

PERFORMANCE**

	FMR Performance		Russell 1000	Dow Jones	S&P 500
	Taxable	Retirement	Value	Industrial	Dividends
2017 Q1	4.49%	3.82%	5.51%	4.56%	6.06%
2017 Q2	0.73%	1.90%	2.52%	3.32%	3.09%
2017 H1	5.72%	5.80%	8.22%	8.03%	9.34%

Domestic and global markets alike were not rattled by the myriad of potentially disruptive issues, and refused to go lower in the second quarter. Despite political high drama, the French elections, North Korea's aggressive and despicable behavior, Russian intrigue, problems in the Middle East, lackluster and contradictory economic data, and the second Fed Funds rate increase this year, the markets continued to move higher! U.S. stock market indices hit new all-time highs in June, even with pockets of significant overvaluation with the S&P 500, now up **9.34%** for the year. **Our 2017 forecast for total return for FMR portfolios remains at +6% to +8% with a weighted average portfolio dividend yield of 3.5% and dividend growth of at least +6%.** Narrowly focused corporate tax reform, if enacted to take effect in 2018, would raise our total return expectations. We would currently rate the probability at 60% on this important issue that could attract bipartisan support in an otherwise contentious year.

Why such complacency?

While the answer is multi-faceted, we go back to an acronym created last year, called "**TINA**" or **There Is No Alternative**. This was discussed in some detail in FMR's 3Q16 Quarterly Newsletter, available along with all FMR quarterly newsletters on www.fivemileriver.com. TINA implies that, for both individuals and institutions, low returns from bonds, notes, and Treasury bills do not meet actuarial assumptions for pension plans; do not meet funding obligations of foundations and educational endowments; and do not provide individuals with 401k and IRA retirement plans adequate returns after inflation. Equities and equity-like investments have been the only alternative for long-term investors who need or will need both growing income (bond interest payments do NOT grow), **AND** long-term capital appreciation to fund future commitments. The 10-year Treasury note, the most widely tracked government bond, yields 2.3%. Inflation is roughly 2%. At

this low a bond yield, bonds do not work well in meeting a large cross section of investor objectives or goals, nor do bonds allow investors to keep ahead of the cost of living.

The Federal Reserve (FED) raised the Fed Funds rate a quarter point to **1.25% on June 14, 2017, two months after it raised it to 1.0%**. This is the fourth rate increase in less than 18 months. The 2008 recession caused the FED to lower the Fed Funds rate to 0.25%, where it stood for seven years! The FED has signaled that it will gradually normalize rates and raise this short-term rate again to **1.5%** in 2017, to **2%** in 2018 and **3%** in 2019. The Fed Funds rate controls ALL short-rates such as: banks' prime rate, the London Interbank Rate (LIBOR), most adjustable-rate mortgages and interest-only loans, as well as credit card rates. The FED's intention to normalize interest rates has been well publicized. This was done intentionally to avoid upsetting investors. Investors should remain calm assuming the economy continues to grow at least by 2% with 2% inflation.

The U.S. economic expansion is now over eight years old, the third longest on record and also the slowest on record. The record longest economic expansion occurred for the ten years from 1991 to 2001. As we have covered in newsletters, the current economic recovery has been grinding at 2% due to: over-regulation, demographics, low productivity, low capital investment, high corporate tax rates, to name a few. Inflation has been low, and unemployment has come down, although wage growth has been absent for most of this period. A continuing 2% annual GDP growth rate is realistic for the foreseeable future, unless we get significant constructive corporate tax reform. In that event, the economy could grow faster, and the stock market valuation of companies would rise. This has been, and is the definition of a "**Goldilocks economy**," one that is not too hot or not too cold, and suggests that the next recession is more likely to be mild and is still several years away, which would break the 10-year longevity record for economic expansions.

Pocket of Overvaluation

We highlighted earlier this year in our detailed S&P 500 analysis, the disproportionate technology company weighting (**22%**), and the impact of this sector on the index's performance. The S&P 500 is capitalization weighted, not equal weighted. That simply means the biggest market cap companies dominate how this index performs. The technology sector is the largest sector by a wide margin and has outperformed all other sectors this year. It has had the second highest profit growth of the 11 S&P sectors. Technology has clearly been a stock market **momentum** group (Apple, Microsoft, Google, Amazon, Facebook) rather than a **fundamental** valuation group. By that we mean that while growth fundamentals are good, valuations are either rich or fairly valued, and the emotion of the crowd of short-term traders is the dominant factor in this dramatic rise. These technology stocks have benefited from the growing dominance of mountains of cash pouring into passively indexed Exchange Traded Funds (ETFs) that mimic the S&P 500 index, thereby creating overvaluation of many of the largest 50 companies that represent 50% of this index.

Less than ten companies accounted for 40% of the S&P 500 first half 2017 performance of 9.34%. The valuations of the technology sector today are on average *only* 60% of the peak valuations of the 1999 dot-com bubble (**technology was a 32% weighting then versus 22% today**). However, this "pocket of overvaluation" is likely due for a rest, if not a correction.

Technology has been what investment professionals call a “**crowded trade.**” This is not the extreme overvaluation during the period between 1999-2000, but is one of the reasons why this sector could have a “**reversion to the mean**” (or another way of saying, a price correction) which implies that fundamental active investors will pull back when these valuations get extreme, even for the very best companies with the best growth prospects. In our view, the current overvaluation of some of the technology stocks is not a big problem across the entire technology sector. We would be remiss not to point out that so much money has flooded into this index to mimic its performance, some investors will be surprised that they are NOT as diversified as they think.

Diversification only works well if investors and managers alike understand and accept that some sectors and some companies in their portfolios **will always lag** behind others. **It does not mean that something is wrong, or that your active manager is incompetent. Diversification implies risk reduction, and it means your plan to reduce risk is working and patience is your ally and an asset.**

Five Mile River invests in companies that generate **free cash flow (FCF) from their operations that is sustainable and can grow at 5% to 10% per year.** This root metric, rather than the generally accepted accounting number called net income, provides a more accurate picture of a company’s true profitability and management’s options to increase shareholder value. These options include the capability to pay dividends, grow those dividends, and buy back shares, in addition to more capital investment, research and development (innovation), or accretive acquisitions that can enhance productivity and growth.

A 2016 article in the Financial Analysts Journal titled “What Difference Do Dividends Make” by Conover, Jensen and Simpson concluded “The focus on dividend-paying stocks and companies that buy back their shares significantly **reduces risk, independent of style.** This finding is true for value and growth portfolios as well as small-, mid-, and large-cap portfolios. **For value investors, an investment in dividend-paying stocks reduces risk without sacrificing return.**” * The risk reduction from dividend paying stocks is an important pillar of FMR’s investment strategy.

We welcome your questions, and are available for a conference call to discuss Five Mile River’s investment strategy and market outlook. We wish you a fun and relaxing summer season.

Sincerely,

Lee

Todd

Martha

**If you would like to receive a copy of the article, “What Difference Do Dividends Make” (Financial Analyst Journal), please email or call Martha Robbins for a copy.*

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