The Type 2 Investor
December 5, 2016

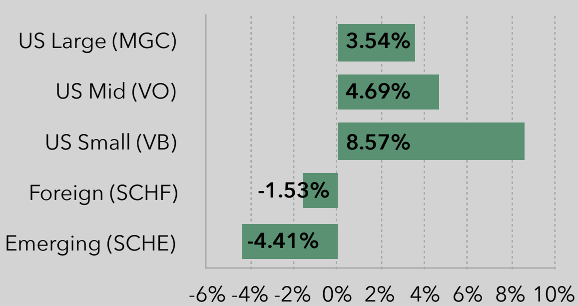
November 2016

Economic Data

- The ISM Manufacturing Index for November came in better than expected at 53.2 (numbers above 50 indicate growth)
- Year-over-year inflation (CPI) continued its upward trend to 1.6% in October from 1.5% the previous month; the core edged down to 2.1%
- Retail sales continue to show strength, up 0.8% in October after a revised 1.0% the previous month
- 178,000 jobs were added in November and the unemployment rate fell to a nine-year low of 4.6%, but the labor participation rate continued to move lower to 62.7% and hourly earnings fell 0.1%

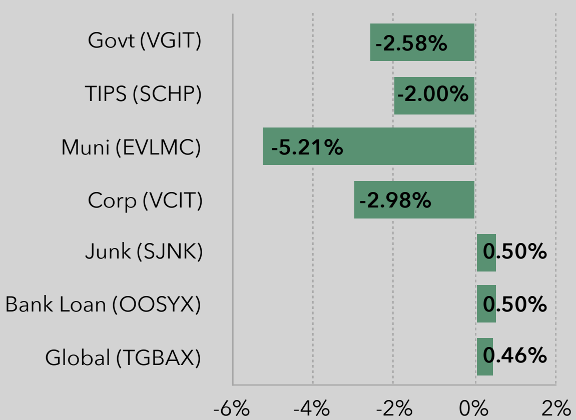
Stocks

November Returns



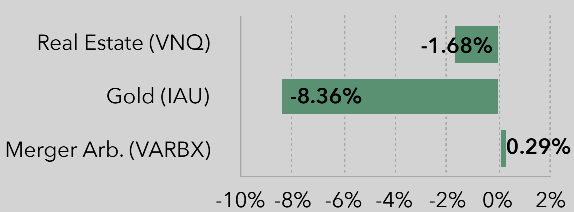
Bonds

November Returns



Alternatives

November 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.

A Visit From Trump

'Twas the day of the election, when all through the exchange, not an asset was trading, outside a tight range. The polls all showed and the media was sure, that America would certainly be voting with "Her".

The city folk were nestled in front of their TV, while visions of victory is all they could see. And me with my bourbon and cider night cap, had just settled in with the remote in my lap.

When there on the screen, Wolf Blitzer looked stumped, when it appeared Ohio, was swinging towards Trump. Away from CNN, over to FOX instead, it now looked like Florida, would also swing red.

More rapid than eagles, the reporters they came, calling the other, states out by name. Now, South Carolina! Now, North Carolina! Now, Georgia! Now, Iowa! On, Arizona! On, Pennsylvania! On, Wisconsin and Michigan!

The liberal elites, living on the coastal seas, had forgotten all about, fly-over country. With all the states colored, on the electoral map wall, the Drumpf had won, three-hundred-and-six votes in all.

Cheers of joy rang out, across the heartland, the establishment had been crushed, by this oaf of a man. No hair on his head, cotton candy in its place, the first president-elect, with resting bitch face.

Snowflakes had tears, pouring down their shocked faces, as they ran to hide, in their campus safe spaces. The highest office, the presidential role, would now be held, by an internet troll.

His inflammatory comments, should have assured his defeat, but instead gave him free coverage, on every news beat. "Make America great again", that was his mission, is he a lucky fool, or a skilled tactician?

