Lee Adaptive Large Cap Sector Update

Monthly Commentary

July 2017

The rally continued in July, with the S&P 500 Total Return Index up +2.06%[1] for the month and +11.59%[1] for the year. Our Lee Adaptive Large Cap Sector Composite ("LALCS Composite"), on a net of fee basis, was up an estimated +1.88% in July and an estimated +10.22% year-to-date. For more detail, please see the performance discussion below.

July made nine consecutive up months for the S&P 500 Total Return Index. Winning streaks that long are rare. There was a ten month run from December 1994 through September 1995, and before that a nine month one August 1983 to April 1984. And compared to those, ours is a bit anemic, up just +18.01% since Halloween. The 1995 streak was up +31.69% and the 1983 version +53.53%.

Is this anemia a good or bad sign for the market? Of course we have no idea. There is hardly any data from which to draw a conclusion. That is the consistent challenge in trying to predict the future of markets. Even when there is a great deal of data it is rarely conclusive. The fact that something worked 51% of the time in the past could be an indication of a tendency that will repeat in the future. Or it could be random variation.

Good quants marry empirical examination of data with a theoretical viewpoint on how the markets work. Ideally, a theory is tested with data. The alternative, that data is examined and then a theory is invented, is not generally a good idea for the simple reason that it is so easy to find a clever sounding after-the-fact explanation for almost any set of data. And just about the worst thing that you can do is confuse an empirical observation with a theory. A pattern that has appeared in the past is not itself a theory of how the world works.

Which is a long-winded introduction to the thesis that just because the market has been rising for more than a few years now, and has reached new all-time highs, it does not necessarily follow that it must now go down because it has in the past gone down in certain similar circumstances.

A recurring theme amongst market prognosticators is that this bull market is particularly old and must therefore expire soon. We addressed that idea here a year ago, demonstrating rather ploddingly that although the bull market had even then been much longer lived than average, it was not, and still is not, nearly the longest lived. Nor is there something that could be called a typical bull market lifespan. What we did not discuss, but perhaps should have, is an often overlooked and begged question. Why would we think that older bull markets are more likely to end? What is the theory?

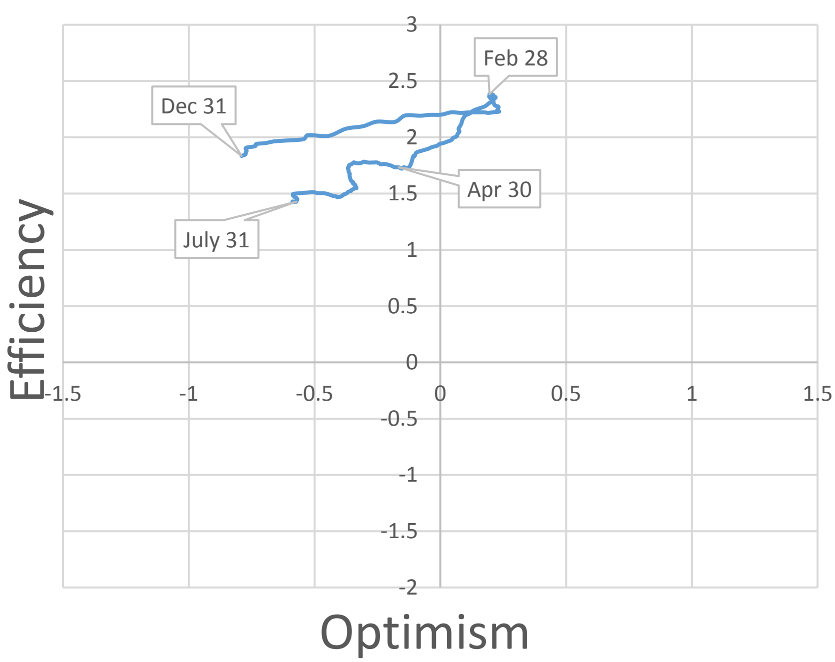
And, of course, there is no theory. What often passes for market analysis is merely the pointing out of rare or unique events or aspects of the market. There is often the implication that these rarities are likely short-lived and normalcy will inevitably return. Mean reversion is not a theory either.

[1] Source: FactSet®

We believe that this bull market will end at some point. We believe this not because every bull market in the past has eventually come to an end (although as empirical observations go, that one is fairly convincing) but because we believe that markets are made up of humans who have certain emotional tendencies. One of those tendencies is to panic, to become frightened when others are frightened. There is a potential bear market built into the brains of all market participants, which makes the eventual end of the bull market inevitable, much as a child playing with matches will eventually start a fire.

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.



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 much of its gain for the year, to end July at a 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.

[1] Source: FactSet®

Performance

For the month of July 2017, the LALCS Composite, on a net of fee basis, was up an estimated +1.88%, in line with the S&P 500 Total Return Index, which was up +2.06%[1] on a total return basis. For the first seven months of 2017, the LALCS Composite has gained an estimated +10.22% net of fees as against +11.59%[1] 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 was/is 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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