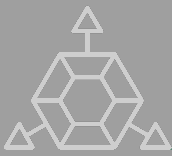


A Personalized Portfolio

Our Bespoke Equity Strategies are constructed using a structured and disciplined investment process, but personalized for your clients. We take into consideration the client's tax situation, outside holdings, desired income, and other unique circumstances and preferences to build and manage a portfolio of stocks that is tailored to her specific needs and wants.

A personalized portfolio gives the client a greater sense of ownership in her investments. It also allows for better management of her tax situation, avoiding unexpected capital gains distributions from actively managed mutual funds while also being able to surgically realize capital losses that an index ETF could not. Our Bespoke Equity Strategies also give your client the potential to outperform the broader market.

Reducing Unsystematic Risk

Systematic risk affects all stock and cannot be diversified away. This is the risk you get paid for with a higher expected return. Unsystematic risk, however, is firm-specific to the individual stock. This includes both negative risks — such as the loss of a key management person, labor disputes, or a large lawsuit — and positive risks — such as FDA approval for a new drug or a successful product launch. All of these things can make a stock move independently of the market, and these are precisely the kinds of risks that can be dramatically reduced through diversification. This is paramount because investors don't get compensated for taking on unsystematic risk.

To effectively accomplish this we construct portfolios that have between 30 and 50 stocks from all sectors.

Diversifying Away Risk

A portfolio of between 30 and 50 stocks should eliminate about 94 to 97% of the diversifiable risk. The marginal risk reduction gained by including additional stocks beyond 50 becomes increasingly negligible. We thus cap the number of securities in a portfolio here to avoid adding lower conviction holdings and receiving essentially no benefit in in the form of risk reduction.

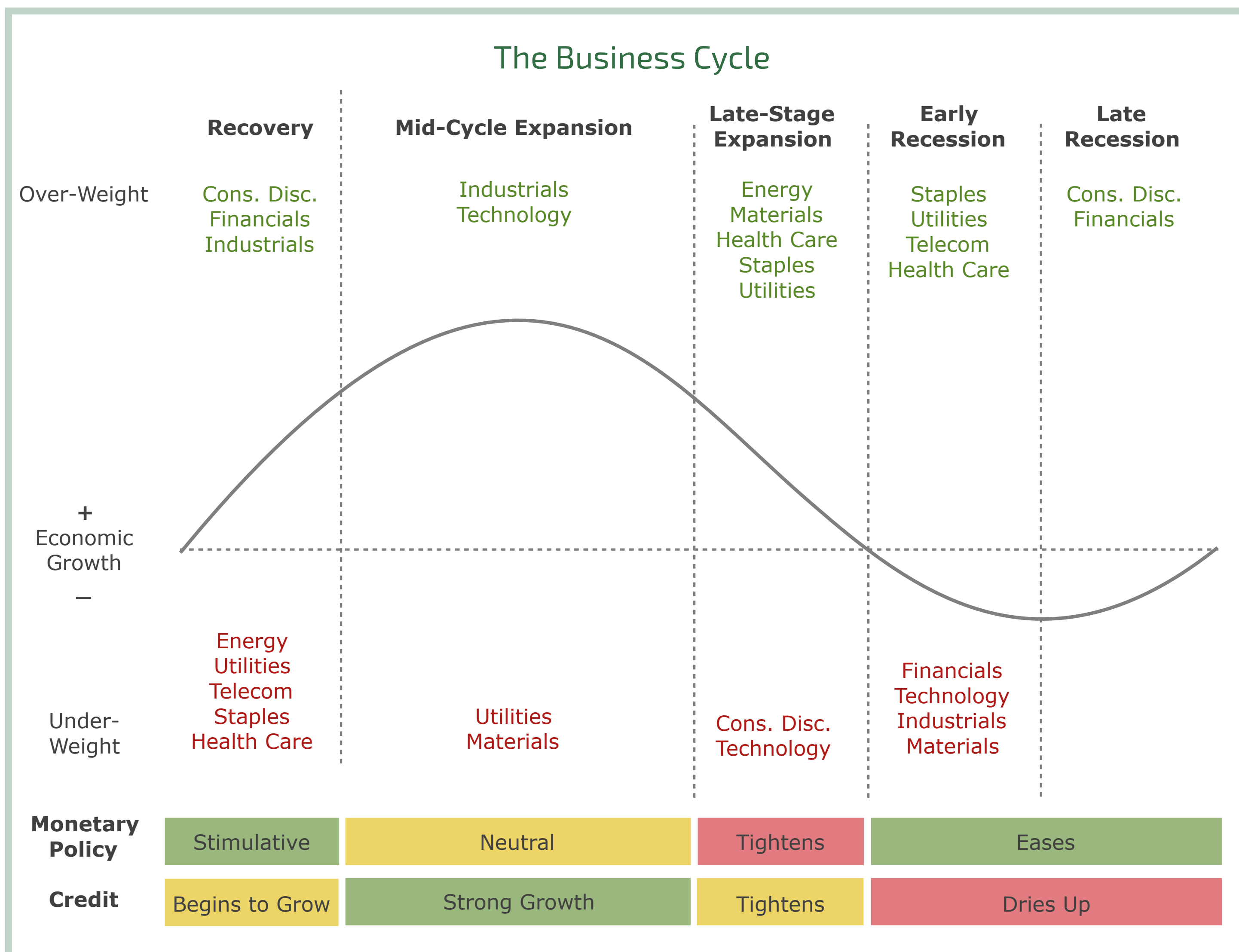
Based on data from a 1987 study on diversification; Nguyen C., 2008, Analytical Management Techniques, page 27.

