The Type 2 Investor

December 12, 2017

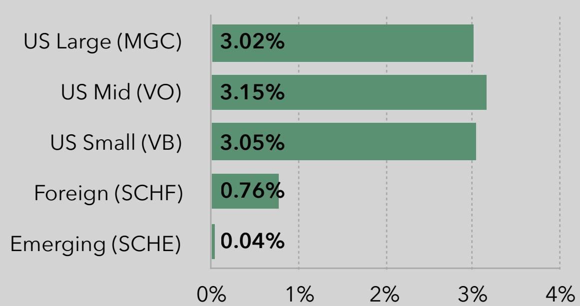
November 2017

Economic Data

- 228,000 jobs were added in November, but wage growth is still tepid at only 2.5%; the unemployment rate remains at a 17-year low of 4.1%
- Existing home sales were up 2.0% in October to a 5.48 million annualized pace, and new home sales hit an expansion high annualized rate of 685,000
- Housing starts were up a strong 13.7% in October
- Year-over-year inflation (CPI) fell two-tenths to 2.0% in October, while the core rate edged up one-tenth to 1.8%
- Retail sales rose a modest 0.2% in October

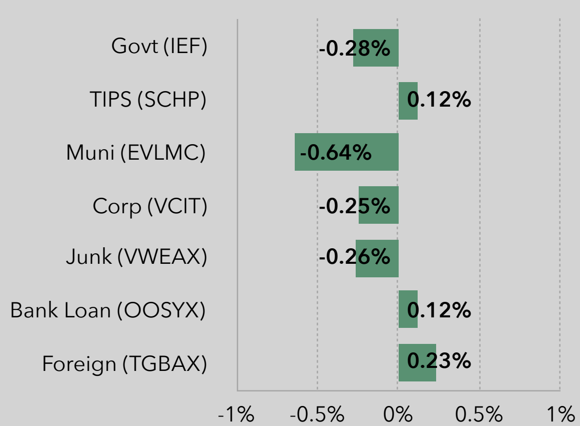
Stocks

November Returns



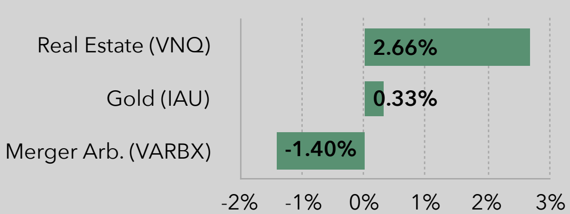
Bonds

November Returns



Alternatives

November 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.

The Financial Planning Implications of Everybody's Least Favorite Proposed Tax Reform

Before I go any further it is incumbent upon me to disclose that I am not a Certified Public Accountant (CPA), and as such I am not qualified to give tax advice. I will only try to give you an investment manager's perspective on the topic. You should always consult a tax accountant regarding any questions related to taxes.

The Senate version of the tax reform bill was passed on December 2nd and nobody is 100% happy, which, I guess is good? The House and the Senate still need to reconcile their differences, and the President would need to sign off on it, but it looks like some version of the bill will eventually become law.

The real meat of it is the cut to corporate taxes, which has probably been the largest impetus to the rally in equities over the past 13 months. As difficult as it may be for some to appreciate this, the U.S. has the highest corporate tax rate among developed countries. A cut is badly needed to remain competitive, lest we continue to lose our corporations to Ireland.

For most individual taxpayers, however, the bill is a mixed bag and nothing to really be too jazzed about. As it pertains to financial planning, here are a few proposed changes changes to be aware of:

- 529 plans
- REIT dividends
- Tax lot selection
- Doubling of the standard deduction

First, some good news for parents. 529 plans were already the preferred vehicle for saving for your kid's college education, but under the proposed tax reform they could also be used to save for K-12 expenses, too, which is huge if you send your kids to private school. As I once wrote in my blog, "let's face it, in some cities sending your kid to private school could mean the difference between them going to a good college or getting shanked on the playground over a chocolate milk dispute." Parents utilizing this option will want to reconsider their investment strategy to account for shorter time horizons. The tax overhaul would also eliminate Coverdell Education Savings Accounts, but the $2,000 limit on annual contributions already made these relatively unpopular and ineffective.

