The Type 2 Investor

February 8, 2017

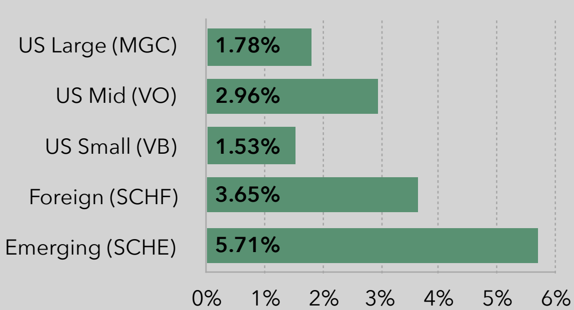
January 2017

Economic Data

- GDP growth fell to 1.9% in the fourth quarter, down from 3.5% the previous quarter
- Year-over-year inflation (CPI) cracked the Fed's 2% target for the first time in two-and-a-half years coming in at 2.1% in December, up from 1.7% the previous month; the core rate edged up to 2.2%
- Retail sales growth came in at 0.6% in December, but was dead flat if you exclude autos and gasoline, which aren't typically holiday gifts
- 227,000 jobs were added in January, but the unemployment rate edged up another tenth to 4.8%

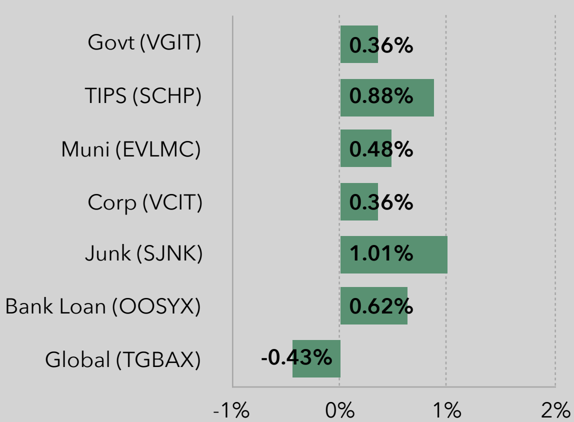
Stocks

January Returns



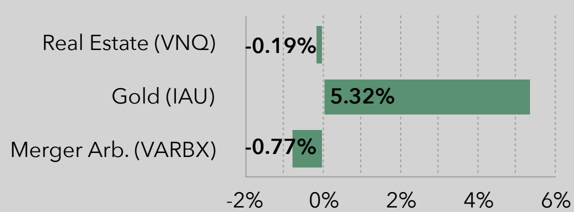
Bonds

January Returns



Alternatives

January 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.

Secretary of Labor, Brought to You by Carl's Jr.

The first time I heard of Carl's Jr., a west-coast fast-food chain, was in the 2006 film *Idiocracy*. If you haven't seen it, you should – it's one of my favorite comedies. The basic premise of the film is that intelligent, high-performing members of society aren't procreating enough, while the dimmer end of the spectrum is doing so with reckless abandon. We are given a glimpse into the future these breeding patterns might produce when mismanagement of a military experiment leaves the protagonist, average-guy Joe Bauers – played by Luke Wilson – cryogenically frozen for 500 years.

One of the first things Joe encounters when he wakes up in the year 2505, is an exchange between a customer and a Carl's Jr kiosk that, presumably, replaced humans after the minimum wage was raised to $15 per hour:

> *Kiosk: "Enjoy your EXTRA BIG-ASS FRIES!*
>
> *Customer: "You didn't give me no fries, I got an empty box."*
>
> *Kiosk: "Would you like another EXTRA BIG-ASS FRIES?*
>
> *Customer: "I said I didn't get any!"*
>
> *Kiosk: "Thank you, your account has been charged. Your balance is zero. Please come back when you can afford to make a purchase.*
>
> *Customer: "C'mon, my kids are starving!" [customer bangs on kiosk]*
>
> *Kiosk: I'm sorry you are having trouble. [kiosk sprays customer in the face with an anesthetizing gas]. This should help you calm down. Please come back when you can afford to make a purchase. Your kids are starving. Carl's Jr. believes no child should go hungry. You are an unfit mother. Your children will be placed into the custody of Carl's Jr. Carl's Jr.: f**k you, I'm eating!"*

Joe, a perfectly average man in the year 2005, turns out to be the smartest man on the planet in 2505, and is therefore named Secretary of the Interior by President Camacho – brilliantly played by Terry Crews. He is introduced to his fellow cabinet members:

> *Secretary of State: "I'm the Secretary of State. Brought to you by Carl's Jr."*
>
> *Joe Bauers: "Why do you keep saying that?"*
>
> *Secretary of State: "Cuz they pay me every time I do. It's a really good way to make money."*

Idiocracy is intended to be satire. The situational irony to that last bit of dialogue from the film is that one of the current nominees to President Trump's cabinet is, in a way, actually brought to us by Carl's Jr. Andy Puzder, the nominee for Secretary of Labor, is the President and CEO of CKE restaurants, which those on the west coast can thank for Carl's Jr., those in the south and midwest can thank for Hardee's, and those in northeast can thank for nothing except maybe those commercials that overtly objectify insanely beautiful women (and Paris Hilton). To be fair, the marketing campaign has been highly successful with roughly 50% of the population.