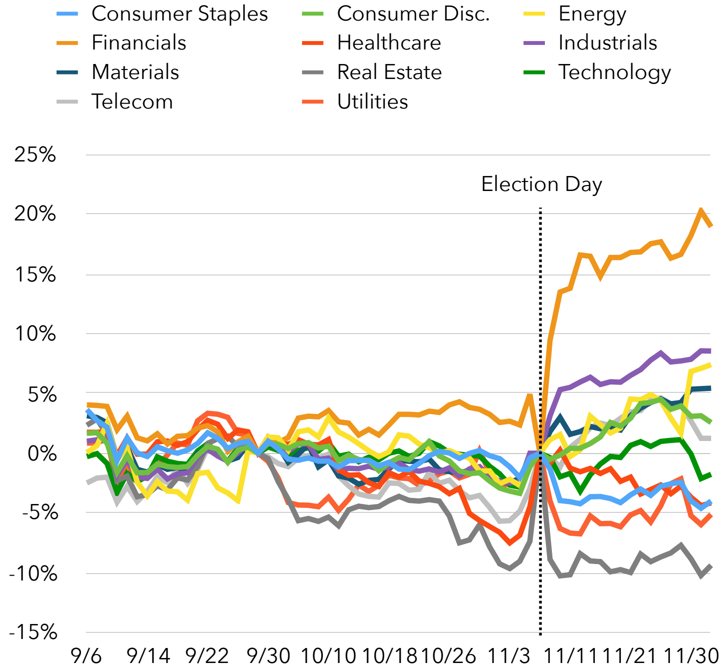
Once the butt of jokes, now the one to anoint, as Dow futures fell, more than 800 points. But a strange thing happened, when the market opened, US stocks rallied, and the world didn't end.

The Trump rally continued, new records were smashed, as emerging markets struggled, and the Peso it crashed. Bond yields soared higher, as their prices fell, and gold has not, been doing very well.

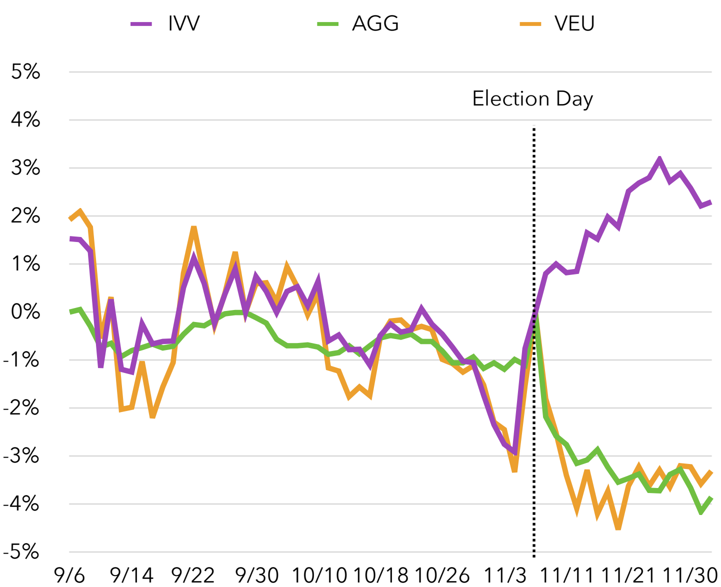
It has been a nice run, but it won't last long, optimism is high, but fundamentals aren't strong. I heard him call it, before his big win, a "big, fat, ugly bubble", and I agree wth him.

Diversification is Back

Diversification is the idea that if you hold a variety of different assets in your portfolio it will reduce the overall volatility, because when a few might be zigging, the others might be zagging. However, the benefits only exist when the assets are uncorrelated. And prior to the election that hadn't really been the case.