Another key change will be the tax treatment of pass-through income, like what your's truly makes as the sole-owner of an LLC. In the House version, pass-through income would be subject to a maximum 25% rate, while in the Senate version a 17.4% deduction on that income would apply. The good news for REITs (Real Estate Investment Trusts) is that both proposals would treat ordinary REIT dividends, which are currently taxed at ordinary income rates, as pass-through income and thus tax them at a lower rate.

Now the bad news. The nice thing about the current law is that you can cherry-pick which shares you wanted to sell, thus minimizing your taxable capital gains. When an investment position is added to over time, you can end up with certain tax lots that are at a loss even when the position as a whole is at a gain. For example, let's say you spent your birthday money on XYZ stock every year for the past three years. The first year you got 100 shares at $20 each, the second year 100 shares at $30 each, and the third year 100 shares at $70 each. If the price today is $50 per share, you'd be sitting on $3,000 in net gains. Under the current law, you could sell the 100 shares that were purchased at $70 and realize $2,000 in capital losses that you could then use to offset other gains or as a deduction on your income taxes. The change, however, would require you to sell the first lot purchased (FIFO, for those who remember accounting class) or the average if your brokerage firm provides it. FIFO would mean realizing $3,000 in capital gains for selling 100 shares, while the average cost basis method would result in $1,000 in gains. This hurts the individual investor, but don't worry about the giant mutual fund industry. With the help of its lobby groups, mutual funds were able to secure an exemption for themselves. One potential work-around to this would be to just open a bunch of different brokerage accounts over time and buy the same securities in each. Which just shows you how stupid the rule change is in the first place.

Another change is the elimination of the personal exemption and the doubling of the standard deduction. On the whole, this is a good move as it simplifies things and reduces taxable income for most people. It does, however, reduce or eliminate some other advantages. A higher standard deduction coupled with the elimination of the deductibility of state and local taxes (SALT) means the hurdle for itemizing would be much higher. Many fewer people would itemize under the new law, which means fewer people would benefit from the deductibility of mortgage interest. This could impact one's decision to buy a home, or whether or not to pay down their mortgage early, as the tax advantages were a primary reason why you wouldn't.

The higher standard deduction will also mean fewer charitable contributions are deductible, as you need to itemize to take advantage of this. A potential strategy for dealing with this would be to utilize an every-other-year gifting schedule. For example, instead of making your donations around Christmas every year, make them in January and December in 2019, skip 2020, and make them in January and December of 2021. Organizations would still be getting your donations roughly every year or so, but this way you could potentially increase your tax savings.

MoviePass

MoviePass – the Netflix for movie theaters – caught my eye a few months back when they offered customers the ability to see one movie per day in any theater for only $9.95 per month. I decided to give it a go, and I have been quite happy with it so far. About once a week I'll walk down to the newly renovated, but still classic, Davis Theater and enjoy a film. So far, I've seen eight movies costing $72, but only paid $19.90.

This is, of course, a horrible business model for a company. You can't sell something for less than it cost you and hope to make it up on volume. Interestingly enough, they sent me an email last week offering the service to me for even less – $6.95 per month – if I paid for a whole year in advance. Normally I would jump at the chance, but I suspect they made this offer for one or both of the following reasons:

1. They have found that users tire of the movies after the first couple months of excitement wear off, and cancel before they become profitable
2. They are desperate for cash and this is a Hail Mary to keep the company afloat for another couple months

I really hope MoviePass survives, but I have legitimate doubts the company will be around in a month, let alone a year.

