

Quarterly Letter:
Five Mile River Investment Management LLC
2nd Quarter 2015

July 20, 2015

PERFORMANCE

	FMR* <i>Taxable</i>	FMR* <i>Retirement</i>	S&P 500	Dow Jones	Russell 2000
1Q2015	-1.16%	+2.54%	+0.95%	-0.26%	+4.32%
2Q2015	-3.82%	-3.31%	+0.28%	-0.88%	+0.42%
1 st Half	-4.94%	-0.85%	+1.23%	-1.15%	+4.75%

The S&P 500 index started the year at 2059, closed the first quarter at 2067, and finished the second quarter on June 30th at 2063, up only 1.23% for the year amidst a myriad of surreal news headlines from Greece, China and the U.S. Both FMR taxable and IRA qualified portfolios trailed the S&P 500 in the second quarter as the energy sector underperformed. Year to date, IRA portfolios were virtually flat at -0.85% versus taxable portfolios with higher energy weightings (master limited partnerships) at -4.94%.

As we have discussed in our past letters, the market reached fair valuation in mid-2014 and is now only moderately overvalued with some small cap sectors in technology and biotechnology overvalued. We are not surprised at this flat market with the S&P 500 selling at approximately 18 X estimated 2015 earnings (price/earnings ratio). After six years of an up market with only one 10% correction, investors should expect lower returns that are mid-single digit with more volatility. Growing cash distributions and dividends will contribute a larger percentage of portfolio performance. Five Mile River portfolios weighted average dividend yield is 3.7% (versus 2% for the S&P 500) and the weighted average dividend growth of our companies is 9.0%.

Bond Market Volatility

The U.S. economy had a negative real growth rate of -0.2% in the first quarter, the U.S. Ten-year Treasury Bond yield spiked as high as 2.5%, and the yield on the German Ten-year Bund fell to the ridiculous low of 0.073% on April 17th. "Critical thinking left the room," because who in their right mind would lend money at a negative real interest rate (after inflation) to any government where the monetary policy is simply printing tons of money? This is what Quantitative Easing (QE) is all about: monetary authorities buying government bonds in the hope of raising inflation and economic growth. During this past quarter about one third of all European government bonds had negative yields and the European Central Bank's (ECB) deposit rate hit a -0.2%. These zero interest rate policies (ZIRP) have not worked in Europe, the U.S. or Japan, and have had counterproductive consequences to raising economic growth above the anemic 1% to 2% levels experienced over the past several years.

Counterintuitively, the good news is that negative real interest rates are not sustainable because monetary policy alone **without** prudent fiscal policies cannot create jobs or strong economic growth of 3% or more. Imprudent fiscal policies that have resulted in budget deficits and unmanageable government debt are witnessed in Greece, Puerto Rico, Detroit, Argentina and Iceland. Consumers do not consume more when interest rates are suppressed: they save more! Companies do not invest more in plant and equipment in a low interest rate environment because they do not see sufficient demand.

The U.S. dollar has appreciated strongly against the Euro, and all else being equal, lower input costs from a strong dollar will restrain inflation in the U.S. and continue to attract capital from abroad. U.S. GDP growth should rebound from the down first quarter and continue to grow at the moderate 2% pace experienced over the last five years. Realization has spread that the Euro is not really a currency, it is an experiment, and the EU is anything but unified as we watch the Greek drama unfold. Bottom line, Greece cannot ever pay back the debt it owes, whether they drop out of the EU or pretend to acquiesce to EU demands. Bond prices in both the U.S. and Europe have declined as yields have risen in spite of Mario Draghi and Chairman Yellen's monetary experiments. Recessions in either Europe (minus Greece) or the U.S. are not likely, but neither is high growth, because of a multitude of failed and dysfunctional fiscal policies.

We expect normalization of U.S. interest rates to finally get under way with the first increases of at least ¼ % to ½ % in the federal funds rate in the September or December meetings. Chairman Yellen has indicated that the “normalized” fed funds rate is highly likely to be lower (perhaps 2%) in the future than the 3% to 4% fed funds rates we have experienced in the past. If that normalized number is in fact lower, and the rise is gradual over 2016 and 2017, then the concerns over a big stock market correction are overblown, and U.S. stocks will outperform bonds.

