The Type 2 Investor

August 8, 2016

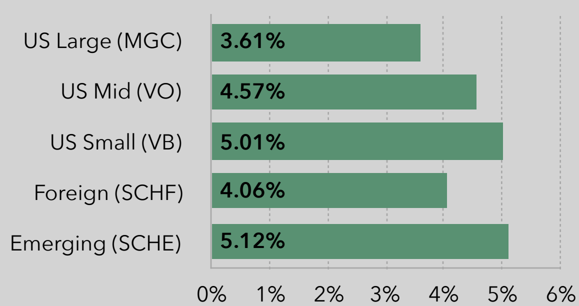
July 2016

Economic Data

- Year-over-year inflation (CPI) held at 1.0% in June; gas price base effect should provide upward pressure through February
- Retail sells were up 0.6% in June with strength in the building materials & garden equipment component
- Second quarter GDP was well below expectations at 1.2%
- A much-better-than-expected 255,000 jobs were added in July, while June figures were revised up to 292,000; unemployment rate remains at 4.9%; participation rate edged up to 62.8%

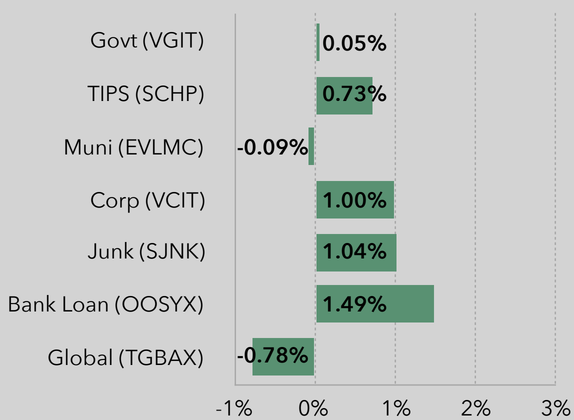
Stocks

July Returns



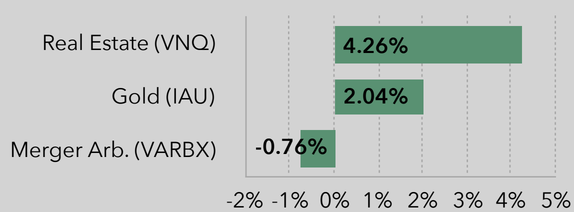
Bonds

July Returns



Alternatives

July Returns



Performance data provided by Morningstar.

The brain uses two systems to process information. The first type is intuitive but lazy, rapidly forming judgements with no conscious input. The second system is slow, reflective, and is not guided by emotions. It is that second system – type 2 – that we want in control of our investment portfolios.

Hell Has Frozen Over

I tend to roll my eyes every time I hear someone utter the phrase, "throwing money away on rent." It's one of those pieces of conventional wisdom that warrants reconsideration. You are not throwing your money away when you rent, you are paying for the use of a shelter – a basic necessity – for a certain period of time. Are you throwing money away on food when you go to the grocery store, or gas to keep you warm in the winter? What's more, very little of your monthly home ownership expenses actually go towards building equity. Instead, you are now "throwing money away" on closing costs when you buy and when you sell, mortgage interest, association dues, property taxes, insurance, maintenance, and depreciating home improvements. For many people, especially those who don't plan on staying in one place for more than a few years, renting is often the more financially prudent choice.

Despite home ownership never really being a goal of mine and my overall reservations about it, I nonetheless found myself buying a condo together with my girlfriend last month. We plan on staying in Chicago for the foreseeable future, and the numbers made sense. Home valuations here are relatively reasonable compared to income levels and rapidly rising rents make the rent vs. buy comparison compelling. Perhaps this is because people are wary of buying a home in a city with an estimated $33.8 billion hole in its pension obligations (up from the frequently cited $20 billion due to a shift to more realistic accounting standards), which works out to about $12,424 per Chicagoan. And that is to say nothing of the Chicago Public Schools pension, CTA obligations, Cook County liabilities, the state budget stalemate, and a host of other debt. Crap, what the hell did we get ourselves into!

Seriously, Chicago is a mess. And Illinois – a state where four of the previous seven governors have gone to prison – isn't much better. But that's not really why I bring up my home purchase. I bring it up because our buying experience somewhat resembles the stock market today. Even with the evident fiscal issues of Chicago that will either have to be resolved with devastating property tax increases, massive haircuts to the ludicrously generous pension systems, or a bankruptcy à la Detroit, the real estate market is doing pretty well. People are buying and prices in non-war-torn neighborhoods have been appreciating.

Similarly, in the face of deteriorating corporate earnings and a somewhat soft economy, stock prices have continued to climb in much the same way. These two asset classes share a common tailwind: a Federal Reserve that is keeping interest rates – and hence mortgage rates – low, making stocks more attractive and homes more affordable.

Another comparison can be drawn between the two in that there is shrinking demand, but corresponding declines in supply to compensate. Chicago's population fell last year for the first time since at least 1990, according to census data, but we still found ourselves in three separate bidding wars in our attempts to purchase a home. We finally won the battle for our condo in Ravenswood, a charming north side neighborhood with quiet tree-lined streets, convenient access to all three forms of mass transportation, a burgeoning tap room scene, and – perhaps most importantly –. one of the lowest crime rates in the city. It is the only neighborhood we wanted to live in. The problem is there isn't much supply in the way of 2br/2ba condos in this neighborhood, and nothing in the way of new construction. It actually seems more common to see two houses razed to the ground to make room for one larger house than a new condominium being built.

