The Type 2 Investor

January 12, 2022

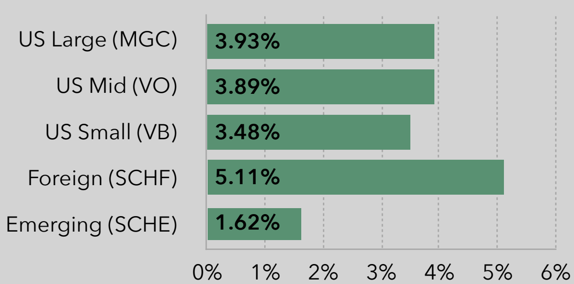
December 2021

Economic Data

- Huge miss on payrolls as only 199,000 jobs were added in December; the unemployment rate fell to 3.9%, though
- Retail sales were only up 0.3% for the month of November, dragged down by department stores and electronics & appliance stores
- Y/y inflation (CPI) rose to 6.8% in November—the seventh month in a row at or above 5% and the highest print since 1982
- Existing home sales rose 1.9% in November; median home price were flat at $353,900

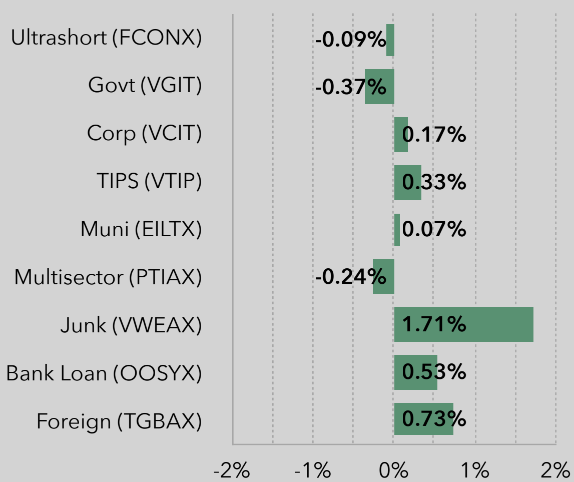
Stocks

December Returns



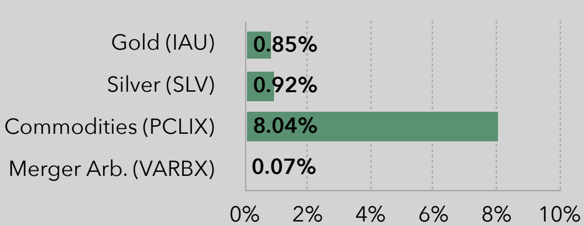
Bonds

December Returns



Alternatives

December Returns



Performance data provided by Morningstar.

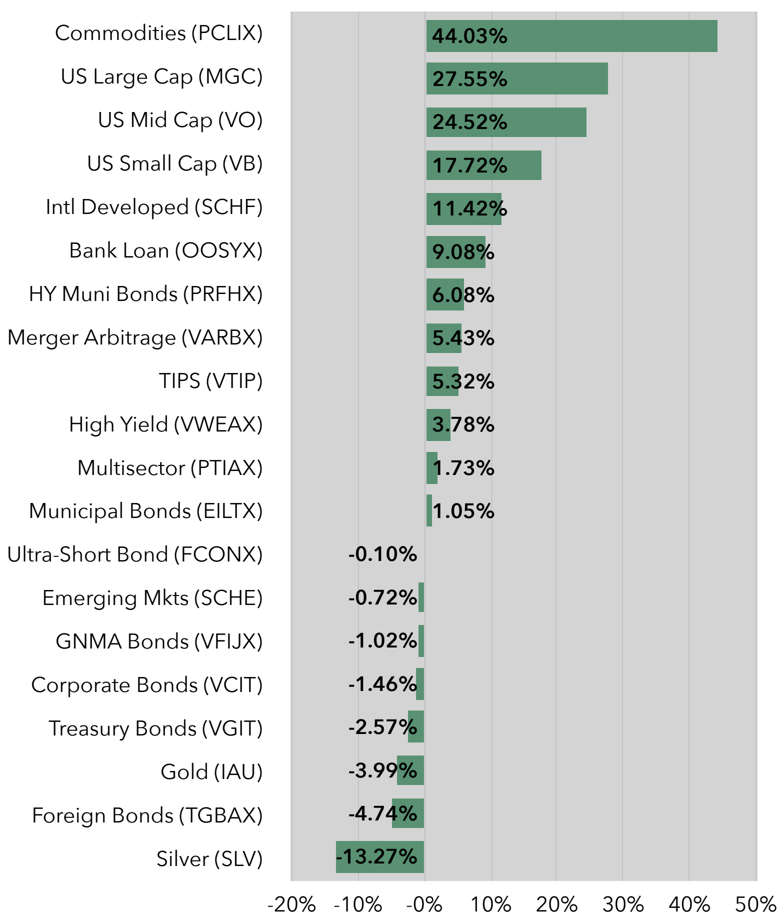
The brain uses two systems to process information. The first type is intuitive but lazy, rapidly forming judgements with no conscious input. The second system is slow, reflective, and is not guided by emotions. It is that second system — type 2 — that we want in control of our investment portfolios.