Sector Rotation

Investing is an arena where elements of skill and chance coexist. Our goal is to tilt the scales in your clients' favor. We avoid foolish attempts to time the market and remain fully invested at all times. We do, however, make tactical shifts in our sector weightings as the economy moves through the business cycle. Historically, relative sector performance has tended to rotate as the economy moves from one stage of the business cycle to the next.

Our top-down philosophy begins with an examination of the broader economy to determine where we are in the cycle and in turn how we should overweight and underweight the various sectors. In the early stages of recovery, we see economic activity picks up and profits begin to grow rapidly. Monetary policy is typically still accommodative at this time and retail sales are picking up. Consumer Discretionary and Industrials stocks tend to do particularly well during this time, and Energy, Utilities, and Telecom are best weighted lightly. Growth begins to peak and monetary policy becomes more neutral during the mid-cycle phase — typically the longest lasting phase of the cycle. Information Technology stocks begin to outperform while Utilities and Materials tend to lag. As we move to the later stages of an economic expansion and monetary policy and credit tighten, we reduce exposure to more economically sensitive sectors and add to Energy, Consumer Staples, Materials, and Health Care. We hold an overnight to Staples and Healthcare as we enter a recession, but also overweight Utilities and Telecom stocks which also tend to hold up well in lean times. Finally, as the economic decline begins to slow and monetary policy has eased, we position again for the recovery.

Some business cycles last only one year while others can span a decade, and they don't always follow the text-book pattern. Every business cycle is different, but certain patterns have shown a tendency to repeat themselves. Knowing how to exploit these patterns increases our probability of outperforming the market for your clients.



Security Selection

Once we have determined our desired sector weightings and the number of security slots we are looking to fill, we then go about selecting securities. To properly diversify the portfolio, we strive to add names within each sector that complement each other. For example, if we are looking to buy two energy stocks it does us little good if they are both oil & gas producers. If oil prices fall, they will both feel the pain rather equally. Instead, we would perhaps look for one oil & gas producer and complement it with an oil refiner as these stocks tend to do well when oil prices fall.

It is essential we have a strong team of analysts behind us when we are attempting to sift through hundreds of different stocks to find the most appealing to build your portfolio. The most important factor when considering the weight to give a particular analyst's equity recommendation is whether or not they are independent. That's why we utilize Morningstar for our equity research. Morningstar does not engage in the very profitable business of investment banking, therefore, their analysts are not influenced to write favorable reports on equities so as to not offend current or potential investment banking clients. Only 277 of the 973 stocks that Morningstar covered as of November 2015 had a 4- or 5-star rating ("buy") while 203 had a rating of 2 stars or less ("sell"). That is as close to objective as you are likely to get in a world where its not uncommon to find only 1 or 2% of companies in the broad market carry a "sell" rating.

We believe that a company's intrinsic worth results from the future cash flows it can generate, and we try to identify stocks trading at a risk-adjusted discount to that value. Morningstar uses four key factors to determine a stock's intrinsic value:

- an assessment of the firm's economic moat;
- an estimate of the stock's fair value;
- the analyst's uncertainty around that fair value estimate;
- and the current market price.

This concept of an economic moat plays a vital role not only in the qualitative assessment of a firm's long-term investment potential, but also in the actual calculation of the intrinsic value estimates. An economic moat is a structural feature that allows a firm to sustain excess profits over a long period of time. The five sources of economic moats are:

- intangible assets;
- switching costs;
- network effect;
- cost advantage;
- and efficient scale.

Monitoring the Portfolio

Acting as curator, we continue to monitor the portfolio and its individual components. If a particular stock overshoots its intrinsic value estimate by too wide a margin, we are quite happy to take profits and look for new opportunities to reinvest the proceeds.

We minimize turnover as much as we feel it prudent to do so to avoid realizing capital gains in taxable accounts and transaction costs in all accounts. Managing the holdings in the portfolio in a tax-sensitive manner also means we stay on the lookout for tax-loss harvesting opportunities throughout the year — not just in December.

About EmeraldSpark

EmeraldSpark Investments, LLC is a registered investment advisor based in Chicago, IL. We were founded by Ryan P. Layton, CFA in 2015 to provide outsourced investment management services to community bank trust departments and independent trust companies. Our investment process blends the foundations of Modern Portfolio Theory with the latest research in the field of behavioral finance. We specialize in asset allocation and investment due diligence to help provide our clients with investment strategies personalized to match their specific goals and risk comfort zone.

Not FDIC Insured | No Bank Guarantee | May Lose Value