The Type 2 Investor

July 1, 2016

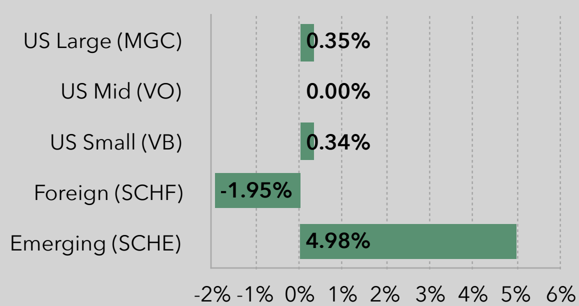
June 2016

Economic Data

- Year over year inflation (CPI) edged down to 1.0% in May; gas prices should force it higher in the coming months
- Retail sells were up 0.5% in May with a surprising boost from out sales
- No Jobs Report until next week due to the holiday, but 4-week initial claims average is roughly 10,000 below a month-ago which is somewhat favorable
- ISM's Manufacturing Index showed surprising strength in June at 53.2, it's highest reading since February of last year. New orders were especially strong at 57.0. Anything above 50 indicates growth

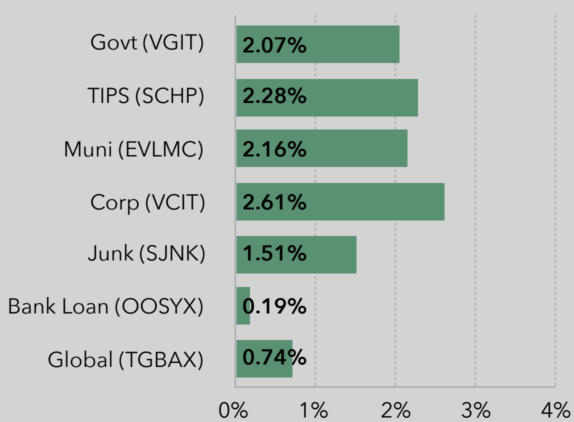
Stocks

June Returns



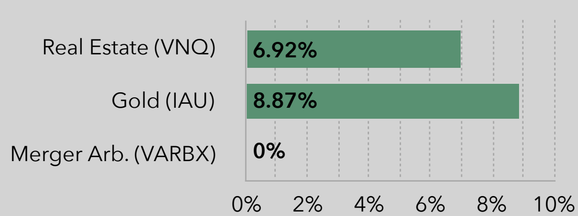
Bonds

June Returns



Alternatives

June 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.

Brelax

The four words most lacking from the countless articles written with regards to what Brexit will mean: 'I don't know.' So let me begin by saying I don't know what Britain's divorce from the EU will look like and I don't know what the long-term impact will ultimately be. David Cameron and Boris Johnson don't know. Angela Merkel and that tosspot Jean-Claude Juncker certainly don't know. And if they don't know, nobody does. But as I am about to speculate on the matter nonetheless, I recommend you read what follows using a British variation of your inner-monologue narrated by Dame Judi Dench. I think the accent will lend me just enough false credibility.

First, a brief history lesson. The idea for the EU was born out of the ashes of World War II. Its aim from the beginning was to end the frequent and bloody wars between European neighbors. The UK, along with Ireland and Denmark, joined the original six nations on January 1, 1973. In 1993 the so-called Single Market was completed with the 'four freedoms': movement of goods, services, people and money. But when it came time to give up the venerable pound and adopt the euro currency (thus becoming part of a monetary union), the UK (along with Denmark) negotiated an exemption. They drew a line then, and have since had one foot in and one foot out. As the EU expanded its power and integration and moved towards a fiscal union, the UK resisted.

Last Thursday Britain defied expectations as it voted to leave the EU in a non-binding referendum. UKIP leader Nigel Farage triumphantly declared, "Let June the 23rd go down in our history as our independence day!" This is somewhat ironic when you consider there are currently 59 countries whose independence days are a celebration of gaining their freedom from the United Kingdom itself, but I digress.

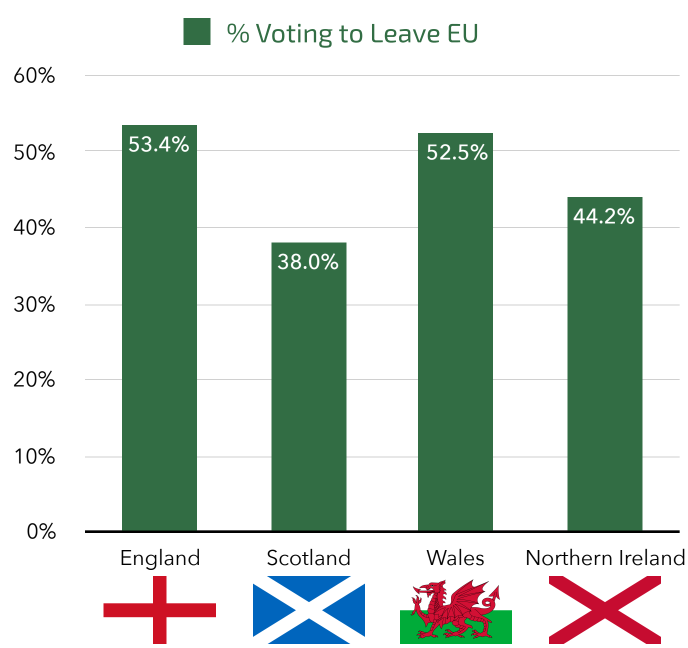
According to polls compiled by Lord Ashcroft, voting was pretty clear across various demographics. The young were 'in' (73% in the 18-24 bracket), the old were 'out' (only 40% in 65+). 57% of what they call 'ABs' (upper/middle class - professional/managers etc) voted remain, while only 36% of the 'C2DEs' (working class) did. Furthermore, the Wall Street Journal reported some 70% of college graduates voted in favor of remaining in the EU, whilst 68% of those who didn't finish high school voted to get out. The City of London wanted to remain, while the shire folk wanted to leave. It's a socioeconomic battle between the haves and the have-nots, and a political battle between the urbanites and the ruralites. Voters are clearly disenfranchised and lashing out against the establishment. This is part of a larger populist, nationalist, and xenophobic trend rising in the Western World. A battle between the losers of globalization and its winners.