2021 in Review

It's time to review investment performance for 2021, which was an absolutely absurd year full of SPAC frenzies, gamma squeezes, red-hot inflation, meme stocks, meme coins, and people setting fire to real art and selling NFTs to commemorate it. The best and worst performing assets of 2020 swapped places in 2021, with silver (which soared 47.3% higher in 2020) falling from grace while broad commodities (which were down 9.15% in 2020) surged. That is often the way things go from year to year. I mean, if one asset class was consistently and predictably the top performer every year, we would abandon broad diversification and just invest in that.

Meanwhile, domestic stocks clocked in their third straight year of impressive double-digit returns, a streak that I believe is unlikely to continue this year. Bonds, on the other hand, performed relatively poorly with the exceptions of lower quality credits as investors sought out yield, and TIPS as inflation heated up. Speaking of inflation, CPI was up 7.04% for the year. That's a lot. It hasn't been that high since before Cabbage Patch Kids (1982), and it means that many of the investment vehicles in the chart below unfortunately failed to keep up with the rapidly rising cost of living.

2021 Investment Vehicle Performance



2022 Contribution Limits

The contribution limit for employees who participate in 401(k), 403(b), most 457 plans, and the federal government's Thrift Savings Plan increased to $20,500 for 2022, up from $19,500. Unfortunately the limit on annual contributions to an IRA remains unchanged at $6,000 for the 4th straight year, although with inflation running the way it is I think they will have to adjust this next year. The IRA catch-up contribution limit for individuals aged 50 and over is not subject to an annual cost-of-living adjustment and remains $1,000. Roth contribution eligibility phases out between $129,000 and $144,000 in income for single filers and between $204,000 and $214,000 for those that are married and filing jointly. Please remember you still have until April 15th to make your 2021 contributions.

Build Back Better; Bye Bye Backdoor?

The House passed the Build Back Better (BBB) Act, but it failed to pass in the Senate and appears to be dead at this time. The $1.7 trillion, 2,137 page behemoth would have ended the "backdoor" and "mega backdoor" Roth strategies, as well as Roth conversions in general for those above a certain income. Fortunately those financial planning strategies appear safe, at least for now.

Adventures is Amateur Epidemiology

The data continues to support my belief that the much lower hospitalization rates of Omicron should have us hailing the variant, not creating a narrative of panic over it. Infection rates are up, yes, but hospitalization rates, length of hospital stays, and mortality rates of those infected are down significantly. Hopefully Omicron will mark the end of the pandemic phase, and this just becomes another endemic sickness that is largely seasonal. Besides a few more weeks of people calling in sick to work, the virus really isn't the a major risk to the economy anymore. The real risk is the way people, businesses, the media, and governments decide to respond to it.

