZIRP

Stock market valuations are fairly valued today because of the abnormally low level of interest rates. Company fundamentals and balance sheets are in good shape, and corporate earnings are growing an estimated 8% to 10% in 2017. We only see extreme valuation for just a few "star growth stocks" (e.g. Netflix, Tesla and Amazon). We want to emphasis that these valuation levels are **NOT** the price earnings multiples of the "dot-com bubble" era. For example, at the March 2000 peak, Microsoft's (MSFT) price earnings multiple was **50X** expected earnings. Today MSFT's multiple is **20X** expected 2018 earnings. **Fairly valued?** Yes. **Has the position size been reduced in Five Mile portfolios?** Yes. **Why were position sizes reduced?** Microsoft stock has more than doubled since original purchase. Reducing positions when short-term price objectives are met is one example of FMR's strategy for managing risk. **Why hold MSFT?** Because MSFT has $133 billion of cash, of which $127 billion is offshore; has a yield of 2.3% growing at 8% to 10%/year; MSFT annually has large share buybacks; MSFT has a fast-growing enterprise "cloud" business; MSFT has double-digit earnings growth. **What about MSFT management?** Outstanding CEO, Satya Nadella is focused on business software growth and creating shareholder value. MSFT has been a very successful holding for FMR that checks all the boxes and continues to meet FMR's dividend growth strategy.

Bull markets typically do not end until our own monetary policies have created bubbles or banking crises. When the Fed makes serious policy mistakes, the result can be either an economic slowdown with flat GDP growth plus inflation (stagflation) or a mild recession. We do not see large dangerous bubbles at present, but we do see individual sectors with too much debt, like subprime auto loans and student loans, neither of which is of the scale to start a recession. Unemployment is low at 4.5%, the labor participation rate has stabilized and is beginning to rise, and we are finally seeing improved wage growth. In addition, GDP expanded at a 3.1% rate in 2nd quarter 2017. While comprehensive tax reform is highly unlikely, we believe the prospects for more limited and focused corporate tax reform are better than 50/50. Company and market valuations would likely rise further if U.S. corporate tax rates were no longer the highest in the developed world.

Energy Update

Over the summer, oil prices stabilized and then rose 20% to the $50 to $52 level for West Texas Intermediate (WTI), and as high as $58 to $59 for the world benchmark, Brent Crude. Why? Three principal reasons:

1) **OPEC has reduced supply.** Contrary to the expectation that OPEC would cheat on its November 2016 quota commitment to cut back production, compliance has been strong, including non-

OPEC Russia. OPEC country budgets, dependent on higher oil prices, have been seriously hurt with widening deficits from lower oil revenues. Even Saudi Arabia, with substantial cash reserves, is burning through these reserves at an alarming rate ($200 billion in last three years). For the largest producer in the Middle East with a growing population, this path is unsustainable.

2) **U.S. production has NOT increased to offset OPEC's cut back.** Energy pundits were convinced that huge increases in U.S. shale oil production would overwhelm and offset growing demand, and the OPEC production cuts. Until recently, the International Energy Agency (IEA) based in Paris, supported this bearish outlook. In addition, the energy analyst community speculated that a 2018 U.S. production increase of as much as 1.4 million barrels per day was probable. Also, the U.S. Department of Energy (DOE), has quantitative models that have consistently overstated oil production. Each of these three forecasts have been dead wrong, as U.S. oil production slowed since mid-year due to moderation in drilling and completion activity.

3) **Supply/Demand rebalancing is in sight.** Robust global oil demand is rising faster than net supply. Excess global inventories will show declines in the 3rd and 4th quarters with balance probable by the end of the 1st quarter 2018. Because oil prices are inversely correlated with global inventories, oil prices should continue to rise through 2018.

Five Mile River holdings in the high-quality energy master limited partnerships with current yields of 5% to 6% and distributions growing 5% to 10% a year, have rebounded nicely this fall and have further upside. These growing payouts are supported by sustainable, growing, fee-generating pipeline volumes of oil and natural gas. The U.S. is now exporting both oil and liquefied natural gas (LNG) to India, Asia, and Europe. Demand for LNG is expected to triple by 2040. Chemical demand growth is estimated at 45% over the next ten years and will be a driver for LNG demand growth. Natural gas is projected to surpass coal as the world's second largest energy source by 2025, with demand growing 50% by 2040. For investors in U.S. energy assets, the long-term outlook is very strong as the U.S. has now become the incremental source of low-cost, long-lived oil and gas reserves.

We welcome any questions regarding Five Mile River's dividend growth strategy and our market outlook. While we discuss the markets and investment strategies in quarterly letters, Five Mile River brings best in class resources to our clients. We offer superior market analysis and investment advice; provide products that support the financial needs of our clients; and FMR is backed up by the strength and stability of our custodial bank, the Royal Bank of Canada (RBC) Capital Markets.

Do not hesitate to call or email us at any time. With a little advance notice, we can arrange for a conference call with the Five Mile Team to discuss our commitment to grow and protect our client assets.

Sincerely,

Lee Todd Martha

**The Russell 1000 Value performance numbers are represented by the ETF of that name.*

***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 weighting it contributes to the S&P 500 Index performance. The index referenced <u>includes the dividends</u> issued by these 500 companies. This index is used for a comparison for FMR accounts.*

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