Post-election, assets are moving much more independently of each other. Financials (+13.31%), Energy (+7.95%), and Industrials (+7.90%) sectors have seen dramatic gains on expectations of regulatory easing and infrastructure spending. Meanwhile, high-dividend-paying Real Estate (-2.77%), Consumer Staples (-4.04%), and Utilities (-4.82%) are all down amid rising interest rates. Technology (-1.52%) has also struggled due in part to concerns that restrictions on immigration will make it difficult to attract foreign talent.



The decoupling of assets was also evident on a broader scale. While domestic stocks rallied (IVV +2.33%), foreign stocks (VEU -3.30%) and domestic bonds (AGG -3.84%) fell.

Ciao, Renzi

On Sunday Italy held a constitutional referendum vote that the people rejected in convincing fashion, with about 59% voting against it. Although the referendum was actually about streamlining the legislative process, a 'No' vote was seen by Italians as a way to give the middle finger to the pro-EU establishment.

Prime Minister Matteo Renzi, who had staked his political career on the vote, resigned in response, clearing the way for the populist Five Star Movement to potentially take control of the Italian government some time in the coming months. Once they gain control, they will almost certainly hold a referendum to leave the euro and return to the lira. And if this vote is any indication, the referendum will pass, severely weakening the continental currency and the EU as a whole. The dominos will start falling one by one.

Portfolio Positioning

Anticipating a potential Trump win, we trimmed our exposure to international and emerging markets stocks, as well as REITs, and placed the proceeds in cash. Though there has been a rally in U.S. stocks, it has not been broad-based. All three of these assets are currently trading below the price we sold at the day before the election. While we don't like to keep money

Tactical Asset Allocation					
Asset Class	Heavy Under-weight	Under-weight	Neutral	Over-weight	Heavy Over-weight
Cash				●	
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					●

in cash with yields so low, this may be a tactical position we hold for another month or two.

We remain underweight in stocks. It's not a comfortable tactical position to take, as stocks have historically outperformed other asset classes over the long-term. But from our perspective the downside risks are greater than the upside potential right now. Stock valuations remain well above historical averages, and geopolitical risks are elevated.

Yields on bonds have spiked, with the 10-Year treasury going from 1.86% on the day of the election to 2.39% today. When yields go up, prices go down, so most bond sectors have been taking it on the chin the past few weeks. We think yields have topped out for the time being, though, and are starting to look more attractive now that they are finally higher than the 2.01% yield on the S&P 500.

We are still underweight bonds, but may look to increase our weighting soon. Treasury bonds are getting more attractive, and municipal bonds even more so.

Within the alternative bucket we still see merger arbitrage as one of the safest places to allocate capital. Gold has struggled recently as the dollar has rallied, but is still up 10.36% year-to-date. We continue to like the shiny metal as it hedges us in the event the dollar comes back down to earth, and tends to due well in times of panic.

As we briefly mentioned in last month's newsletter, we are beginning to question whether REITs (Real Estate Investment Trusts) deserve a separate allocation in the portfolio, or if they should simply be viewed as another equity sector and be rolled into the overall stock allocation. While their tax structure makes them unique to other stocks, they are already components of broader equity indexes. We expect to make a final decision on this in our annual strategic asset allocation review.

Ryan P. Layton, CFA
612-810-2230
ryan@emeraldspark.com

Binge Box

3%

This is a new feature. Every month I will recommend a different binge-worthy series on Netflix, Amazon Prime, or HBO GO. This month it's Netflix's "3%". The Brazilian series is in Portuguese, but it's well worth the effort to read the subtitle (it's dubbed in English if you are too lazy). You also need to overlook the shoestring budget (an entire episode was shot in a storage facility). The story is set in a dystopian future where 20-year olds living in the slums of the Inland can compete in "The Process", a merit-based competition where the top 3% earn their ticket to the Offshore, a utopian paradise with abundant resources and no crime. It's been compared to the Hunger Games, but it addresses the issues of economic inequality in a much more thoughtful fashion, in my opinion. The twist in the final episode really gets you thinking.

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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