Lee Adaptive Large Cap Sector Update

Monthly Commentary

June 2017

June's market gains were modest, but they were gains. For the month, the S&P Total Return Index was up +0.62%[1], its eighth consecutive monthly advance. (A streak unequalled since 1974.) The Lee Adaptive Large Cap Sector Composite ("LALCS Composite"), on a net of fee basis, was up an estimated +0.54% in June. For more detail, please see the performance discussion below.

The quote of the month belongs to blogger and Financial Advisor Joshua Brown, who tells us that "The stock market is now 35% passive and 65% terrified." A casual observer might wonder about that 65%. The first half of 2017 saw the S&P 500 Total Return Index quietly and fairly calmly rise +9.34%[1]. The market has been enjoying an ideal-sounding and unprecedented run of low volatility combined with positive returns. And yet, as has been widely commented on, few investors are celebrating. The only relaxed ones are those that have been blissfully ignoring events. The others are confused and terrified.

Brown was actually writing about how traditional portfolio managers are worried about losing their jobs, but his quip could just as easily be applied to the long running debate over active versus passive investing. That controversy is generally between cynics who advocate investing in a passive index of all stocks and optimists who argue for hiring somebody to select only the good stocks. Interestingly, both groups generally take as implicit the core strategy of buy-and-hold, that whether your collection of stocks is selective or not, you should own it through thick and thin, throughout the market cycle.

This blanket acceptance of buy-and-hold is a bit peculiar. Stock picking and not using buy-and-hold, practicing what is usually called market timing, are both types of active management. Believing that you can select the best stocks is no less arrogant than believing you can pick the best times to be in the market. And although stock picking is now much less fashionable than it once was, it is still commonplace. Investing in an actively managed equity fund is currently akin to drinking carbonated beverages, looked down on by the enlightened, but still socially acceptable. In contrast, market timing is more like smoking cigarettes, so broadly thought to be unwise that it is rarely done in public.

The best argument against market timing is that the deck is stacked against it. The market tends to go up, so a day or month spent out of it is, on average, a lost opportunity to make money. In contrast, stock picking is, at its worst, mostly harmless. The proverbial monkey throwing darts should, on average, do as well as the market as a whole. (Provided that the monkey does not charge fees.)

To give a more concrete example, consider two possible strategies. The first is fully invested in the S&P 500 during even numbered weeks and entirely in cash during odd numbered weeks. The second is a portfolio of 250 stocks, constructed by sorting the members of the S&P 500 by capitalization and choosing every other one. If these strategies were implemented over a long period, ten or twenty years

[1] Source: FactSet®

perhaps, what would be the expected returns? Since it is invested half the time, the alternate week portfolio would be expected to produce half the return of the S&P over the period, which is to say that it would be expected to underperform significantly. The 250 name portfolio, on the other hand, will have returns very close to the S&P, even over comparatively short periods.

So it can be argued that market timing starts out in a hole. The mere fact of being out of the market in some periods reduces your expected return and means that you must be that much more successful at timing to make up the difference. Stock picking, on the other hand, can be expected to break even with the market even if your choices are monkey and darts random.

The problem in that argument, and in similar arguments, is that it ignores risk. The alternate week strategy may have exactly half the return of the buy-and-hold S&P investment, but it also has exactly half the volatility. Market timing has both a downward return bias relative to buy-and-hold and a matching downward risk bias. A better apples-to-apples comparison might be with a portfolio that is 2x leveraged to the S&P in alternate weeks and in cash otherwise. That portfolio will have essentially the same returns and risk as the buy-and-hold S&P.

If you believe that in any given week or month the S&P has the same expected return and volatility, then you must also believe that randomly choosing time periods to be in or out of the market should produce, on a risk-adjusted basis, the same returns as buy-and-hold. There is no hole for market timing to climb out of. (Of course, we do not believe that all weeks and months bring the same expected return and volatility for the S&P. Nor is our choosing of time periods to be in or out of the market random.)

But perhaps the biggest flaw in buy-and-hold is that, as simple as it is, it is surprisingly hard to implement. Market timing is hard not to do. Consider, for example, the General Electric pension fund, currently underfunded by a staggering $31 billion. As troubling as that number is, what really makes it notable is that GE was once a model pension manager. At end 2007 it was overfunded by a very comfortable $15.2 billion. Then the financial crisis hit and the risky assets in GE's portfolio went down in value sharply, which prompted a sober reassessment of asset allocation strategy. The allocation to risky assets (i.e. equites) was significantly reduced in favor of less risky assets (bonds) and alternatives (hedge funds.) And then, as we all know, the following eight years were great for stocks and lousy for bonds and hedge funds.

If you periodically review and adjust your allocation to asset classes, as any thoughtful and responsible investor would, you are inevitably doing some market timing. Ultimately, the issue is not really buy-and-hold vs. market timing so much as it is intentional market timing vs. accidental market timing. We believe intentional works better.

