The Type 2 Investor

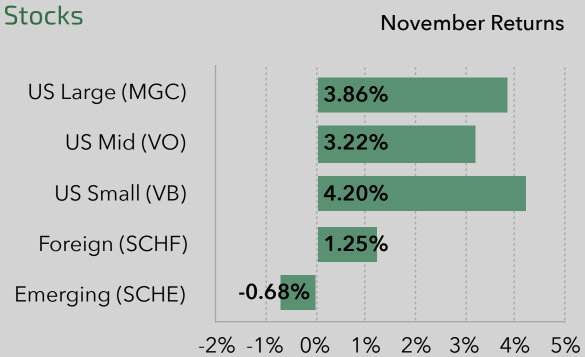
December 11, 2019

November 2019

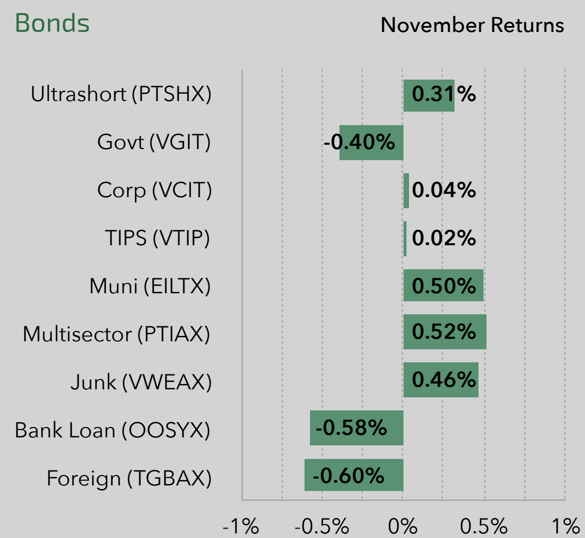
Economic Data

- US payrolls solidly beat expectations and rose 266,000 in November following the end of the GM strike; unemployment edged back down one-tenth to 3.5%
- Retail sales were up 0.3% in October, but sales of big-ticket household items declined
- Y/y inflation (CPI) edged up one-tenth to 1.8% in October
- Existing home sales rebounded 1.9% in October
- The Conference Board Leading Economic Index (LEI) dropped for the third straight month in September

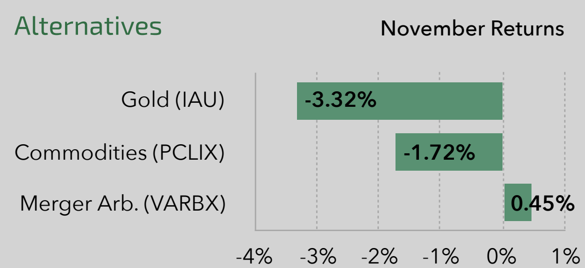
Stocks



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.

Robinhood's Infinite Leverage Cheat Code

I spoke at the Trust Advisors Forum conference in Pinehurst earlier this year on the topic of Millennials and investing, and one of the things I discussed was some of the emerging technology and apps in the world of personal finance. This included Robinhood, the trading app that targets millennials and lets them buy and sell stocks and cryptocurrencies all they want for free until they've day-traded away all of their money.

This has, unfortunately, turned investing into a smartphone game. According to the co-founder of Robinhood, users with positions check the app an average of 10 times per day. And that's a bad thing. It means users aren't evaluating their investment decisions over years or decades, as they should, but rather over the time it takes between trips to the bathroom. This narrow-framing can cause investors to lose sight of their long-term goals and trade way too frequently. And as Gene Fama once said, "Your money is like soap. The more you handle it, the less you'll have." As a generation, they want immediate feedback, but as investors they should be coached to reduce the frequency in which they check on their investments and enjoy the emotional benefits of ignoring day-to-day market volatility.

Anyway, an alarming series of stories came out about a month ago regarding a "cheat-code" in Robinhood that offered users the potential for infinite leverage. It worked by allowing users to buy stocks with money borrowed on margin, write deep-in-the-money covered calls against the leveraged position, and then allowing them to borrow more money against the premiums. Rinse and repeat. A group of sociopaths on Reddit began engaging in this practice and posting their ludicrous amounts of leverage on the site, with each one trying to outdo the others. One devil-may-care trader claimed he turned a $3,000 deposit into a $1.7 million position. This is, of course, not good, and this user lost $180,000 according to an article on Business Insider, and many of the other foolhardy people attempting it also lost sums of money many multiples above what they could afford to lose. And make no mistake about it, you are still on the hook for any borrowed money still owed after your account is wiped out.

