Five Mile River Investment Management, LLC January 23, 2022
Quarterly Newsletter
4th Quarter 2021

PERFORMANCE

	FMR Performance		Dow Jones	S&P 500
	Taxable	**Retirement**	**Industrial**	**Dividends***
2021 Q1	6.48%	6.72%	8.29%	6.17%
2021 Q2	9.01%	8.32%	5.08%	8.55%
2021 Q3	-2.90%	-2.60%	-1.46%	0.58%
2021 Q4	9.18%	9.54%	7.90%	11.00%
2021 FY	**23.05%**	**23.33%**	**20.90%**	**28.70%**

The S&P 500 rose 28.7% in 2021, powered mostly by technology stocks. This was the third consecutive year this index has risen by more than 20%. While this 500-company index persistently rallied from both small corrections and the initial Covid-19 virus sell-off in March 2020, the 20%+ performance is misleading because it is distorted by the dominant weighting of five large companies. Apple, Amazon, Alphabet, Meta Platforms (formerly Facebook), and Microsoft (five largest companies by market capitalization weighting in the S&P 500) account for 23% of the total index. Furthermore, these five companies, when joined by Tesla and chipmaker Nvidia (the next two largest companies), accounted for 25.9% of the S&P's 2021 performance, and for nearly all of the performance gains since April 2021. Unlike the dot-com tech bubble of early 2000 that was dominated by companies with a promise of future returns, today big companies like Apple and Microsoft have offered both strong and predictable growth from ubiquitous products and services. After three years of outperformance, the top five companies reached fair valuation as 2021 came to a close.

The first week of the new year reminded both the stock and bond markets that there is a serious inflation problem that has proved to be anything but "transitory". Federal Reserve Chairman Jerome Powell had, on August 27, 2021, said "we expect the inflation effects . . .are transitory". However, by the end of November Chairman Powell admitted that inflation was more powerful and persistent and withdrew the term transitory. Previous Fed Chairs have attempted to stem inflation's upward climb by raising rates concurrently, or even in advance of rising inflation. Early in 2021 inflation was apparent in consumer purchases suggesting there will have to be necessary catch-up of rate increases. As we have discussed since last summer, the Federal Reserve's overly easy monetary policies were reckless, and they are "STILL BEHIND THE CURVE." Belatedly, the Federal Reserve now recognizes it will have to stop their government bond buying and let interest rates rise from zero. Many Fed governors now know that their task is to prevent an escalating "wage-price" inflationary spiral as we hope to be exiting the worst of the pandemic.

Why did both stocks and bonds sell off quickly on January 5th? On January 5th the Fed released the minutes from the Federal Reserve's policy meeting on December 15th. While this is normal operating procedure to release the notes three weeks after the meeting, the difference was the December 15th notes **disclosed that the FED would now reduce the debt on the Fed Balance Sheet**, and not simply dial back the bond purchases. This was not mentioned by Fed Chair Powell in his interview immediately following the December 15th policy meeting. Overlooking this dramatic policy change in his post-meeting communication was a mistake by Powell and the Fed. Sadly, this hurts the Fed's credibility. This was NOT merely slowing the Fed balance sheet's debt increase, rather the plan was to actually reduce the debt! The public was only made aware of the change when the meeting notes were released on January 5th.

On January 5th both large and small growth stocks began a sharp sell-off. In less that a week the S&P 500 dropped 1.9%, the Nasdaq Composite (small growth stocks) was down 4.5%. Stock and bond markets do not like surprises like this! The 10-Year Treasury Note declined with its interest rate rising from 1.4% to 1.77%, with more bond price declines likely. The 30-year fixed rate mortgage interest rate increased from its low last year of 2.65% to 3.22% as of January 6 this year. For a market that is expensive in all sectors, the surprise of the Fed policy change was certain to result in immediate correction. This valuation reset is positive and necessary to balance out risk and return in the public equity markets. While investment dollars are leaving speculative companies, this money is now being channeled into those businesses that are attractively priced and are showing current earnings strength (i.e., banks, health care, real estate, and commodities). FMR believes that the companies with strong balance sheets, pricing power, free cash flow, dividend growth, and stock buy backs are now the most attractive investment opportunities.

It is important to note that under the guise of the S&P 500 performance of up over 20% last year, 90% of these 500 companies declined in 2021 by more than 10%. And 40% of the Nasdaq (smaller companies) had fallen at least 50% or more from their one-year highs. This presents a clear picture that many stocks have room to grow.