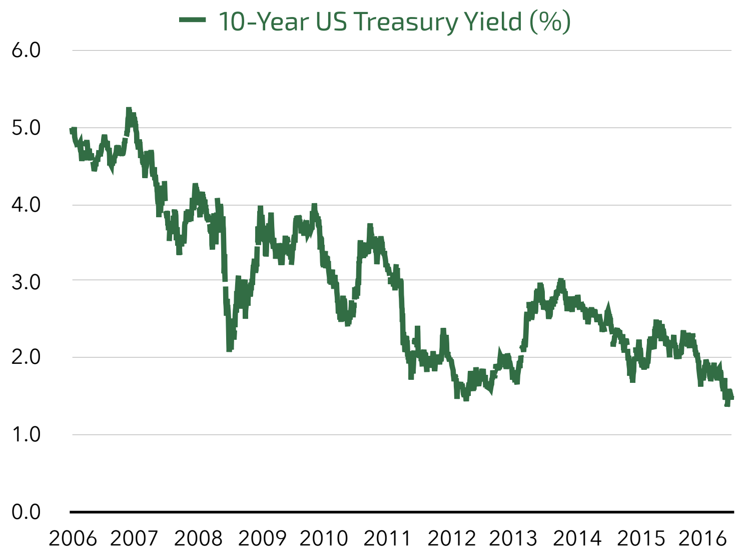
Supply is the stock market is also tightening at a time when only 52% of Americans own stock, down from 65% in 2007, according to a Gallup survey. In our May Newsletter we estimated the entire US stock market had shrunk by about 3.35% in 2015 due to corporate buybacks. According to S&P Dow Jones Indices, the 12-month period ending March 2016 saw a 9.5% increase in buybacks from the previous year to $589.4 billion, setting a new 12-month record for the S&P 500. The record it replaced? The $589.1 billion set in December of 2007 at the precipice of the Global Financial Crisis.

Portfolio Positioning

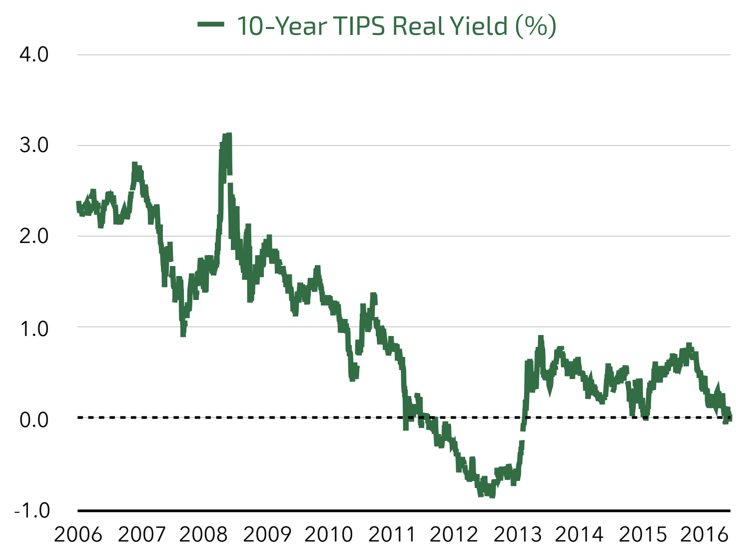
The Brexit shock didn't last very long, as US stock prices recovered all of their losses within two weeks and continued to climb from there. As we predicted last month, President Obama's threats towards Britain proved hollow as the UK found itself not at the back but at the very front of the queue fore a trade deal, as preliminary discussions for a free trade agreement have already commenced.

Tactical Asset Allocation					
Asset Class	Heavy Under-weight	Under-weight	Neutral	Over-weight	Heavy Over-weight
Fixed Income		●			
Core Domestic		●			
TIPS				●	
US High Yield		●			
Bank Loans				●	
Foreign Bonds		●			
Equities			●		
Large Cap		●			
Mid Cap			●		
Small Cap			●		
Developed Intl.			●		
Emerging				●	
Alternatives				●	
Real Estate			●		
Commodities				●	
Hedging					●

The S&P 500 keeps hitting new highs, up 3.57% for July and 6.34% so far this year. I can't tell you how long this bull market will last, but history has repeatedly shown that markets eventually revert to fundamentals. Buybacks are expected to begin slowing and profits are deteriorating. Complacency is high right now, and the stock market is quite vulnerable to a sharp correction. Markets could continue higher still, though, because of the so-called TINA scenario – "there is no alternative." Meaning there really aren't any attractive places to put money to work right now.



10-Year US Treasury yields closed at an all-time low of 1.36% on July 8th. They have never been lower! There are two ways this ends. We either muddle through a prolonged period of ultra-low interest rates and ultra-low returns, or interest rates rise and bond prices fall dramatically. Despite this we are still invested in government bonds because we believe interest rates could fall even further if and when the stock market finally corrects.



Real yields on 10-Year TIPS have dipped into negative territory. In December of 2012 they reached levels as low as -0.87%, so zero hasn't proven to be a hard barrier in the past. We still see inflation protected securities as being more attractive than straight Treasury bonds, but upside for both is becoming increasingly limited.

No changes were made this past month in portfolios. We remain neutral on stocks, underweight in bonds, and overweight in alternatives. If I were to anticipate our next move, it would likely be to cut equities further and move to an underweight. The only question that needs to be answered is where to reallocate the proceeds. After all, TINA.

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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, as well as fiduciary investment management for select individuals. 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.

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