Adventures is Amateur Epidemiology

The bigger risk to the stock market, in my opinion, is the Fed. Federal Reserve meeting minutes pointed to a possible rate increase in March. This is, of course, is quite necessary and frankly way behind the curve in the face of 7% inflation. However, it will be difficult for stocks to continue to perform well in the face of Fed tightening.

Binge Box

Station Eleven (HBO Max)

The limited series is based on Emily St. John Mandel's prescient 2014 novel about a pandemic. I know you might not be interested in anything more pandemic-related at this point, but oh, man, *Station Eleven* is a really, really beautiful piece of storytelling. There is a lot of time-jumping in the story, which usually annoys me, but it seems to work well here. The show has a great cast, including Gael García Bernal of *Mozart in the Jungle* fame and Mackenzie Davis from *Halt and Catch Fire*. The story also takes place around Lake Michigan, so there are familiar settings for all of us former or current Chicago and Michigan people.

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					●

Guess Again

Lastly, The New Year is when I like to go back and review all my predictions from the previous year to see how prescient (or unprescient) I was. I do this because despite knowing how terrible humans are at predicting the future, I keep doing it anyway. It really is a rather fun part of the job description. I think it is a worthwhile exercise to talk about what we get wrong because it helps to keep the heuristic-driven bias of overconfidence in check.

The first step in this process is going back and reading all the newsletters I wrote in 2020 and plucking out all of the predictions. I made only one dumb prediction in January of last year to kick off 2021: "Look, I'll be the first to tell you many have been made to look like fools calling Tesla overvalued and predicting its imminent fall from meteoric heights. But I'm going to do it anyway." I felt quite good about myself when Tesla proceeded to drop 34% over the next four months following that prediction. Until, of course, it rallied to end the year up almost 50%.

In February I adjusted portfolio allocations by taking money out of ultra-short bonds and re-allocating to TIPS, broad commodities, and merger arbitrage in search of better inflation protection and returns. Those were all good moves, particularly commodities (PCLIX) which ended up being the best performing investment in our portfolios for the year.

In March I said, "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." The Defiance Next Gen SPAC Derived ETF (SPAK) peaked on February 16 and has since fallen over 41%. Furthermore, zero new SPAC deals have been announced so far in 2022.

In May, Regarding DogeCoin, I said, "Even if cryptos are here to stay—and I believe at least some of them are—these sort of parabolic charts are almost always indicative of a bubble." DogeCoin hit a high of $0.74 within a few days of that writing. Today it will fetch you about $0.15—

that'a an 80% crash. I also repeatedly questioned the Fed's "transitory" narrative given the dramatic rise in input costs, which they finally abandoned months later.

In June I talked about idle labor saying, "With almost half the states cutting benefits this month, one more next month, and the rest in just three months, this will likely be short-lived." I again talked about this Great Resignation in November saying it "probably won't last forever, and we will likely see a surge in hiring over the coming months as savings dry up." This hasn't come true yet, but I hope I'm not wrong. The alternative is not desirable, as we could see a decline in living standards as products and services get harder and more expensive to get if people don't go back to work.

In October I said, "I expect the rise in new car prices will be sticky, while the bulk of the increase in used car prices will dissipate. Not in the next few months, mind you, but perhaps in the next few years. I see larger price increases on the horizon for other components, however." We'll have to wait and see on this one, too.

Aside being made to look a fool again by Tesla, it was overall a pretty good year of predictions for me. So what do I think 2022 has in store for us? Here are a few guesses:

- The Fed will be tapering and hiking this year and that's bad news for both stocks and bonds
- The Fed loses its backbone after the first sign of a market crash and pumps the breaks on tightening
- With real short-term interest rates at -7%, precious metals make a comeback
- $100 oil and continued rise in food prices keep inflation running hot through 2023, or at least until the next recession
- Value stocks in the Financials, Energy, and Consumer Staples sectors outperform growth stocks in the Technology and Consumer Discretionary sectors
- Weed stocks become en vogue again
- Matt Stafford finally wins a playoff game…and another…and another…and a Super Bowl ring

Thanks for reading and have a happy New Year.

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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.