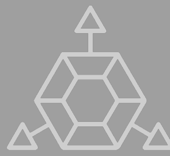
The Type 2 Investor

May 2, 2016



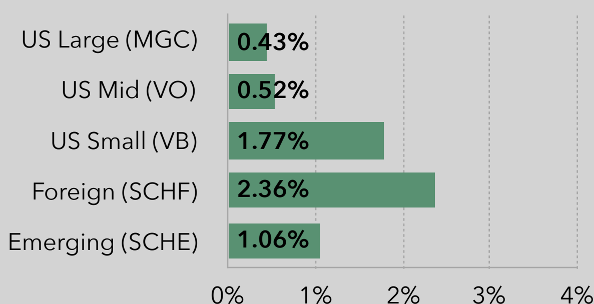
April 2016

Economic Data

- 1Q16 GDP came in weaker than expected at an anemic 0.5% annualized rate
- Year over year inflation (CPI) slowed to 0.9% through March; core (ex-food and energy) cooled slightly to 2.2%
- Retail sells fell 0.3% for March, driven lower by increasingly weak auto sales and a drop in discretionary spending at restaurants
- Initial jobless claims fell to their lowest levels in 42 years in April

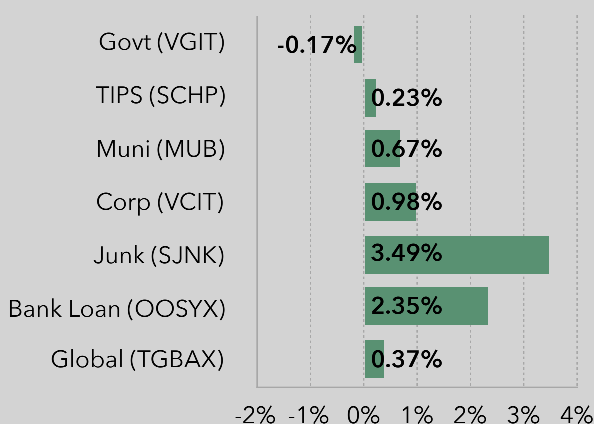
Stocks

April Returns



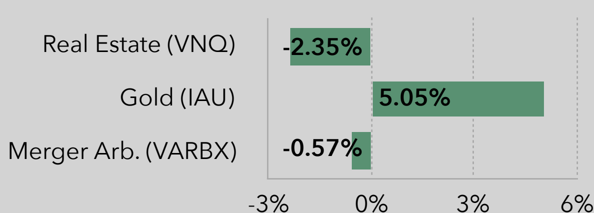
Bonds

April Returns



Alternatives

April Returns



Performance data provided by Morningstar.

Name Change

It has been brought to my attention that "Investment Newsletter" isn't a very captivating title for an investment newsletter. Truthfully, I've known this for some time but had not yet been struck by the inspiration for something more permanent. Up until now, most of the ideas I have had included either foul language or references to Ben Stiller's awkward comedy, *Meet the Parents*.

When I started this advisory firm I wanted it to be different than the other firms I had worked for in the past. I didn't want to be chained to old ways of thinking when newer, better ideas were out there. Behavioral finance is a relatively new field of study that has only recently started to see some adoption by the investment community. It brings the human element to an industry that has long relied on text-book theories that failed to incorporate the predictably irrational nature of market participants.

One of the most eminent contributors to the field of study, Daniel Kahneman, explains there are two systems in which our brain processes information. The first type is lazy, impulsive, impatient, and ever in search of immediate gratification. It is intuitive and efficient, rapidly forming judgements with no conscious input, but can cause systematic errors in judgement that can have a devastating affect on investment performance. The second system is slow, reflective, analytical, and isn't guided by emotions like the first system. It is that second system – Type 2 – that we want in control of our investment portfolios.

With that, this investment newsletter will hereafter be titled *The Type 2 Investor*. Let the diabetes jokes commence.

Additionally, *The Type 2 Investor* will be published monthly – not quarterly. It is my sincerest hope the increased frequency will push me to better embrace the art of brevity.

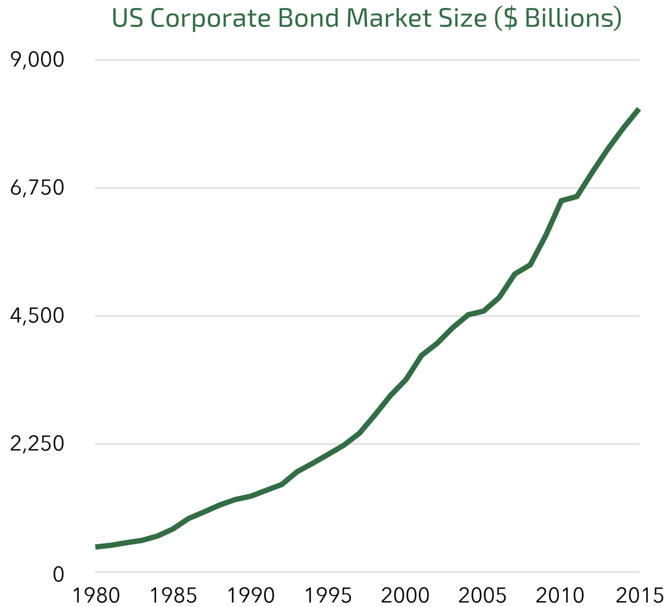
How to Financially Engineer a Better Stock Market

There are two ways to make earnings per share (EPS) bigger. The first – and my personal favorite – is to increase the numerator by growing earnings. This is a sign of a healthy business or a healthy economy, or both. The only other way to grow EPS is to shrink the denominator by reducing the number of shares of the earnings pie.