"Nearly half (49%) of leave voters said the biggest single reason for wanting to leave the EU was 'the principle that decisions about the UK should be taken in the UK,'" found Lord Michael Ashcroft. Britons voted for sovereignty; for freedom. Freedom from the burdensome rules set forth by an unelected foreign bureaucracy. As citizens of a nation born out of rebellion – and with the commemoration of that rebellion happening this holiday weekend – we should applaud this.

Article 50 of the Lisbon Treaty still needs to be invoked, and that's not expected to happen until at least October – if at all. This was a non-binding referendum, after all. David Cameron says he will step down in three months, and believes it should be the task of his successor to file the requisite paperwork. Even then, Scotland wants to try and block it citing the need for consent from Scotland's semiautonomous Parliament.

If and when Article 50 is invoked, they will have two years to negotiate their exit from the EU. It would likely be in Britain's best interest to at least formulate a negotiation plan prior to starting the two-year countdown clock. Two years is not a lot of time to renegotiate terms of economic and political accords that were built over the course of more than 40 years as a member of the EU.

The EU might want to take a hard line with the UK to discourage any other potential defectors. However, a decent trade deal for the UK would be in everyone's best interest, especially Germany's who exports almost twice as much to Britain as Britain does to it. Let us not forget that Switzerland and Norway both operate just fine outside of the EU. It's also important to remember that Scotland and Northern Ireland voted overwhelmingly to stay in the EU. Is the EU willing to cut off Scotland and Northern Ireland to spite England and Wales?



President Obama has warned the UK it would find itself at the "back of the queue" in any trade deal with the US if the country chose to leave the EU. But it wouldn't be his administration dealing with it, and I doubt the US would sit back and idly watch the EU punish the UK. The wise thing to do would be to prioritize a free-trade agreement with Britain and enhance our "special relationship" at a time when they would be desperate for friends. 'Free-trade agreement;' now there is an oxymoron.

Will Article 50 even get invoked? Will the Brexit be devastating for the UK economy, or will it benefit from a trade-friendly negotiated exit and the freedom to pursue better trade deals on its own? Will Scotland and Northern Ireland secede to stay in the EU? Is the UK just the first of many departures, signaling the beginning of a slow death for the EU? Is this the pivotal event future historians will point to as the precursor to World War III? We simply don't know the answers to any of these questions, and likely won't for years or decades.

Hindsight Bias

Heading into the Brexit vote, we had already trimmed equities twice – once on April 12 and again at the recent high on June 8 – completely eliminating our overweight to equities. We also reduced our credit risk in bond portfolios on both those dates. Moneys were reinvested into government bonds, gold, and merger arbitrage – risk-off asset classes that all did very well in the wake of the referendum vote.

The moves made in client portfolios over the preceding three months have been directionally correct, but hindsight bias compels us to question their magnitude. Hindsight bias is the propensity to see events that have already occurred as being more predictable than they actually were. Why didn't we take twice as much out of equities, or more? But leading into the vote the polls, the oddsmakers, the pundits, and the markets gave every indication the outcome of the referendum would be 'Remain'.

We did not participate in the indiscriminate selling of stocks in the days immediately following the Brexit vote. We prefer anticipatory moves over reactionary ones. Stocks have now recovered almost all of their post-Brexit losses, but haven assets like US Treasury bonds and gold are still in high demand. This points to lingering concerns.

Portfolio Positioning

Equity valuations are high, and the second quarter reporting period begins in a couple weeks with corporate profits expected to decline yet again. These conditions would normally compel us to move to an underweight in equities, but there are a couple things still working in favor of stocks. Overall, the lack of better investment opportunities keeps stocks in play. The S&P 500's 2.09% yield, while certainly not exciting, is still comparatively better than the 10-year Treasury's 1.49%. The Brexit also gives central banks around the globe just the excuse they need to keep using policy to drive up asset prices.

Money seems to be chasing every asset out there despite signals of a weakening economy. Since reducing credit risk in portfolios in April, high yield spreads continued to tighten dramatically and hit a low of 5.83% on June 8. Fitch Ratings expects default rates to hit 6.0% this year, and recovery rates have been extremely low by historical standards at only 13.9% so far this year. With higher defaults and lower recovery rates, we didn't believe investors were being adequately compensated for the risk they bore.

We increased our underweight to high yield debt and increased our overweight to TIPS. We expect headline inflation to be north of 3% by February because of the base effect of gas prices. 10-Year TIPS are currently pricing in inflation of only 1.40%, so we believe this asset class is poised to do relatively well. Overall, we remain underweight to bonds and expect only low single-digit returns at best out of this asset class.

Since we initially reduced our overweight to equities on April 12 the S&P 500 rose another 2.8% by June 8. We didn't see much further upside in domestic equities at that point, so we trimmed them further to bring our tactical weighting back to neutral. The reduction in stocks came from large, mid, and small cap domestics, while a point was added to emerging markets. With the Fed on hold due to the weakening labor market and Brexit, emerging markets stocks should benefit.

Despite the troubles in the merger arbitrage space, we believe it is still one of the safest places for money right now. The remaining proceeds from equities were reallocated to this space.

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					●

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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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