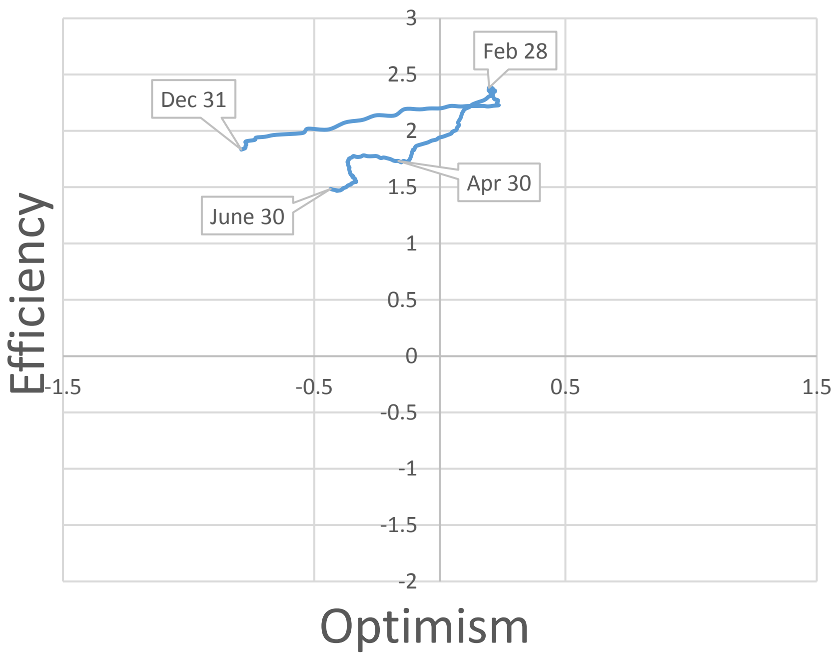
The Market Sentiment Framework

We use our Market Sentiment Framework to adapt the mechanics and weightings of our full quantitative model to changing market conditions. The Sentiment Framework gauges the current state of market psychology on two dimensions. Efficiency measures the crowdedness of the market, the volume of participants seeking investment opportunities. Lower levels of efficiency imply more market mispricing. Optimism measures the willingness of investors to take on risk in exchange for distant and uncertain rewards. Higher levels of optimism imply a better outlook for risky asset classes.

[1] Source: FactSet®

After falling during the closing weeks of 2016, Optimism gained ground through the first two months of 2017. Since then it has more gradually retreated, giving up about three fourths of its gain for the year, to end June at a neutral to modestly negative level.

In contrast, Efficiency has been largely stable, maintaining its high level for more than a year.



The current positioning of the Sentiment Framework implies a market that is crowded and efficient, with few opportunities for easy relative gains from stock picking. Optimism, although somewhat improved relative to the past few years, is in the context of a longer history at a below neutral level, a place that implies neither optimism nor pessimism, but possibly anxiety.

Performance

For the month of June 2017, the LALCS Composite, on a net of fee basis, was up an estimated +0.54%, in line with the S&P 500 Total Return Index, which was up +0.62% on a total return basis. For the first half of 2017, the LALCS Composite has gained an estimated +8.19% as against +9.34% for the S&P 500 Total Return Index.

The strategy was fully invested in all sectors for the entire month.

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[1] Source: FactSet®

Definitions:

Lee Adaptive Large Cap Sector Composite ("LALCS Composite"). A capital weighted performance composite of an investment strategy known as the Lee Adaptive Large Cap Sector strategy (the "Strategy") that holds some combination of the U.S. large cap sector ETFs and/or cash, as determined by a proprietary quantitative model. The Strategy is currently offered by LCM to (A.) certain qualified investors through (i) a single account which is a component of the overall strategy offered through the private fund Lee Diversified Opportunities Fund LP ("LDOF"), during the period commencing on December 18, 2015 through July 1, 2016 and (ii) the private fund Lee Adaptive Strategies LP ("LAS"), during the period commencing on June 1, 2016 through current and (B.) certain accounts managed by LCM on a discretionary basis ("Managed Accounts"). LAS, LDOMF and the Managed Accounts all use the same investment program as the Strategy. The LALCS Composite performance is based on actual trading profits/losses/expenses net of a management fee of 0.55%. Actual expenses of operating the Strategy may vary, depending on the investment structure in which the Strategy is used, which could result in lower returns than those stated for the LALCS Composite. Such expenses may detract materially from the performance of the Strategy and, consequently, the results shown above may not be fully indicative of the actual performance results of the Strategy.

The LALCS Composite is being shown for illustration purposes only and should not be relied upon. No representations or assurance is made that any investor will or is likely to achieve results comparable to those shown above or will make any profit or will be able to avoid incurring substantial losses.
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S&P 500 Total Returns Index. The returns for the S&P 500 index on a total return basis, that is, with dividends included and does not reflect the deduction of fees and expenses. You cannot invest directly in this index. The returns for the S&P 500 Index are provided for comparison purposes only to show how the LALCS Composite compares to a broad-based index of securities. The S&P 500 is comprised of a representative sample of 500 large-cap companies. The index is an unmanaged, float-weighted index with each stock's weight in the index in proportion to its float, as determined by Standard & Poors. The index is one of the most widely used benchmarks of U.S. equity performance. The index is not subject to any of the fees or expenses to which the LALCS Composite is subject. It is not possible to invest in this index. The index is used for comparison purposes only. It should not be assumed that the Strategy will invest in any specific securities that comprise the index or that the investment program of the Strategy will track the index. Consequently, the returns of the LALCS Composite may or may not be highly correlated with those of the index.

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