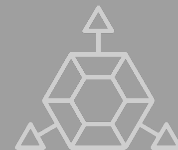
The Type 2 Investor

September 8, 2016

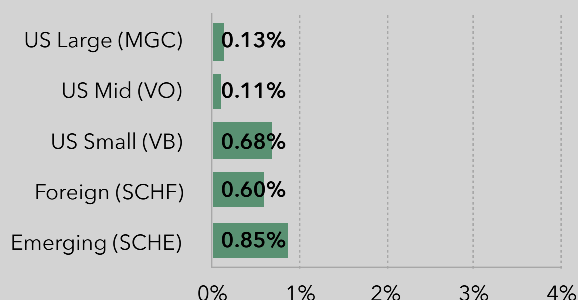


August 2016

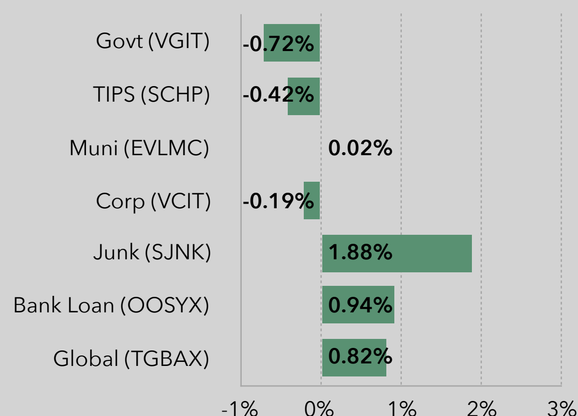
Economic Data

- Year-over-year inflation (CPI) declined to 0.8% in July with core at 2.2%; gas price base effect should materialize November to February
- Retail sells were flat in July and would be down 0.3% if not for the automobile component
- The housing market is showing weakness as existing home sales swung into negative territory in July, declining 1.6% Yr/Yr
- 151,000 jobs were added in August while July figures were revised up to 275,000; unemployment rate remains at 4.9%

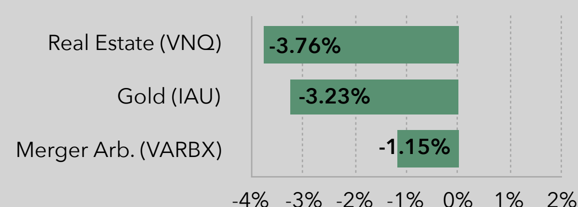
Stocks



Bonds



Alternatives



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.

Let's Fantasize About Football

Football season is upon us! I am a much bigger fan of reality football (although as a long-suffering Lions fan, I'm not sure why), but in our culture today it is hard to not get sucked into the world of fantasy football. I am in two leagues this year and drafted in both last week. One is an eight-team league that has seen a bit of attrition from the 12 teams that formed it last year. Everyone in that league seemed very happy with their teams this year as compared to last year (perhaps with the exception of the guy who was in Italy and auto-drafted, ending up with a team built around Blake Bortles). They felt they got really good players at seemingly good value compared to last year. Ezekiel Elliot, a mid-first round running back according to most experts fell to the middle of the second round. After an early run on wide receivers I had taken the Saint's Brandin Cooks in the 2nd round of my 12-team league, so I was delighted to see him still on the board when I was on the clock in the 4th round of this draft.

Most fantasy leagues are between eight and 16 teams, so of course you are going to feel like you have a great squad with only eight teams in your league! It's simple supply and demand. In a league with 16 teams, you have twice as many people fighting over the same talent pool. Unless the draft was a total dumpster fire, the lineup from an eight-team league is going to score more fantasy points on average than a lineup built in a 16-team league.

It's not as if the stock market needs more analogies (eggs in baskets, bulls and bears, dead cats bouncing, etc.), but I'm going to make another one anyway. An eight-team league is like the stock market was in March 2009 at the bottom of the financial crisis, where there weren't many people who wanted to play and you could easily build a rock-star team (portfolio) that was going to generate a lot of points (expected returns). A 16-team league, on the other hand, would be like the stock market in March 2000 at the pinnacle of the dot-com bubble where everyone wanted to play and putting together a high-scoring team (high-return portfolio) was much more difficult.

