The Type 2 Investor

June 7, 2018

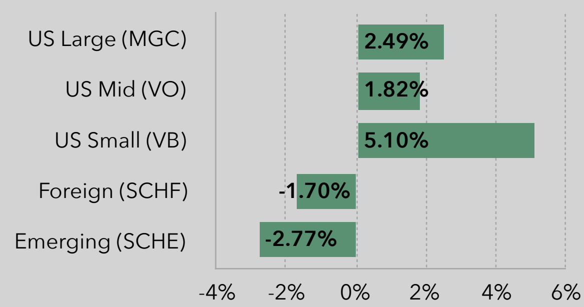
May 2018

Economic Data

- A higher-than-expected 223,000 jobs were added in May and the headline unemployment rate fell a further one-tenth to 3.8%; there are now more job openings than unemployed people
- Year-over-year Inflation (CPI) edged up one-tenth to 2.5% while the core held at 2.1% in April
- Existing home sales fell 2.5% in April and are 1.4% below last year
- Retail sales were up 0.3% in April

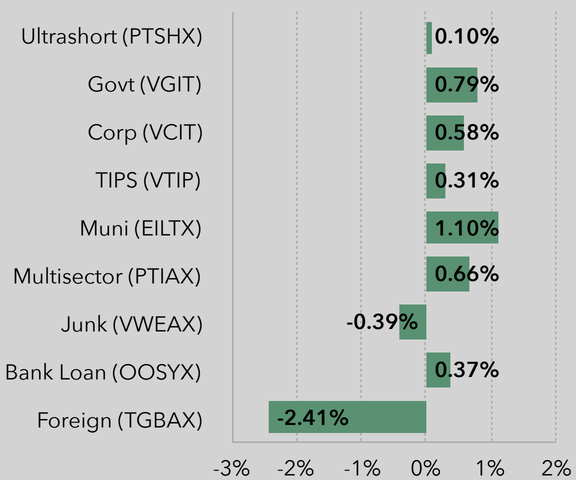
Stocks

May Returns



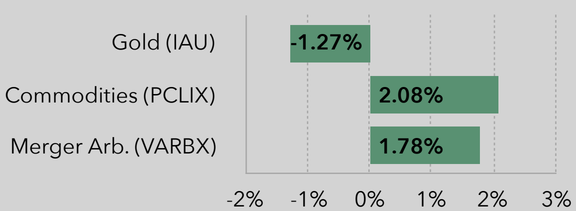
Bonds

May Returns



Alternatives

May 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.

Changes to Our Asset Allocation

- We reduced domestic equity exposure in large and mid cap stocks
- We reduced exposure to leveraged loans
- We slightly increased our allocation to Treasury and multi-sector bond funds
- Lastly, we increased our allocation to alternatives

US Equity Market Looks Fragile

In February, I said I believed the market selloff was just the beginning, and a very leveraged market still needed to address higher borrowing costs and the removal of stimulus from the Fed. I wasn't ready to further trim equities at the time – amidst a selloff – but rather preferred to be patient. Historically, markets tend to recover a good junk of their losses in the first few months immediately following a correction, and if history echoed itself May looked as likely as any month to be a good time to take a little more off the table. May came, and we made our move by trimming large and mid cap equities at levels that were about 5% below the January high, but also about 5.5% above the February low. These changes were admittedly marginal, as we were already underweight equities, but we believe the table is now properly set for what we think lies ahead. At this point we are about as light on stocks as we are comfortable with for each investment objective, and are unlikely to make any further cuts.

It just doesn't get much better than this, and that's a problem. Unemployment is at 3.8%, and economic conditions appear to topping out. The overall economy continues to give little indication of an impending recession in the next 12 months, but there are signs of a potential recession in late 2019 or 2020. Remember, equity prices move in anticipation of the future. By the time we enter a recession it's well past time to do anything about it. With the economy peaking, interest rates rising, the Fed removing stimulus, some tech stocks at dot-com-bubble-like valuations, and a global trade war brewing, this market looks very fragile to me.

Weakening Loan Covenants Are a Concern

In January, we greatly reduced our exposure to credit and duration by completely eliminating both our junk bond and investment-grade corporate debt positions. This move has so far worked in our favor as junk bonds (VWEAX) and investment-grade corporate bonds (VCIT) have fallen 1.33% and 2.14%, respectively, since then. We held onto our position in floating-rate bonds (OOSYX) as our primary lever for the credit risk factor. OOSYX has been the better horse, up 1.56% since the move, but we are growing increasingly concerned about weakening covenants in this space.

Covenants are agreements between the borrower and the lender assuring the borrower will or will not do certain things. These are typically in the form of financial ratios, such as the borrower will not exceed a specific threshold for debt-to-equity. The goal of covenants is to protect the lender from borrowers acting like irresponsible children. However, weaker credits and covenants increasingly dominate leveraged loan issuance. This won't be a problem right away, but it's only a matter of time. There is a looming maturity wall in 2020, and many of these issuers might not be able to refinance at such generous terms. We have therefore moved to an extreme underweight in this space, and have reallocated the proceeds to safe-haven Treasury bonds and our multi-sector bond fund (PTIAX), both of which we find more attractive at this point.

Strong Backwardation in Energy

We initiated a position in the PIMCO CommoditiesPLUS® Strategy (PCLIX) in January, and it has been the best performer in portfolios since. Despite the recent pullback in oil, I am still convinced we are in a commodities bull market that coincides with the end of this business cycle. Backwardation, a downward sloping futures curve that creates positive "roll yield" when rolling commodities contracts over from month to month, remains in the oil market and supports the case for further investment.

Trade War Threats Inflating Merger Arbitrage Spreads

Our merger arbitrage fund (VARBX) suffered losses in March and April amid trade war threats between the US and China and uncertainty about how the DOJ will treat vertical mergers. The fund recovered in May, but well-above-average spreads still present a good opportunity. Thus, we have reaffirmed our overweight to this strategy – one we believe will hold up relatively well in a strong market downturn.

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Tactical Asset Allocation

Asset Class	Heavy Under-weight	Under-weight	Neutral	Over-weight	Heavy Over-weight
Fixed Income			●		
Ultrashort					●
US Govt.		●			
TIPS				●	
Multisector			●		
Bank Loans	●				
Foreign Bonds			●		
Equities	●				
Large Cap	●				
Mid Cap	●				
Small Cap	●				
Developed Intl.		●			
Emerging			●		
Alternatives					●
Commodities					●
Hedging					●

Binge Box

Crazy Ex-Girlfriend (Netflix)

Do you like musicals? Yeah, me neither. But the sometimes risqué numbers come in small enough doses in *Crazy Ex-Girlfriend* that I don't seem to mind. The show centers around Rebecca Bunch, a literal (not figurative) crazy person who quits her job as a lawyer in New York City and moves to West Covina, CA to stalk her summer camp romance from 15 years ago. She quickly inserts herself into his life and builds a circle of friends and coworkers that have problems of their own. The show tackles mental illness from the perspective of the afflicted, deftly weaving a tapestry of musical, romantic comedy, satire, drama, and thriller genres to reflect the main character's own roller coaster ride of psychological highs and lows. It somehow works, as I find myself still really enjoying it after three seasons.

About EmeraldSpark

EmeraldSpark Investments, LLC is a Registered Investment Adviser based in Chicago, IL. We were founded by Ryan P. Layton, CFA in 2015 to provide personalized financial planning and fiduciary investment management services to 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.