The Type 2 Investor

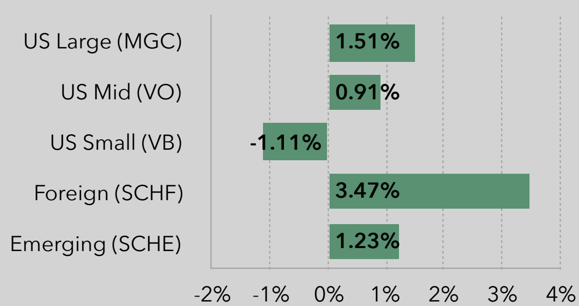
June 8, 2017

May 2017

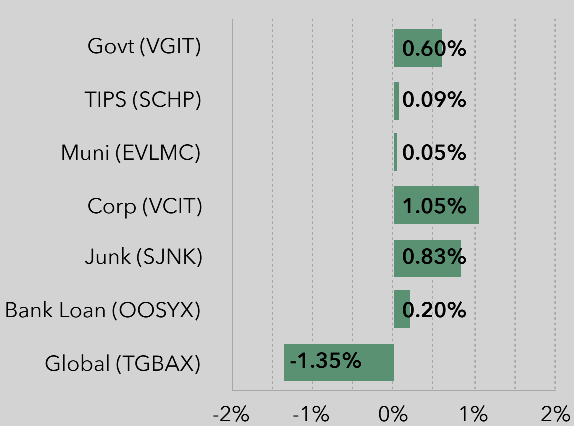
Economic Data

- Only 138,000 jobs were added in May, which was lower than expected and puts next week's June rate hike in some doubt, but the unemployment rate fell one-tenth to 4.3%
- Existing home sales fell 2.3% in April, and new home sales fell 11.4% for the month
- Year-over-year inflation (CPI) fell to 2.2% in April, and the core rate (ex-food & energy) edged down to 1.9%
- Motor vehicle sales snapped a three-month losing streak to help push retail sales 0.4% higher in April

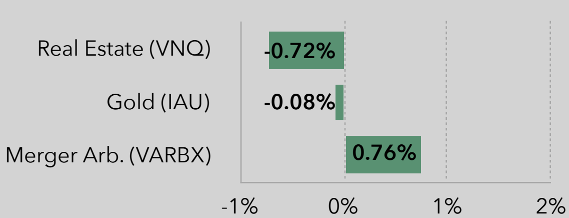
Stocks



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.

Anchors Aweigh

The shopping mall, a brainchild of Victor Gruen, sprung to life in the 1950's as suburban and automobile culture was on the rise. When I was growing up, the annual back-to-school trip to the Twelve Oaks Mall in Novi, MI was something to be eagerly anticipated. Will this be the year mom lets me get an I.O.U. sweatshirt and a pair of Girbaud jeans?! I can happily say the answer was no.

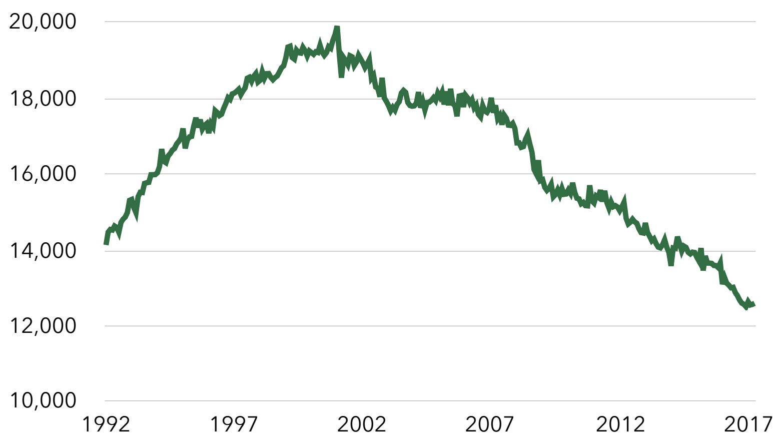
The blueprint for the planned shopping mall is pretty simple. Place large department stores at each end, and fill the spaces in between with smaller, specialty stores. The large stores are called "anchor stores", and they provide financial stability to the project and help draw in the crowds, thus boosting traffic to those smaller stores that people wouldn't usually be willing to make a special trip for. Sears, Macy's, JCPenney, and Kohl's are some of the more common anchors. These large department stores typically get reduced rent, while those smaller shops pay a premium to be near them. If the anchors aren't there, the whole system crumbles and you are left with something called a "grayfield", which is just another word for a dead mall. Uh oh:

- Sears Holdings has so far announced the closing of 254 Sears and Kmart stores this year
- JCPenney announced it will be closing 138 stores
- Macy's is closing 68 stores

None of this has been good for shopping malls, or the REITs that own them. In a research report issued by Credit Suisse recently, the firm predicts that 20 to 25 percent of all malls will close their doors over the next five years. A model – nay, a culture – that worked so well for half a century is now in its twilight.

