

PERFORMANCE

	FMR Performance		MLP Weighted Benchmark*	Russell 1000 Value	Dow Jones Industrial	S&P 500 Dividends**
	Taxable	Retirement				
2016 Q1	0.01%	2.91%	-0.09%	1.64%	0.36%	1.34%
2016 Q2	9.19%	5.93%	9.01%	3.91%	1.38%	2.45%
2016 H1	9.20%	9.01%	8.90%	5.61%	1.75%	3.82%

The second quarter felt like déjà vu compared to the first quarter of 2016. A stock market selloff followed by a rebound in the world stock markets in the second quarter was similar to the first quarter performance, although with entirely different triggers. The totally unexpected June vote in the U.K. for Brexit, Britain's exit from the European Union (EU), precipitated an immediate 3% to 5% worldwide stock market selloff that quickly rebounded, leaving the S&P 500 up 2.45% on the quarter. The first quarter selloff was precipitated by the overreaction to China's stock market crash and currency devaluation, but the world stock markets rebounded, resulting in an S&P 500 positive performance of 1.34% for that quarter, recovering from a 10.5% decline in January and early February. With all that volatility, the markets closed by June-end for a 2016 year-to-date performance at a positive 3.82%. We are likely to continue to experience market volatility as global monetary, political, and economic policies diverge and upset investors and markets. The key is to not get whipsawed into playing the short-term volatility game, but rather stick to a *fundamentally based* long-term investment strategy. Please visit FMR's website at www.fivemileriver.com for a detailed discussion of our investment policies.

What is the market outlook for 2016?

The U.S. stock market is fairly valued, and has been since the summer of 2014. At the end of the quarter, the all-time high for the S&P 500 had been made on May 21, 2015 at 2,130 (Monday, July 11th saw this number surpassed, closing last week at 2,161). Unless price/earnings multiples (P/E's) can expand and corporate earnings accelerate, low positive equity return expectations of 5% to 7% for 2016 continue to be the most likely outcome. Equities are more attractive on a risk-reward basis than bonds, and this will be discussed in more detail later in this letter. FMR's dividend-paying and dividend growth names remain compelling even in a fairly valued market. Why? Up front dividend yields of 3% to 4% and dividend growth of 5%, to as much as 10%, beat inflation. And because dividend yields and dividend growth characteristically provide consistent long-term, risk-adjusted returns, they now appear to be in the sweet spot for equity investors.

Brexit

There is no certainty as to how this unexpected decision will play out because there are vast permutations and possibilities from complex trade and financial negotiations with the remaining 27 EU countries

over the next two years. Negotiations should start in earnest now that Theresa May, the new British Prime Minister, is in place. Gross domestic product (GDP, or total economic output) is likely to be lower in Britain and most EU countries, although not catastrophic.

U.S. exports to Britain last year were only \$56 billion, accounting for just 0.3% of U.S. GDP, or only about 4% of the total U.S. exports. Total worldwide exports by the U.S. account for only 13% of U.S. GDP. This compares to Britain's total exports of 30% of their GDP. It should be noted that China remains the biggest trading partner to the U.S. accounting for 8% of total U.S. exports, and even China's domestic growth slowdown last year did not throw the American economy into a tailspin. Therefore, we expect U.S. GDP growth to remain slow at 1% to 2% (this has been the rate since the end of the Great Recession in June 2009), and Brexit will probably not materially affect this rate of growth.

Volatility – the new norm

Volatility is here to stay. Current events and those on the near horizon will continue to perpetuate this new normal. The Federal Reserve's initial plan to raise short-term interest rates four times in 2016, was then modified by the Fed to two times in 2016, and Fed Chairman Yellen recently announced that there is now possibly only one increase in December, a scenario that the market is pricing as a certainty. Overseas assets fleeing the yen, pound, and the Euro have pushed down the yields of U.S. government notes and bonds. The recent 10-year Treasury Note was yielding 1.4% at the end of the second quarter. This is a historic record low yield. The "safe" government bond is far less attractive than the so called "risk-on" effect to own a stable companies stock with a growing dividend. Also, we are at the beginning of an uncommonly bitter and divisive presidential race that will likely dominate the headlines in the U.S. for the next four months, unfortunately complicating present uncertainty.

While the outlook for the world economy is for poor to low growth, investors should expect lower returns on all assets, and continued volatility, until such a time as both the developed and the emerging economies are able to "right their ship." In three of the four biggest developed country markets, publicly traded equities offer a higher yield than their longest-dated government bond. The U.S. is the exception with our 30-year bond yield at 2.2% versus the S&P average yield of 2.0% (remember that FMR portfolios have 3% to 4% yields). By comparison, Germany's 30-year bund yields -0.1%, Japan's 40-year government bond yields 0.3%, and Britain's 30-year bond yields +1.7%. These bond yield rates imply low growth and low inflation.

Dividends – growing and compelling

The companies in FMR portfolios offer very attractive investment alternatives compared with returns from bonds and other competitive assets. High quality U.S. dividend paying companies look more and more attractive. Dividend growth from companies in FMR portfolios are anticipated to produce annual growth in dividends by 5% to 10%. Individual investors can therefore find growth in their portfolios, whether by price appreciation, corporate share repurchases, or cash dividend payouts.

Thus, we expect dividend and dividend growth companies to remain quite popular, as bonds continue to be less attractive with yields staying low and uncompetitive. It is historic that 77% of worldwide government debt yields less than 1%, and half of this total has a negative yield. Given these low and negative bond returns, it is no surprise that money is flowing from these investments into U.S. assets, including equities and long-term bonds. The majority of investments in FMR portfolios offer returns that are higher than the inflation rate, and possess the added performance benefit derived from reinvested growing dividends. As long-term investors, most of us need to have our capital invested to generate consistent income from our portfolios today, and will need

that income in the future for our mature years. Though not guaranteed, dividends are a far less volatile and a more reliable driver of returns in a slow-growth environment. FMR's portfolio strategy is right for these turbulent times.

