Five Mile River Investment Management, LLC July 27, 2018
Quarterly Newsletter
2nd Quarter 2018

PERFORMANCE*

	FMR Performance		Russell 1000	Dow Jones	S&P 500
	Taxable	Retirement	Value	Industrial	Dividends
2018 Q1	-3.96%	-2.70%	-3.52%	-2.49%	-0.76%
2018 Q2	5.16%	4.11%	1.18%	0.70%	3.43%
2018 H1	1.00%	1.30%	-2.38%	-1.80%	2.65%

The S&P 500 rose 3.43% in the second quarter in what was a choppy three months. While 2017 was noteworthy due to the absence of stock market volatility, it has clearly returned during the first half of 2018, and will likely continue. The market turned more cautious in its valuation of future earnings, as the S&P 500 was up only 2.65% in the first half of 2018 and did not surpass its January high. Companies that are high dividend payers were among the best performers in the 2nd quarter. Dividend growth companies are the hallmark of Five Mile River (FMR) portfolios, and FMR portfolios outperformed the S&P 500 in the second quarter. The energy sector was the lead performer for 2Q, up 13%, with the more defensive consumer discretionary sector up 8%, and technology continuing to outperform up 7%. "Macro" news headlines will probably heighten market volatility. Since Price Earnings ratios (P/E) move inversely with interest rates, the path of higher interest rates should cause market P/E's to drift lower. The fundamental positives still carry the day as double-digit earnings growth combined with accommodative monetary and fiscal policies continue to provide a framework for a moderately higher market.

It is FMR's belief that "the market" is discounting or has "priced in" both the rising short-term interest rates, AND the earnings boost caused by the tax cuts. As we write this letter, the market still faces a handful of "macro" unknowns. Prominent are the following:

1) What will be the extent of the impact of tariffs on domestic growth and inflation, if enacted as is threatened?
2) What are the economic consequences, **if any**, from November Congressional elections?

While opining on these big "macro" issues has little direct relevance on the implementation of Five Mile River's dividend growth strategy, FMR remains constructive on the market because there are probable favorable resolutions on tariffs (question #1), and the November election resolutions, for either party control of Congress, will probably have minimal impact on the economy (question #2). FMR suspects that the tariff issues will potentially become more inflamed as they slow the economy and raise U.S. prices. Nevertheless, the U.S., China, Canada, EU and Mexico will find a way, sooner if not later, to de-escalate and resolve the imbalance of trade tariffs. Currently, economists estimate the potential impact of trade disputes to reduce 2018 GDP by, at most 0.2%! With 2nd quarter GDP growth reported at +4.1%, a negative 0.2% trade/tariff drag barely moves the needle. Obviously, should the trade disputes escalate throughout the second half of 2018, then both the negative impact on GDP could be greater and stock price volatility might increase.

Cash and Dividends

In the long term, both dividend growth and stock price appreciation are derived from earnings growth. In healthy companies, dividends are normally paid out of free cash flow, not from taking on more debt or selling more equity. The S&P 500 will continue to experience an acceleration in dividend growth rates due to the robust U.S. economy that has benefited from the tax cuts. It is important to note that only 25% of U.S. companies pay dividends. So, a dividend growth portfolio is always going to perform differently than the popular S&P 500 broad index, which is significantly over weighted with technology stocks. Due to the excessive weighting in technology, the S&P 500 is not diversified. It is more appropriately a growth tech index where Facebook, Amazon, Netflix and Google (FANG stocks) make up a disproportionate share of the index.

Returning cash to shareholders via buybacks of shares is quite different from supporting and growing a cash dividend. The former is more common as 54% of all cash returned to shareholders in 2017 was with buybacks. Warren Buffet of Berkshire Hathaway has lamented that the value of buybacks depends on the price at which shares are repurchased, and too often management's actual repurchase activity does **not** historically align with low stock prices. In a nutshell, too many companies repurchase shares at the top.

For Five Mile River portfolios, we research and own growing "free cash flow" companies that balance the repurchase of shares and growth in dividends, along with executing prudent capital investment projects. The primary investment goal of most individual investors is to fund their eventual retirement, or for estate plans. FMR's free cash flow dividend growth strategy produces a growing, reliable, and spendable cash stream, representing a very conservative long-term investment strategy. While we do not own the most difficult to value dominant cloud and e-commerce "FANG" company called Amazon we do own a conservative, dominant, dividend growth company that participates directly in Amazon's success. According to Banking

Regulators, Registered Investment Advisors such as Five Mile River Investment Management cannot recommendations specific stock details to non-clients through quarterly letters such as this. If you would like to know about the referenced company, which is a direct beneficiary of Amazon's success, please feel free to give us a call.

We are happy to discuss by phone, or in person, any questions pertaining to Five Mile's investment focus, securities holdings, and how FMR can tilt portfolios to yield as much as 4+%, or portfolios that can be managed in a higher growth strategy. We wish you a fun and relaxing summer season.

Sincerely,

Lee Todd Martha

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