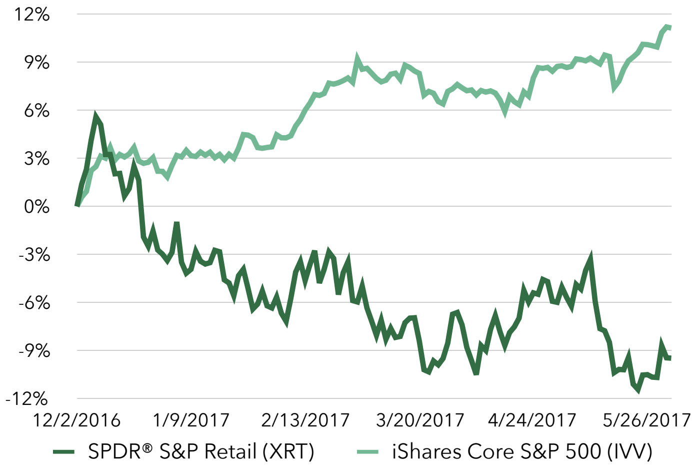
And with the anchors go the smaller shops as well. RadioShack filed bankruptcy again in March and closed more than 1,000 stores over the Memorial Day weekend. At its peak the company had 7,300 stores. Today, only 70 corporate stores and 500 dealer stores remain across the country. It's one of the largest retail casualties so far this year, but its got plenty of company. The most recent count showed 21 retailers have declared bankruptcy so far this year.

Retail Trade: Department Stores Excluding Leased Departments (in Millions of $)



Source: U.S. Bureau of the Census

Retail Stocks Underperforming



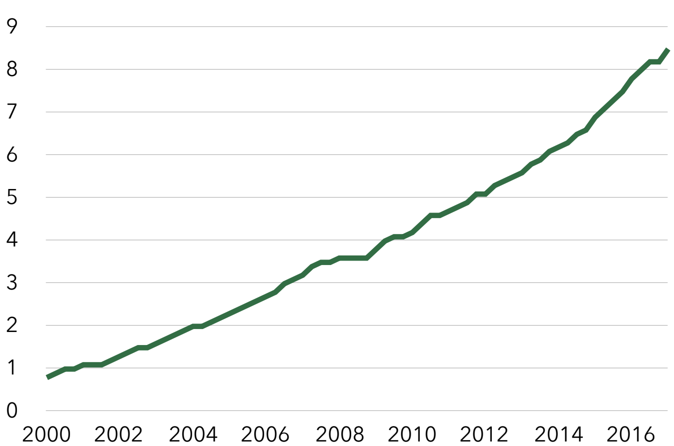
Source: NASDAQ

The closings just keep piling up:

- Payless shoes has announced the closing of 512 of its stores and is petitioning the court to allow them to close another 300 in the wake of the company's recent bankruptcy filing
- Rue 21 has also filed for bankruptcy and is in the process of closing about 400 stores
- Wet Seal closed all of its 171 remaining stores
- Bebe has closed all of its 180 or so stores nationwide
- Abercrombie & Fitch will thankfully be closing about 60 stores this year as leases expire
- Guess will close 60 as well
- Crocs has 160 stores on the chopping block
- The Limited closed all of its roughly 250 stores at the beginning of the year
- American Apparel has already closed all of its remaining 110 stores
- Electronics retailer HHGregg shuttered all of its 220 stores at the end of May
- Michael Kors will be closing between 100 and 125 stores over the next two years, according to a May 31 press release

There are others still, but I think you get the point. Credit Suisse estimates as many as 8,600 brick-and-mortar stores will shutter their doors this year – more than twice the number of last year.

E-Commerce Retail Sales as a Percent of Total Sales



Source: U.S. Census Bureau

Retail isn't dead, though, it has just changed. Shoppers find out about products on social media more than anywhere else now. They are price-sensitive and use the internet to find the best deals. As I type this, a pair of DSTLD jeans (pronounced 'distilled', I believe) are sitting in the back of a delivery truck that left a warehouse in Sparks, NV a few days ago and will arrive at my home here in Chicago later today. It's a new brand of denim that checks all the boxes for the modern-day shopper: a premium product, socially conscious, attractively priced, and available only online with free and easy returns. At least that's what their website says.