Promising Opportunities: Real estate investment trusts (REITs); and the Permian Basin

Among other considerations, FMR portfolios have benefited from significant weightings in REITs; and also are positioned to benefit from investments in production and exploration (E&P) companies in the best geophysical basin in the United States, the Permian Basin of west Texas. Both of these sectors offer opportunity for growth in portfolios. Here we provide background and rationale for both.

REITs are trusts that are income-oriented and pay attractive dividend yields because they are not subject to income tax as long as they pay out 90% of their income in dividends to shareholders. Average REIT yields range between 4% to 5%, making them the fourth highest-yielding sector in the S&P 500. We expect REIT dividends to grow on average anywhere from 5% to 7% with a few at 10%+ over the next several years. Your FMR portfolios contain a diversified cross-section of REITs in all kinds of real estate properties: cell phone towers, data centers, medical office buildings, nursing homes, theaters, warehouses, apartments, and even tree farms. REITs have outperformed the S&P 500, 11.2% to 9.1% over the past 25 years since the very first REIT, Kimco Realty (KIM), a commercial shopping-center operator that went public in 1991. REITs are attractive because they tend to be less volatile than financials, and have a lower correlation to the market indices like the S&P 500. They are sensitive to interest rate changes as rates affect the borrowing and refinancing costs of REITs, but unlike many other entities, REIT assets tend to retain and mostly increase in value over time. Finally, come September, real estate will become its own separate sector in the S&P 500 as previously it had been lumped into the financial sector where it was overshadowed and underweighted versus banks, brokers, and insurance companies. As a result, we believe that this new S&P category already has, and will continue to attract increased analytical research coverage and stock ownership by both institutional and individual investors. **REITs are particularly attractive to qualified non-taxable accounts** such as 401k, IRA, ROTH IRA, profit sharing and defined benefit pension plans.

Next we would like to discuss exciting investment opportunities in E&P companies operating in the **Permian Basin**. The Permian Basin in west Texas is one of the oldest oil producing basins in the U.S. with about a 100 year history of conventional vertical oil production. It is a huge basin approximately 250 miles by 300 miles. It has multi-zone opportunities for oil production ranging from the shallowest at 1,500 feet, down to as deep as 20,000 feet. Horizontal drilling is now able to turn ninety degrees and drill as much as two miles horizontally at these depths in the richest pay zones containing oil and gas. Productivity from the time to drill a well to the quantity of oil and gas reserves produced per well has resulted in more production per well, produced in a shorter timeframe and produced at a lower cost. The Permian Basin is truly the best quality asset or geological "rock" in what is certainly a cyclical commodity business. The quality of your rock, whether oil or gas, or for that matter almost any kind of mining, is the driver for determining whether you can be the leader and the lowest cost producer. Without the best geological assets, everything about the oil business is far more difficult.

The Permian Basin had been on a 35-year decline, peaking in the early 1970's at just over 2/million barrels (MMB) per day declining to 800,000 barrels per day by 2008 when production flattened out. However, Permian Basin production stopped declining as a result of innovative vertical well completion technology and horizontal drilling technology best implemented by several companies in FMR portfolios. Companies that control the best Permian Basin geological rock have lowered E&P costs by as much as 30%, and have been able

to profitably grow their oil production, even at sub \$40/barrel (B) oil. Meanwhile, much of the industry has cut back drilling, completions, and oil production, leading to a decline in U.S. oil production in the last year of an estimated 1/MMB per day.

Companies focused on premium drilling locations can generate a 30% after-tax rate of return at \$40/B flat oil. With current oil prices having recovered from \$26.31/B on February 11, 2016, to \$49.00/B as of the end of June, rates of return are approaching the neighborhood of 40%. This is not the case facing much of the industry. At \$30/B oil, almost nobody can make money. At \$30/B, Saudi Arabia drained their government cash reserves at a rate of \$80 billion dollars/year.

The U.S. energy industry in total includes many different basins and quality of rock across the U.S., all with higher breakeven prices than are found in the Permian Basin. The consensus estimates are that the West Texas Intermediate (WTI) oil price will need to return to the \$70/B to \$80/B range for U.S. production growth to resume. Most anticipate this to be a post 2020 event. Everybody cannot succeed at the same level when oil prices are \$30/B to \$50/B, while everybody could succeed at \$95/B oil. Future oil demand increases will be supplied by the Arab Gulf states and the U.S. The world will need more U.S. horizontally-drilled unconventional oil, which has become a major new supply source. Why? Natural depletion (declining reservoir production) worldwide is running approximately 3/MMB per day and demand is growing between 1/MMB to 2/MMB per day. Normalization of oil prices, by year end 2017, will not only be positive for the best exploration and production companies, but also bodes well for the mid-stream MLP companies that will continue the build-out of energy infrastructures such as pipelines, storage terminals, and processing plants.

We welcome any and all questions.

Sincerely,

Lee

Todd

Martha

**Five Mile River's investment strategy for taxable accounts, with its emphasis on value investing which includes MLPs, is best compared with a blend of a value style index, the Russell 1000 Value Index (weighted 70%) and the Alerian MLP ETF Index (weighted 30%). Comparing FMR's performance in taxable accounts with this blended index provides a more accurate benchmark.*

***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 weight it contributes to the S&P 500 Index performance. The index referenced **includes** the dividends issued by these 500 companies.*

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