The market cap of listed domestic companies shrunk 4.8% last year, according to the World Data Bank. The Wilshire 5000 Total Market Index (price) was only down 1.45%, so this would imply that the actual supply of stock available to purchase shrunk by about 3.35% in dollar terms. This has largely been done through share repurchases, otherwise known as buybacks.

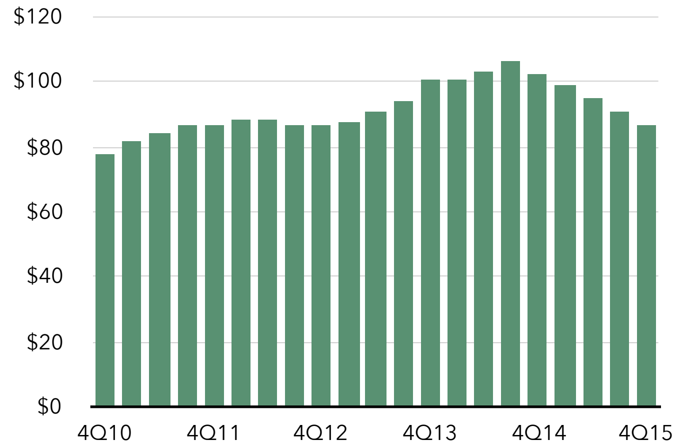
According to FactSet, S&P 500 companies purchased $568.9 billion of their own stock in 2015, and we expect managements to remain committed to share repurchases this year. With individuals and institutions being net sellers of equity for the past 13 weeks, according to Bank of America, buybacks have become the primary source of US equity demand.

Buybacks have helped keep the equity markets afloat, but much of this has been funded with increases in corporate debt. The size of the US corporate bond market has increased 56% since 2008, and almost all of what has recently been issued has gone to buybacks. Not research and development and not new plant and equipment. Buybacks.



Source: SIFMA

By borrowing billions to buy back their own stock, corporations are reducing their overall share counts. This means those smaller profits are now split between fewer shareholders, and – bippity boppity boo – the horrible earnings translate into somewhat less horrible EPS.



Source: S&P Dow Jones Indices

Despite all these efforts, the unsettling reality is 12-month earnings for the S&P 500 have still fallen 18.3% over the past five quarters, and earnings so far this season look pretty bleak as well.

For the game to keep going, companies have to keep re-leveraging. But that increased leverage makes it more difficult for them to weather any downturn in business activity. If we do see a recession soon, stocks could get hit harder than usual.

Portfolio Positioning

After reaching a high of 8.87% on February 11, credit spreads for high yield bonds have narrowed dramatically to 6.19%. With defaults likely to continue to rise this year due to weakness in the Energy and Mining & Materials sectors, we believe this was a good opportunity to take a little credit risk off the table by underweighting high yield fixed-rate corporate debt. We continue to maintain a slight overweight in bank loans, however, as these have much less exposure to those two troubled sectors.

Proceeds were added to higher-credit-quality government debt across the board. While yields on 10-Year Treasury bonds aren't great at 1.84%, we view these bonds as ballast for the portfolio and integral to our rebalancing strategy. And with negative-interest-rate policies (NIRP) being implemented across much of the developed world, roughly 30% of developed country government debt is now trading at negative yields! I mean even Spain, a country that was on the brink of collapse just a few years ago and still suffers from a 21% unemployment rate, has a negative yield on its 2-year

bonds and a yield of only 1.59% on its 10-year debt. How messed up is that?! We think this should make US Treasury bonds more attractive to foreign investors.

Two warning shots have been fired across the bow of the stock market (August and January). We believe that despite poor results so far and low expectations for the remainder of this quarter's earning season, reality has yet to be properly priced into the stock market. With 1Q16 GDP coming in at only 0.5% we are getting closer to recession than I am comfortable with.

We reduced our overweight to equities that was initiated on August 24, realizing some profits on that call. Overall, we still have a very slight overweight to stocks for lack of better opportunities, and we remain underweight to bonds and expect only low single-digit returns at best out of this asset class. Uncorrelated assets, otherwise known as alternative investments, are the third option in a portfolio. As we didn't want to add any money to bonds, proceeds to from stock sales were reinvested here.

Within uncorrelated assets our only allocation to commodities is currently gold. Gold has done very well for us recently because of the market turmoil and increased skepticism of the power of global central banks to bolster their economies. With expectations for more heightened volatility ahead and NIRP reducing the opportunity cost of holding gold, we think the precious metal could have more room to run.

The other uncorrelated asset we added to is the Vivaldi Merger Arbitrage Fund (VARBX). This merger arbitrage strategy has no correlation with stocks and almost no correlation with bonds, and has a fairly consistent track record of delivering mid-to-high-single-digit returns in a variety of different markets. It's a calm harbor to anchor in during a storm.

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

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.

This Newsletter has been prepared by EmeraldSpark Investments. Information contained within has been obtained from sources believed to be reliable, but we do not guarantee its accuracy, completeness or fairness. Views and opinions expressed are for informational purposes only and do not constitute a recommendation by EmeraldSpark Investments to buy, sell, or hold any security. Views and opinions are current at the time of writing and may change. Before acting on this material, you should consider whether it is suitable for your particular circumstances and, if necessary, seek professional advice. Past performance is not indicative of future results. **NOT FDIC INSURED | NOT BANK GUARANTEED | MAY LOSE VALUE**

EmeraldSpark