All FMR investment strategies focus on those companies that have sustained growth in FREE CASH FLOW and return the same to investors through growing dividends and share repurchases. This does tilt FMR holdings to sectors of the economy often described as value names. Because FMR's client portfolios carry higher yields than the market and have lower valuations (P/E's) than the market, FMR portfolios should have less downside volatility than the market, and we believe will deliver upside performance even in the face of persistence inflation. Using these metrics, asset-rich, attractively valued investments are held in FMR client portfolios across major industry sectors and investment groupings. One such grouping held in FMR portfolios are real estate companies in the form of Real Estate Investment Trusts (REITS). REITS are discussed in more detail below.

Real Estate Investment Trusts (REITS)

FMR growth, balanced, and income portfolios have anywhere from 5 to 10 positions in REITS, which can represent anywhere from 10% to 25% weighting in FMR portfolios. Past quarterly FMR Client Newsletters have highlighted a number of specific REITs, but the history and rational for REITs will be discussed in this letter. With the current unusual economic, monetary and inflationary backdrop, overlayed with a two-year running pandemic, it is timely to provide an overview of REITS; of their history, their performance, and their important role in your portfolios.

REITs began on September 14, 1960, when President Eisenhower signed legislation that created a new approach to income-producing real estate investment, where the best attributes of real estate and public stock-based investing were combined. For the first time, the benefits of owning valuable commercial real estate by individual investors became a reality. The groundwork for the current modern era of REITs came in the mid-eighties with the Tax Reform Act of 1986, when REITS were given the authority to both operate and manage real estate, rather than simply owning or financing properties.

REITs provide **tax advantaged income**. Under IRS regulations, to qualify as a REIT, a company must invest at least 75% of its total assets in real estate; derive at least 75% of its gross income from rents from its properties; and pay at least 90% of its taxable income in shareholder dividends each year. REIT income is not taxed at the corporate level, instead it is only taxed as ordinary income from the dividends received by the shareholders.

REITS are companies that own, operate, or finance income producing real estate. Most REITS trade on major stock exchanges and the public REITS own approximately $2.5T in assets representing more than a half million properties of all types. U.S. public REITS have an equity market value of more than $1.35T and invest in a wide variety of property types including offices, apartments, warehouses, public storage, medical and research buildings, data-centers, cell phone towers, timberlands, hotels, and shopping centers. There are three basic types of REITS:

1) Equity REITS, the largest category that own or operate income producing real estate types as listed above.
2) Mortgage REITS finance commercial and residential properties by investing in mortgages on these properties or what are known as mortgage-backed securities.
3) Hybrid REITS that own and operate specific types of properties AND own mortgages as well.

FMR portfolios own only Equity REITS that focus on specific real estate. Mortgage REITS are almost always riskier because they borrow money to buy mortgages and are overly sensitive to interest rate fluctuations.

Equity REITS can be divided into growth-oriented REITS and income-oriented REITS, and are used across the growth, balanced and income FMR investment strategies based on client investment objectives. REITS have delivered very competitive total returns based on high growing dividend income and long-term capital appreciation. Because there is a very low correlation with other assets, REITS are an attractive portfolio diversifier and help reduce overall portfolio risk.

REITS have provided **very competitive long-term total returns** over the past 30 years versus bonds and other public equities. REITS have outperformed both the S&P 500 index, as well have grown faster than the rate of inflation. Quality real estate meets both long-term growth and income objectives for FMR clients and provide a wide diversity of leading specialized real estate holdings.

There is no question that bubbles have occurred in sections of the market. Importantly, as they burst, they are contained to relatively small sectors of the economy and stock market, unlike the widespread Dot-com bubble and euphoria of the early 2000s that dominated the entire market. Five Mile River believes that the U.S. economy is on a multi-year growth path, with strong earnings and potentially significant new capital investment. History validates that stocks will still perform positively UNTIL the 10-Year Treasury Bond yield is above a 3% yield. The Treasury Bond yield is currently at 1.77% and a 3% level is not anticipated until 2024, or later.

Please feel free to call us with questions or if you would like to further discuss any topics presented in this letter. Wishing you a very happy, healthy, and prosperous New Year.

Sincerely,

Lee | Todd | Martha

**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.*

The performance data included in this letter are not audited and have not been otherwise reviewed or verified by an 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.

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