Robinhood says it has since closed the loophole and suspended accounts engaging in this behavior. It's still not clear what will happen to those who lost tens or hundreds of thousands of dollars in this idiotic behavior, but according to a YouTube interview with one they were able to settle for an amount smaller than what was actually owed, but still much larger than what they had deposited. It's possible the legal ramifications for the abusers could go beyond seizure of personal assets to pay off any debts, however, and into the realm of securities fraud. The whole fiasco should serve as a warning to investors about the risks of leverage, as well as a reminder that even in this modern world there is such a thing as personal responsibility.

Portfolio Positioning

We made a few minor adjustments to our Tactical Asset Allocation, and have been rebalancing portfolios to the new targets this week. Let's start with equities. The S&P 500 has been hitting new highs, and is up a respectable 7% or so from the highs hit in September of last year. That's not the case with small and mid-cap stocks, however, which still have yet to climb back to the highs they set 15 months ago. The S&P 500 now trades at an unprecedented level, but corporate profitability has been relatively stagnant. Earnings per share, however, have improved thanks to the shrinking supply of shares (buybacks), which has helped valuation metrics improve. Large cap stocks (S&P 500) and small cap stocks (S&P 600) now trade at price-to-earnings (P/E) multiples of about 19, while mid cap stocks (S&P 400) are slightly more attractive at about 18. The potential for recession still looms and leading economic indicators have been down for three straight months, so we aren't eager to increase domestic equities, but we did move mid cap stocks from a heavy under-weight to just an underweight based on valuation. This was for the most part funded with a rebalance out of large cap stocks, which had appreciated above our target weight.

Looking overseas, the MSCI ex-US index of international stocks is at about a 20% P/E discount to the US, and Europe's P/B (price-to-book value) is at 30-year lows relative to the US. Valuation doesn't matter in the short-term—say weeks, months, or even a couple years—but it absolutely matters over the longer-term. Therefore, we have moved our allocation to international stocks in developed countries up from an underweight to neutral. At the time of this shift, Boris Johnson's Conservative Party looked to be on solid footing to win a comfortable majority in tomorrow's election. However, that margin has been narrowing this week and a victory, while still likely, is no longer such a sure thing. If they do win the day, it would clear the way for the UK to finally leave the European Union on January 31, removing an uncertainty that has been hanging over the heads of European markets for three years now. There would still be much to negotiate about future arrangements between the two, but it would be nice to finally put the big part of the Brexit question behind us.

Moving on to international bonds, the Templeton Global Bond Fund (TGBAX) has struggled this year, significantly underperforming its peer group. This is not uncommon for this fund, however, as Michael Hasenstab, the fund's manager, is willing to make large bets on out-of-favor areas of the market others shun when his team's meticulous analysis warrants it, and then takes a patient approach with those investments. It has led to a number of short-term struggles, but the fund is typically quick to recover and has demonstrated a long-term track-record of outperformance. We think this is a good time to buy the fund's dip, and so we have nudged our allocation up from neutral to an overweight. The move was funded by a reduction in our allocation to Treasury Inflation-Protected Securities (TIPS), as prices in that asset class are near upper resistance.

Lastly, we have decided to take advantage of the recent run-up in oil to $59, as well as nice rebounds in other commodities like coffee, sugar, and live cattle, to reduce our weighting to broad commodities.

Binge Box

Daybreak (Netflix)

I'm kind of embarrassed to admit I watched this, and even more so to admit I binged it. But that's what this little blurb is about: talking about shows that for whatever reason get you hooked. Anyway, Daybreak is about a group of high school cliques surviving in the wasteland of Glendale, CA following a nonsensical biochemical thermonuclear war. It's best to tell your brain to shut up and stop worrying about the science. It's a mash-up of no fewer than three genres, switches styles between episodes, pays homage to *Ferris Bueller's Day Off*, and is full of camp. Despite feeling all over the place, in the end I just thought it was really enjoyable.

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					●

We still maintain an overweight target to gold, but took some profits off the table in the rebalance. Any additional money needed for these changes was taken out of ultrashort bonds.

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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 clients. 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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