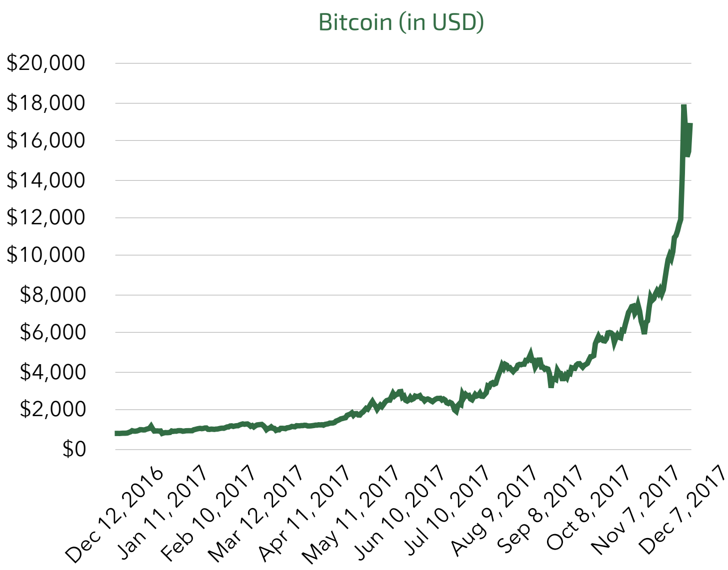
Haters Gonna Hate, "HODLers" Gonna "HODL"

According to Wikipedia, In 1637, the bulb of a tulip known as "the Viceroy" was offered for sale between 3,000 and 4,200 guilders (florins) depending on size. A typical skilled craftsman earned about 300 guilders per year at the time.

Bitcoin might be the only thing more polarizing than Donald Trump. You either think it's an insane speculative bubble rivaled only by the Dutch tulip mania of the 17th century, or you are a true believer who thinks bitcoin will continue to go to infinity and beyond and will "hold on for dear life." If you still don't know what bitcoin is, read my July blog post for a primer. Or don't, and remain blissfully unaware.

The freedom-loving part of me that sometimes bemoans the power of central banks loves the idea of cryptocurrencies like bitcoin. I am conflicted, however. As a student of behavioral economics all I see is the price of something with zero intrinsic value skyrocketing as a once-in-a-millennium speculative frenzy unfolds rights before our very eyes.

FOMO (fear of missing out) is a powerful emotion, so I understand how tempted you might be to pile in. However, I would posit that you already have missed out as bitcoin has soared to $17,468 at the time of this writing. That's not to say it doesn't go to $100,000 from here, but it has gone parabolic and these things only end badly. To give you



Binge Box

Shameless (Netflix)

When I moved to Minneapolis some 12 years ago, it was the first time I lived in a place that was the setting for… anything. I immediately added *The Mighty Ducks, D2, and D3* to my Netflix queue (DVDs by mail back then), and watched in delight as those little rascals rollerbladed through the Skyway I walked through every day on my way to work. It's much more common for Chicago to be the backdrop in movies and TV, but I still get excited seeing something familiar in TV and film. Anyway, *Shameless* follows the degenerate Gallagher family living on the south side. There are plenty of external Chicago shots, great characters, annoying characters, and gratuitous adult scenes in the show. Best of all, it just makes you feel a lot better about your own life. These people really have no shame.

an indication of how close to the peak we might be, I just read an article that gives you step-by-step instructions on how to buy bitcoin for your grandma. People are now running up credit card debt, equity lines, and taking out mortgages to buy bitcoin. You would only be a fool in search of a greater fool.

It's a shame that adoption for bitcoin has come in the form of rampant speculation, instead of adoption as a currency or as a store of value, two functions it does not currently serve. Bitcoin acceptance by merchants was already very low, and has actually declined as it has become more popular. This is because the more people buy into it, the higher the transactions costs get. The average transaction fee got as high as $27.20 last week. Nobody is going to pay that to buy a cup of coffee.

And to be a good store of value something must have a stable price, which is far from reality for bitcoin. Furthermore, bitcoin wallets don't have the the protection of insurance, like that which the FDIC provides to U.S. bank deposits. I combed through news articles of bitcoin hacks over the years, and by my tally no fewer than 1,384,512 bitcoins have been stolen by hackers. That's about one in every 12 coins and about $24 billion at today's price.

Here is another fun fact: an estimated 2.78 to 3.79 million bitcoins are already gone forever due to the loss of private keys from death or carelessness, according to data analytics firm Chainalysis. A "HODLer" would argue this is good, because it means they are even more scarce. A hater would argue the ultimate fate for every bitcoin is that it is eventually lost or stolen.

Still haven't convinced you to avoid buying bitcoin? Very well. If you can answer the following question honestly in any other way than "make me rich quickly," feel free to buy away:

How will bitcoin make your life better?

Mania. Mania never changes.

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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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