The Type 2 Investor

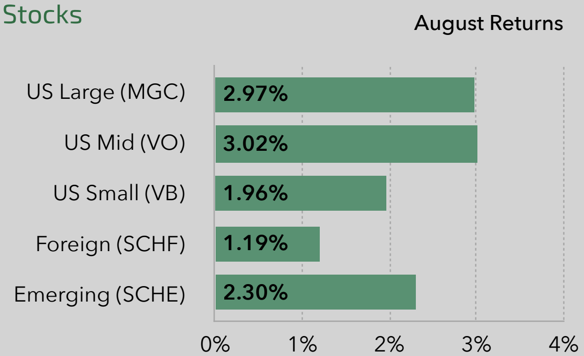
September 8, 2021

August 2021

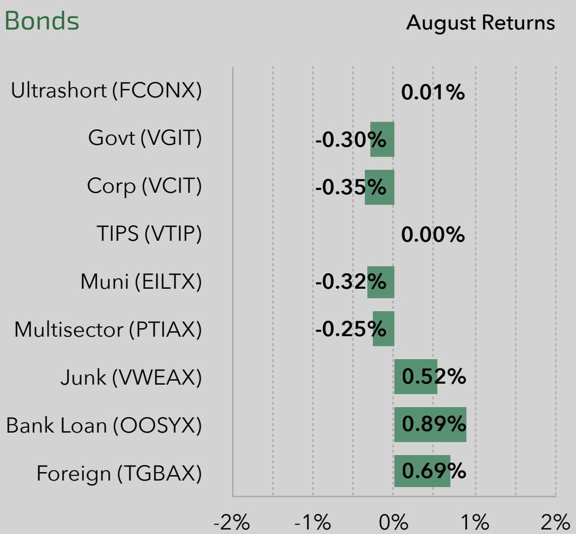
Economic Data

- Total nonfarm employment rose by a disappointingly low 235,000 in August, but survey data showed the unemployment rate fell 0.2% at 5.2%
- Retail sales were down 1.1% for the month of July, led by a decline in motor vehicle sales
- Y/y inflation (CPI) held at a hot 5.4% in July
- Existing home sales rose again in July with a 2.0% rise; median home price was $359,900 as most of the growth is in the upper-end of the market

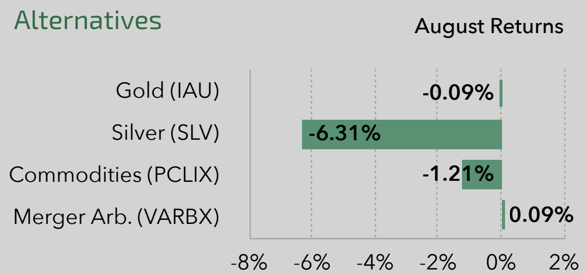
Stocks



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.

Asset Location

"I'm proud to be paying taxes in the United States. The only thing is — I could be just as proud for half the money" -Arthur Godfrey

There is some debate about how large the US income tax code is. If you are just talking about the literal statutes, it comes in at roughly 2,600 pages—about the length of the Harry Potter series by word count. The Tax Foundation claims this is not enough, however, because it doesn't include IRS regulations, revenue rulings, and other clarifications that are needed. Include those and we get closer to 9,000 pages. And if you go further yet and add case law, the number balloons to over 70,000 pages. Finally, there is the *Standard Federal Tax Reporter*, which "contains a comprehensive collection of federal income tax information, such as the full text of all proposed, temporary and final federal income tax law regulations, as well as the full text of federal administrative rulings and documents." This is an incomprehensible 908,521 pages.

Let's just agree that the rulebook is very long and very, very boring. Still, it is important to understand the rules so we can legally minimize our tax burden and maximize our after-tax wealth. I have wrote about a number of ways to reduce your taxes in the past. Today, I want to talk about an often overlooked way, which is called asset location.

Now before I go any further I must 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 qualified accountant regarding any questions related to taxes.

So what is asset location? Well, more often than not investors have a mixture of taxable, tax-deferred (e.g, 401k, traditional IRA), and tax-exempt (e.g., Roth IRA, HSA) accounts. In these situations we must not only consider the overall asset allocation, but also which account is the best place to park each particular investment. As a general rule, it is usually best to put tax-efficient assets in taxable accounts and tax-inefficient assets in tax-exempt or tax-deferred accounts.

Tax-efficient assets have low taxable income yields and low turnover, which means they aren't doing a lot of buying and selling that can realize capital gains. These include municipal bonds and stock funds that track low-turnover benchmarks. These are assets that are typically better off in your taxable account. Depending on the makeup of the rest of your portfolio, it may or may not be more efficient to put higher dividend yielding stocks here, too.

Tax-inefficient assets have high turnover and, in particular, will realize a lot of short-term capital gains that are taxed at a higher rate. A good example of this is merger arbitrage strategies, which are usually investing in deals that will close in under a year, then recycling those proceeds into other deals creating a lot of turnover. Funds with high levels of interest income are also tax-inefficient, like bond funds whose interest is taxed at the investor's income tax rate. These are assets that are typically better off in your tax-deferred or tax-exempt accounts. Stock funds that offer a high dividend yield could be better off here, although dividends are usually taxed at a lower rate. Long-term gains on precious metals, like gold and silver, are taxed as collectibles which has its own maximum tax rate of 28%.

Expected growth is another thing to consider. Your will eventually have to pay taxes when you withdrawal from a tax-deferred account; you won't when you take money out of a tax-exempt account. Therefore, you would rather have higher growth, tax-inefficient assets in your Roth IRA, and lower growth, tax-inefficient assets in your 401(k) or rollover IRA

It is a bit more nuanced than all this once we start factoring in each individual's goals, time horizons, and present and expected future tax situations. And we are often limited by the level of assets in each type of account. In an ideal world we might just park everything in a Roth IRA, but unfortunately we are constrained by contribution limits and restrictions.

So an asset location strategy is not something that can be rigidly employed. It is, however, something that we can customize to try to maximize your after-tax wealth.

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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

Loki (Disney+)

Disney+ has well exceeded expectations since launching in late 2019 and now has 116 million subscribers. That's almost three times as much as Hulu or HBO, and they are rapidly closing the gap with Netflix. And shows like *Loki* are the reason why. I'm not really a Marvel fan-boy, either. Sure, I've seen almost all the MCU films, and enjoyed them well enough. It's a well-oiled machine with a proven formula for putting out a product that ensures you will be entertained. Even after all that has already been released, though, Loki somehow feels fresh and creative. And it answers the age-old question: if you met a female (or male) version of yourself, would you fall in love with each other? Wait, what? Yeah, that's the plot.

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.