The Type 2 Investor

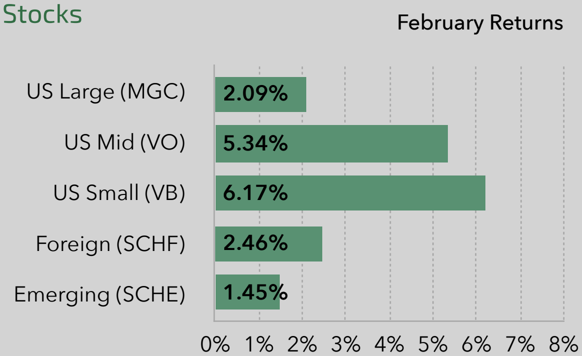
March 9, 2021

February 2021

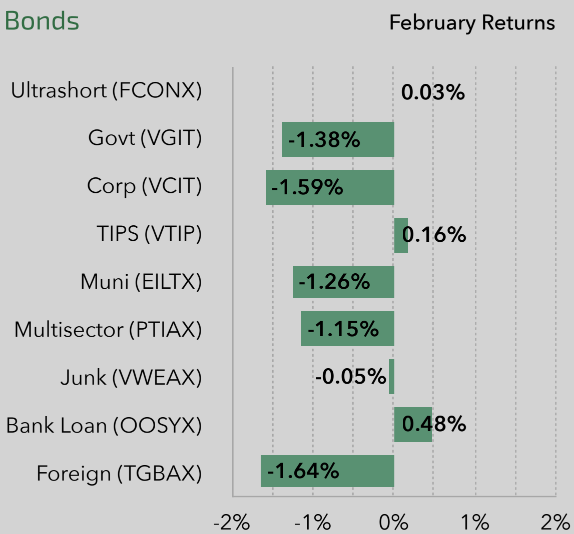
Economic Data

- The number of US workers on payroll rose 379,000 in February and the unemployment rate was little-changed at 6.2%
- Retail sales were up 5.3% for the month of January with particular strength in home furnishings, electronics & appliances, and department stores
- Y/y inflation (CPI) was unchanged at 1.4% in January
- Existing home sales rose 0.6% in January, with a median home price of $303,900—14.1% higher than a year ago

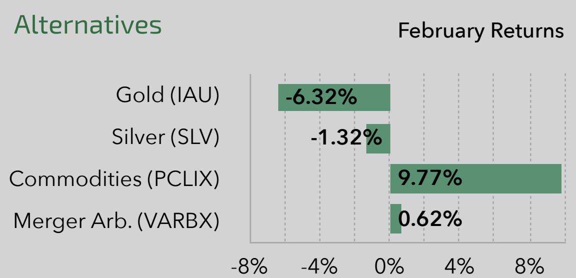
Stocks



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.

SPACulative Frenzy

What do Serena Williams, Alex Rodriguez, and Colin Kaepernick all have in common? If you said they are all athletes, then sure, fine, I guess you are right. But this isn't a sport ball newsletter, is it? The thing these three have in common that is of interest to us is they have all been involved in launching SPACs recently.

You may have heard this term with increasing frequency over recent months, but what is a SPAC? A SPAC, or Special Purpose Acquisition Company, is essentially a company that raises cash from investors, lists itself on a stock exchange, and then sits on that cash until it finds a private company that wants to go public and that it wants to acquire. It's a blank-check company. They have been around for three decades, but their popularity has skyrocketed recently.

Investors in the SPAC typically put up $10 per share which sits in cash in a trust, and in exchange they get shares that—at least in the beginning—are worth $10 per share, plus warrants to buy more shares within a certain timeframe after the deal is done. When a deal is announced, the shareholders can decide whether they want to keep the shares in the soon-to-be-acquired firm, or redeem them for the original $10 plus interest while keeping the warrants. Not a bad deal.

Meanwhile, the sponsors cover the expenses of the SPAC until a deal is done, and in return get a "promote" which is usually about 20% of the value of the SPAC. This is more than they would get in fees for a traditional IPO, so not a bad deal for them, either. But here is the rub. There are huge incentives for the sponsor to get a deal done. If one isn't consummated within a specified timeframe—typically 18-24 months—the SPAC matures and investors get their money back and sponsors lose out. This incentivizes them to overpay for target companies just to make sure a deal gets done.

For the potential target company, going public via a SPAC merger is quicker and easier than a traditional IPO and requires less disclosure. Also, the pressure for the sponsor to get a deal done can result in inflated valuations. Not a bad deal for them.

So who is the sucker in the room? It's the person who holds onto the shares instead of redeeming them. Or worse, the person who pays a massive premium over cash value for SPAC shares in anticipation of a hot deal, like with Churchill IV going north of $60 in anticipation of its deal with Lucid Motors. SPACs haven't had the best track-record for performance post-acquisition, and fraud has also been an issue in some cases (*cough* Nikola *cough*). So far in 2021, the rate of SPACS going public has averaged roughly five per trading day. There is just way too much SPAC money chasing too few quality targets.

This is a speculative bubble, and it will eventually pop if it hasn't started already. However, the structure of these vehicles and the ability to redeem the shares creates an arbitrage opportunity when SPAC shares trade below their cash value. Because investors can redeem that cash when a SPAC deal goes through, buying below that price can result in risk-free returns, plus the potential for equity-like upside if it's viewed as a hot deal by the market. So this is how we want to invest in SPACs, and we in fact have been doing this for months through the Vivaldi Merger Arbitrage Fund (VARBX).

"Stimmy" Checks

More stimulus checks are on their way it would seem. For individuals, eligibility for the $1,400 checks phases out between $75,000 and $80,000 in income. For married couples filing jointly, it's $150,000 to $160,000.

Eligibility will be based on your most recently filed tax return. So if you qualify under your 2019 income but not your 2020 income, do not file your taxes until after you get your hands on that government money. Conversely, if you didn't qualify in 2019 but would qualify based on your 2020 income, file your tax return as soon as possible. Like now.

Portfolio Positioning

We made a few small adjustments to portfolio positioning over the past month. With short-term yields at next-to-nothing, it is getting harder to continue to justify an ultra-short bond position. So some of that was re-allocated to TIPs, commodities, and merger arbitrage in search of better inflation protection and returns. Our allocation to emerging markets stocks was moved up to neutral as well, although in most accounts this did not require a purchase as the allocation had already drifted close to that target.

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Tactical Asset Allocation					
Asset Class	Heavy Under-weight	Under-weight	Neutral	Over-weight	Heavy Over-weight
Fixed Income		●			
Duration	●				
Inflation				●	
Credit	●				
Foreign				●	
Equities	●				
Large Cap	●				
Mid Cap		●			
Small Cap	●				
Developed Intl.		●			
Emerging			●		
Alternatives					●
Commodities					●
Hedging					●

Binge Box

Wayne (Amazon)

Like another favorite of mine *Cobra Kai*, *Wayne* was a You Tube Red orphan that found a second life on another streaming platform. Wayne is a brutal action/dark comedy series that follows the titular character and his girlfriend Del on a road trip from Massachusetts (get ready to drop your R's) to Florida to reclaim his late father's stolen 1979 Pontiac Trans Am. Along the way, Wayne tries to right various injustices he sees in an absurd, over-the-top, ultraviolent fashion. If that doesn't bother you, I think you'll find it to be quite binge-worthy. This show is very deserving of a second season, so hopefully Amazon gives it one.

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.