Stocks Win Over Time (albeit inconsistently) – Dividend Income Growth is More Predictable

Historical market returns from the Ibbotson SBBI Classic Yearbook (published by Morningstar), and Rob Arnott's and Ken French's work on the importance of dividends (two highly regarded financial and economic authors and scholars), support Five Mile's strategy of growing annualized income streams from wide “moat” advantaged companies with **large free cash flow**. Historically, Five Mile River's investment strategy has captured about 85% of the upside and only 75% of the downside of the S&P 500. Risk adjusted, these returns are typical of a value approach that focuses on return of capital to shareholders. Growing cash distributions used for income, or that can be reinvested to compound your long-term return from equities, is an attractive strategy if implemented consistently over time. This approach does not rely on predicting short-term market directions but does take advantage of short-term volatility to add investments to your portfolio that provide growing dividend streams.

Below are highlighted the historical compounded total average annual returns from 1926 to 2014 with dividends reinvested (Ibbotson):

Treasury Bills: 3.7%

Government Bonds: 5.7%

S&P 500 index: 10.1%

Small company stocks: 12.2%

Inflation: 2.9%

Looking behind those long-term returns, there have been only five calendar years since 1926 when stocks actually returned 9%, 10% or 11%. Those years are: 1926, 1959, 1968, 1993 and 2004. So while stocks deliver an average return of 10.1% over longer investment timeframes, they are more often above or below that average and rarely deliver that average in any single year. Long-term equity investors understand both the power of patience and the power of compounding a growing stream of dividends. **A dividend that compounds at 9% annually will double in eight years.**

S&P 500 companies paid out more than \$93 billion in dividends in the first quarter of 2015. Corporate balance sheets hold about \$1.3 trillion of cash, and managements who have been both raising their dividends and repurchasing their stock are being rewarded with higher stock valuations. **The power of compounding dividends is indisputable, and is a very significant contributor to total stock returns over time (40% to 45%).** French's research looked at stock returns from 1924 to 2012, and found that the second highest yielding quintile (20%) performed the best, producing an average annual return of 11.5% compared to non-dividend payers at 8.2%. The very highest yielding stocks (top 20%) slightly underperformed at 10.7% because some of these companies with ultra-high dividends have deteriorating fundamentals.

Five Mile portfolios have focused on companies that pay **above average growing dividends**, and emphasize those companies that have multiple value creating options because they produce **large free cash flows**. Free cash flow is a more reliable measure of value than net income. Net income has broad leeway in the application of generally accepted accounting rules, resulting in a less reliable measure. In most FMR quarterly letters over the past few years the importance of free cash flow has been emphasized as these investments make up 95%+ of all FMR portfolios. Holdings that demonstrate the benefit of free cash flow have been highlighted in recent quarterly letters and include: Dominion Resources, our electric utility; Kinder Morgan, Magellan Midstream and Williams, several of our master limited partnerships (as a note, Williams was recently subject to a substantial takeover premium offer from Energy Transfer Equity Partners); American Tower, the dominant wireless and broadcast communications tower company; CVS, our drugstore and pharmacy benefit manager; and more recently increasing the portfolio weightings in Ventas and Healthcare REIT, both in the healthcare space. Another Five Mile investment with above average dividends and large free cash flow is Pfizer, our large cap pharma holding. Pfizer is proceeding to restructure into three different divisions as a prelude to a spin-off of one or more new companies.

Five Mile River portfolios have an 8% to 10% weighting in the healthcare space, which positions your portfolios to take advantage of the long-term tailwind of an aging population's spending. Individuals over 65 spend four times more on healthcare than younger populations.

One of the more recent additions to Five Mile portfolios in the healthcare space is in part an old friend that we owned several years ago, now in a new corporate structure but with its original name: **Allergan PLC (AGN).**

Allergan was acquired in January of this year by **Actavis**. Interestingly, Actavis then changed its corporate name to Allergan in June, taking advantage of the brand identity associated with Allergan's name. Allergan is one of the two dominant companies in the worldwide ophthalmology market, and the number one company in facial aesthetics with its \$2 billion dollar Botox product. Now with Allergan's former products front and center, the new Allergan is a specialty pharmaceutical company that develops, manufactures and markets both branded and generic medicines. The company has grown by both

acquisitions and organic growth. The former Actavis acquired Forest Labs, Warner-Chilcott, Arrow, Specifar, Ascent, and now Allergan. The company is based in tax friendly Dublin, Ireland, and is in a strong strategic and competitive position to grow earnings by 10% to 15% annually. **Allergan now has an estimated \$8 billion of free cash flow and \$21 billion of revenues.** The management of Allergan has demonstrated its ability to create and enhance shareholder value, and has significant flexibility and options to continue doing so. Allergan's stock price is \$320, and has three year earnings power of \$24 to \$25 per share, without future acquisitions. Our two to three year target price is \$375 to \$400.

We are always available to discuss any of our companies or Five Mile River investment strategies. We welcome your comments. We wish you a relaxing and fun summer.

Sincerely,

Lee

Todd

Martha

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