The Type 2 Investor

August 15, 2018

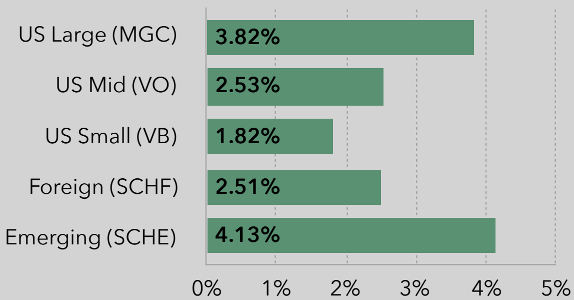
July 2018

Economic Data

- Only 157,000 jobs were added in July, with the Toys 'R Us bankruptcy weighing on the numbers
- Inflation (CPI) was up 2.9% y/y in June, the highest level in six years
- Existing home sales declined for the third straight month, falling 0.6% in June
- 2nd quarter GDP grew at a 4.1% annualized rate, but the increase was largely attributable to one-off factors such as a surge in soybean sales to China ahead of tariffs

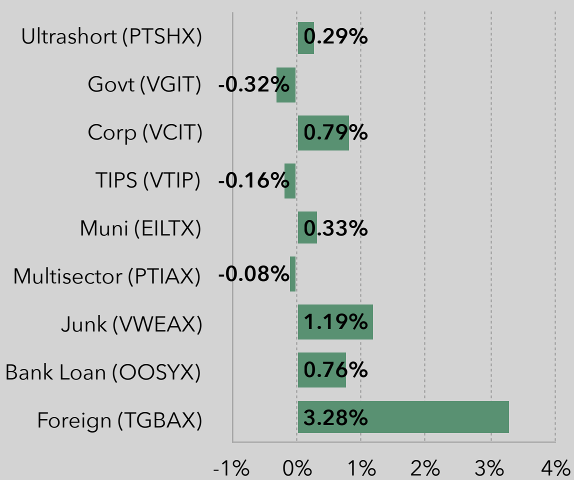
Stocks

July Returns



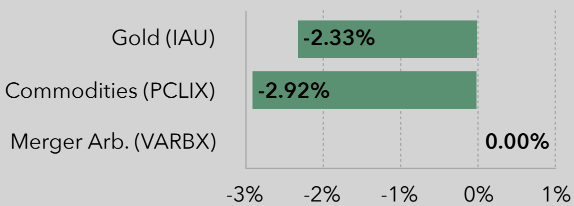
Bonds

July Returns



Alternatives

July 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 Best Retirement Account May Not Actually Be a Retirement Account

There are two basic types or retirement accounts. The first is the traditional, tax-deferred type. This is your traditional 401(k) or traditional IRA. Money that goes in is pre-tax or tax-deductible, the funds grow tax-deferred, and then you pay income taxes on the distributions in retirement (after age 59$^{1/2}$).

The second kind are the tax-free Roth-type IRAs and 401(k)s. You put your after-tax money in them, like the traditional accounts money grows unfettered by the burdens of taxes on capital gains, dividends, and interest, and when it comes out in retirement in does so tax-free. Double tax-advantaged. Pretty sweet. Roths are a great complement to the traditional type, because they give you more control over your tax liability in retirement.

But what if I told you there was something even better? Something that combined the pre-tax advantages of the traditional account with tax-free distributions for certain qualified expenses to be triple tax-advantaged? And that it wasn't a retirement account at all?

That, my friend, is the Health Savings Account (HSA). The HSA is an investment account that can be paired with an eligible high-deductible health insurance plan (HDHP). For 2018, the IRS allows eligible enrollees and their employers to stash away up to $3,450 into an HSA for self-only HDHPs, and up to $6,900 for family HDHP coverage. Contributions via payroll deductions are not subject to income taxes or FICA taxes.

The money is intended to cover medical expenses that HDHP plans do not, so distributions taken out of the account for qualified medical expenses are not taxed, similar to a flex-spending account. Unlike a flex-spending account, however, where you have to use it or lose it each year, the HSA rolls over indefinitely. There are no required minimum distributions (RMD) at 70$^{1/2}$, like with traditional retirement accounts. It's also portable, so you can take it with you when you change jobs. And the money can be invested in the financial markets for long-term growth.

Distributions taken for non-qualified medical expenses are subject to income tax and a 20% penalty, however this penalty goes away at 65. Still, you can use this money to pay for Medicare premiums, prescription drugs, dental, vision, nursing home, and other qualified medical expenses. Which, when you're old, will, you know…could be a lot. According to an annual estimate by Fidelity, the average couple retiring today at age 65 will need $280,000 to cover health care and medical costs in retirement–a figure that will likely grow each year.

So the HSA can effectively be used as a retirement account. A very good one, at that. Instead of using it for your ongoing medical expenses from year-to-year, just leave it be and let it compound tax-free. Then use it to cover your qualified medical expenses in retirement, again tax-free. And if you are fortunate enough to not have large medical bills later in life, it effectively becomes a traditional retirement accounts after age 65, only without the RMDs. Or you could just leave it to your heirs.

Despite the advantages of this strategy, only about 4% of HSA enrollees are actually moving money out of safe investments and into assets with more long-term potential for appreciation. The number of employers offering HSA eligible HDHPs is rising, though, with a 2017 report from United Benefit Advisors showing 24.6% of employer-sponsored plans offering an HSA. As this option becomes available to more people, I believe its popularity will increase.

A high-deductible plan may not be appropriate for everyone, however. If it is an option at your current employer and you would like to discuss the pros and cons in more detail, feel free to reach out.

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Tactical Asset Allocation

Asset Class	Heavy Under-weight	Under-weight	Neutral	Over-weight	Heavy Over-weight
Fixed Income			●		
Ultrashort					●
US Govt.		●			
TIPS				●	
Multisector			●		
Bank Loans	●				
Foreign Bonds			●		
Equities	●				
Large Cap	●				
Mid Cap	●				
Small Cap	●				
Developed Intl.		●			
Emerging			●		
Alternatives					●
Commodities					●
Hedging					●

Binge Box

Explained (Netflix)

I like learning new things, and Netflix's new show *Explained* does just that in easy to digest weekly segments that are only about 15 to 20 minutes long. I finally have a passable understanding of the game of cricket, and know what all the fuss is about over K-Pop. It's also why I haven't expressed the same enthusiasm in emails and texts, as one episode about the exclamation point has made me self-conscious about overusing it. Other topics are varied and include eSports, monogamy, cryptocurrency, weed, diets, designer DNA, and the wealth gap. Not every episode is balanced, so I wouldn't necessarily recommend treating each story as complete. But it's entertaining, informative, and concise.

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.