Portfolio Positioning

We have held an overweight in cash since the eve of the election, and seven months later we are still uncomfortable putting it to work in anything risky. While waiting for a tactical opportunity to deploy this cash, we were compelled to look for something that offers our clients more attractive return potential while still preserving capital. In accounts where taxable bonds are preferred, we will utilize the PIMCO Short-Term Fund (PTSHX) as a placeholder for this cash, and in accounts where tax-advantaged bonds are recommended the Vanguard Short-Term Tax-Exempt Fund (VWSUX) will be used.

PTSHX currently sports a 30-day SEC yield of 1.64% and an effective duration of only 0.28. The 0.45% expense ratio is on the high side, but the fund makes full use of the firm's vast bond capabilities and has shown a long track-record of outperformance.

VWSUX currently offers investors a 30-day SEC yield of 1.04% and an effective duration of 1.13. The fund typically underperforms its muni national short peer group, but does relatively well on a risk-adjusted basis by keeping interest-rate and credit sensitivity so low.

With the post-election rally for small-cap stocks and initial scare for emerging markets seemingly played out, we have moved to an extreme underweight in small caps and moved back up to neutral in emerging markets based on relative valuations.

In our March newsletter we stated our expectation was for the treasury bond yield curve to flatten out, because that's what yield curves do at the end of the growth phase of the business cycle. We have so far been correct, and the March rate hike has only been felt on the short end of the curve with the fulcrum at the 2-year mark. We think there is still room for the curve to flatten further and eventually (not soon, but eventually) invert, and we think the 7-10 year range of maturities is the

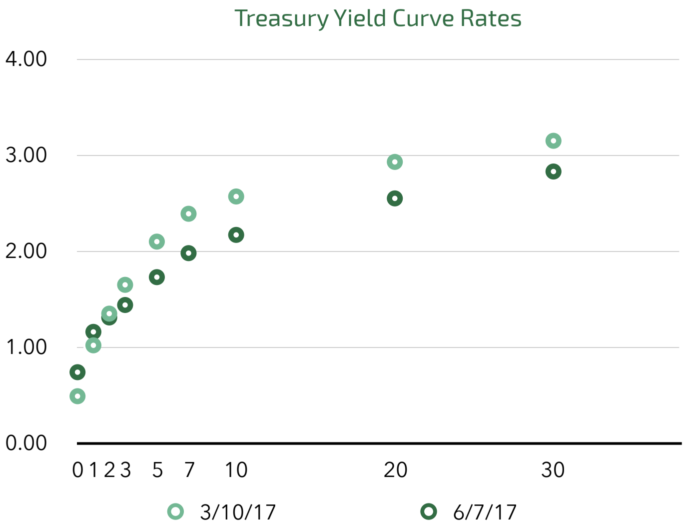
Binge Box

The Last Kingdom

If you've already binged *Vikings* and are going through withdrawals, this one is for you. If you haven't watched *Vikings*, do that now because while *The Last Kingdom* is very good, it's not quite as good as *Vikings*. It's still very much binge-worthy, though.

Follow the story of Uhtred, son of Uhtred, and laugh when he tells you his name is Uhtred, son of Uhtred in an odd sort of Dane accent every opening recap of the previous episode. He is born the son of a Saxon nobleman, but is captured by raiders as a boy and raised as a Dane. He is now a man and back in England seeking to reclaim his birthright. With one foot in both camps, his alliances are often tested. As to be expected, a good mix of political drama and sword battles is the result.

most attractive part of the treasury yield curve right now. Therefore we moved money from the Vanguard Interm-Term Govt ETF (VGIT), with an effective duration of 5.20, to the iShares 7-10 Year Treasury Bond (IEF), with a duration of 7.57. We also dialed back our TIPS overweight and redeployed it to IEF as inflation has peaked for the time being.



Source: U.S. Department of the Treasury

Lastly, we replaced the SPDR® Bloomberg Barclays Short Term High Yield Bond ETF (SJNK) with the Vanguard High-Yield Corporate Fund (VWEAX). SJNK has done well over the past 16 months as junk bond spreads have collapsed, but tracking error has been an issue with the fund. With the BofA Merrill Lynch US High Yield Option-Adjusted Spread currently at a very tight 3.68%, we see trouble ahead for the high-yield space. VWEAX takes a decidedly conservative approach when it comes to credit quality, and its active management gives it the opportunity to underweight more troubled sectors. VWEAX has a rock-bottom expense ratio of only 0.13%, giving it an immediate advantage over its peer group.

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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 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.

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