If and when Puzder finally shows up for work — his confirmation hearing has been delayed four times and counting — his marching orders, which were laid out in a February 3 executive order and corresponding Presidential memorandum, will be waiting. First, the executive order establishes the core principles of the administration for regulating the U.S. financial system, among them:

> *"empower Americans to make independent financial decisions and informed choices in the marketplace, save for retirement, and build individual wealth;"*

Then the corresponding memo explicitly goes after the Department of Labor's Fiduciary Duty Rule. This rule, as you might recall, would go into effect April 10 and require all financial advisers to put their clients' interests before their own when advising them on their retirement accounts, which fall under the jurisdiction of the DOL. That sounds reasonable, right?

> *"(a) You are directed to examine the Fiduciary Duty Rule to determine whether it may adversely affect the ability of Americans to gain access to retirement information and financial advice. As part of this examination, you shall prepare an updated economic and legal analysis concerning the likely impact of the Fiduciary Duty Rule, which shall consider, among other things, the following:*
>
> *(i) Whether the anticipated applicability of the Fiduciary Duty Rule has harmed or is likely to harm investors due to a reduction of Americans' access to certain retirement savings offerings, retirement product structures, retirement savings information, or related financial advice;"*

This is essentially saying that access to bad advice is better than no advice at all. Or as White House National Economic Council Director Gary Cohn put it in an interview with The Wall Street Journal, "This is like putting only healthy food on the menu, because unhealthy food tastes good but you still shouldn't eat it because you might die younger." Good work, Gary, I think you convinced them!

> *"(ii) Whether the anticipated applicability of the Fiduciary Duty Rule has resulted in dislocations or disruptions within the retirement services industry that may adversely affect investors or retirees;"*

Basically, is not being able to screw over their clients by pushing them into high-commission products going to hurt the industry's profits? If so, that's bad.

> *(iii) Whether the Fiduciary Duty Rule is likely to cause an increase in litigation, and an increase in the prices that investors and retirees must pay to gain access to retirement services.*

The logic here being that if this rule means clients can sue their brokers more easily, the industry will have to raise their fees to cover the added litigation expenses. There is some truth to that, I guess. Or, you know, you could just do the right thing for your clients in the first place.

> *"If you make an affirmative determination as to any of the considerations identified in subsection (a) or if you conclude for any other reason after appropriate review that the Fiduciary Duty Rule is inconsistent with the priority identified earlier in this memorandum then you shall publish for notice and comment a proposed rule rescinding or revising the Rule, as appropriate and as consistent with law."*

And there it is, Puzder. Your job is to scuttle this thing before it even goes into effect. Honestly, I'm not too upset about this. In a way, this helps preserve one of our biggest competitive advantages over the majority of the industry. As a Registered Investment Adviser (RIA), EmeraldSpark has operated and will always operate under the fiduciary standard, putting the best interests of our clients above our own.

The problem has always been that the average consumer never knew this industry was divided between RIAs and trust companies that are required to put their clients' interests first (fiduciary standard) and broker dealers and insurance companies that aren't (suitability standard). My hope is that even without the rule, the attention the issue has received will be enough to get consumers to start asking their financial adviser which standard she is required to operate under.

Many firms have already made changes to their business practices to get ready for the rule, and are unlikely to reverse course now. Nobody if forcing consumers to use financial advisers that operate under the weaker suitability standard,

Binge Box

The OA

The OA popped up on Netflix without any warning, save for a short trailer just a week before its release that revealed essentially nothing of the plot but was intriguing enough to draw me in. And I'm glad it did. The story follows Prairie Johnson, a blind woman who went missing seven years ago. When she resurfaces in a hospital, her sight is miraculously restored. The opening credits don't roll until the 57th minute, as a fantastic tale begins to unfold of the events leading up to that moment.

It's not a perfect show, and there are certainly some elements I could've done without. But it was original — very original — and that's something rare in television and movies that which opens them up to higher costs and conflicts of interest. It's a decision they make themselves. With a bright light now shining on this information, are consumers really going to want to work with an adviser who's slogan – to parody the Car's Jr. kiosk in *Idiocracy* – is effectively "suitability standard: f**k you, I'm product-pushing!"?

Portfolio Positioning

There have been no changes to our asset allocation strategy over the past month. We continue to be underweight equities as they remain, in our opinion, overvalued. We are underweight bonds as well, as we see higher inflation putting upward pressure on yields. We are overweight safe-haven alternatives, and we continue to hold a small, but higher-than-normal allocation to cash to deploy when better opportunities present themselves.

Within alternative investments, we believe the Trump administration will foster a much friendlier environment for mergers and acquisitions. The rising interest-rate environment will also bode well for merger arbitrage, as the going risk-free rate is a component of the overall expected return of this strategy.

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

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					●

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 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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