So how does the 2016-2017 stock market fantasy season compare? I would call it a 14-team league. The trailing 12-month price/earnings ratio for the S&P 500 is currently around 25. Not quite as stretched as the roughly 31 number in March 2000, but well above the long-term average of about 16. The global central banks and corporate buybacks are playing in this league as well, though (although fewer announced buybacks suggest the latter has peaked). Think of them as drafting kickers and defenses in the first few rounds, leaving the running backs and wide receivers out there to make the other teams better. Even with their help, however,it is still very hard to put a portfolio together in a 14-team league market that would generate even average returns by historical standards.

Portfolio Positioning

At the beginning of June we made a prediction that weak earnings would catch up to stock prices and it would be a cruel summer for the markets. However, despite a brief panic where the S&P 500 fell almost 6% over the two trading days immediately following Brexit, the index ended the past three-month stretch up 3.53% and currently sits right under an all-time high. There are technically two weeks left of summer, but I'm not hoping to be proven correct on this prediction.

Earnings remain weak. With 97.8% of S&P 500 companies reporting, second quarter profits were down 8.46% over last year. This marks the fifth consecutive quarter of year-over-year earnings declines for the S&P 500, a feat not matched since Q3 2008 through Q3 2009. Annual profits for the index have been running at $86 and change for the past three quarters now, about 18% below their Q3 2014 peak of $105.96. The index was trading at about 19.5 times those earnings at the time they were reported. If we were to apply the same multiple to the garbage we are seeing today, the S&P 500 would be around 1,700 – 22% below today's price!

U.S. short interest as a percentage of float hit a 12-month low recently. When investors short a stock, they borrow shares and simultaneously sell those shares on the market, betting that the stock will go down or hedging another position. When the trade is done – successful or otherwise – the investor must buy back the shares on the open market to give them back to whoever they were borrowed from. This is why heavy short interest is – somewhat ironically – a bullish indicator. Conversely, low short interest – like we have presently – is bearish because it means there are fewer traders that will be forced to buy shares of stock to close out their short positions.

We remain neutrally allocated on equities for the time being, but are getting ever closer to taking more off the table and going to an underweight. It's been a good run and we don't want to overstay our welcome. Bonds offer us very little in expected returns, so they will likely remain an underweight in portfolios for quite some time.

High yield bonds continue to rally despite increasing risks, up 1.88% and outperforming all other bond classes in August. Spreads have collapsed from their February 11th peak of 8.87% and investors are now offered only 5.09% more in yield than comparable Treasury bonds for the risk they take on. What does that risk look like? Well, at the end of July the junk bond default rate was 5.5%, according to Moody's, and they expect it to climb to 6.3% by the end of the year. Meanwhile, recovery rates were only 25% in 2015 and have been reported to be as low as 10% this year. If this is indeed the way things play out, spreads would need to be 5.67% just to break even with Treasury bonds. Investors are simply not being adequately compensated here.

Treasury inflation-protected securities (TIPS) slipped 0.42% for the month with year-over-year inflation (CPI) falling to 0.8%. The suppression effect that gasoline prices have had on inflation is poised to diminish over the next three months and flip in November. Once this component starts adding to inflation instead of holding it back, expect yea-over-year CPI to jump from November to February. Barring any major disruptive events to our investment thesis, we plan to hold our overweight to TIPS through at least March 2017.

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					●

Alternative investments, the third leg of our portfolios, remains an overweight. Real estate and gold were the worst performing assets last month, but that can be forgiven as they are still up an impressive 13.86% and 23.17% year-to-date, respectively. Merger arbitrage's struggles stem from a blow up in the arbitrage spread for the proposed merger of semiconductor manufacturing equipment makers LAM Research Corp (LRCX) and KLA-Tencor (KLAC) due to regulatory approval taking longer than originally expected. Vivaldi's management team's research leads them to believe the deal will still go through and is holding on to the position, so we expect the fund to recover nicely in the next few months.

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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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