Lee Adaptive Large Cap Sector Update

Monthly Commentary

September 2017

September was a month of solid gains, with the S&P 500 Total Return Index up +2.06%[1], bringing it to up +14.24%[1] for the year on a total return basis. Our Lee Adaptive Large Cap Sector Composite ("LALCS Composite"), on a net of fee basis, was up an estimated +1.33% in September and +12.17% year-to-date. Of note, the portfolio held all sectors other than energy, which had a strong month, contributing to the relative underperformance of the portfolio. For more detail, please see the performance discussion below.

We are the kind of people that worry that other people are not worried enough. The market ended September on yet another all-time high, extending to almost a year an extraordinary and possibly unique period of low volatility and steady gains. Although there appears to be a broad skepticism that this is a new normal, it seems inevitable to us that investors will, if only subconsciously, begin to expect more of the same for the foreseeable future.

One of our few strong convictions is that equities will, at some point, enter into a bear market. We believe this not because of a specific prediction of trouble ahead, but rather because of our abiding faith in the irrationality of human beings. Sooner or later fear will overtake greed and expectations of gently rising markets will be replaced by visions of volatile falling ones.

It is relatively easy to list potential causes of a market decline, ranging from the comparatively mundane prospect of a hasty Fed tightening to more exotic scenarios involving a spiking VIX or perhaps a Bitcoin bubble. But that sort of exercise can be misleading, drawing an investor's attention away from the basic nature of the market. Predicting where and how a fire might start is less useful than understanding the basic flammability of the house we are living in.

Even when bear markets have obvious causes, and they often do not, they quickly gain a life and logic of their own. Our most recent debacle, the 2007-09 financial crisis, had a notably easy to articulate cause, and yet it resulted in a peak-to-trough drop of more than 50%. Can a sober and rational argument be made that the problems in mortgage bonds and the resulting liquidity crisis justified a loss of more than half the worth of all publicly traded corporations?

But as easy as it is to say that taken together the market levels of the summer of 2007 and the early spring of 2009 are irreconcilable, it is very difficult to say that either alone is unjustifiable. And that fact goes to the heart of the challenge of investing in equities and the reason why our house is so vulnerable to fire.

The simple explanation of the economic value of equity is that it is the ownership of future corporate profits. As a group, the members of the S&P 500 fairly reliably make a profit and almost as reliably grow those profits over time. Projecting, with useful accuracy, the future profit stream of the S&P 500 is not

[1]Source: FactSet Research Systems Inc.

particularly challenging. But valuing the ownership of those profits is difficult. It is ultimately a subjective question, and one that, as demonstrated by market movements, has been quite controversial over the years.

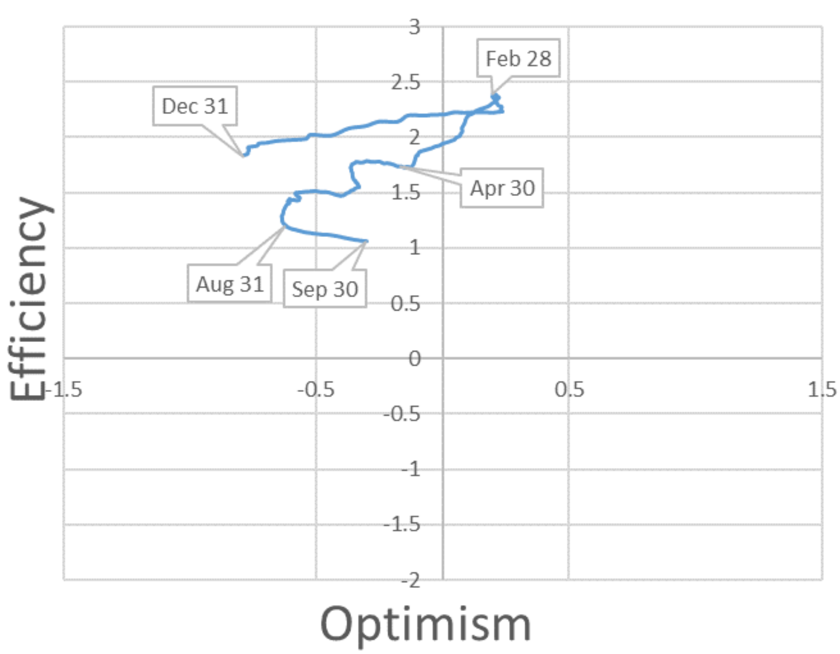
Despite being at an all-time index level high, the S&P is not currently at an all-time high when expressed as a multiple to current earnings. According to the data maintained by Professsor Robert Shiller at Yale, that distinction goes to the summer of 2009, when the multiple exceeded 100, dwarfing our current reading of around 21. But the long term trend is unmistakable. In 1977 the multiple was just under 9.

Put another way, while S&P 500 earnings are now a little more than 11 times what they were forty years ago, the S&P index level is now more than 26 times higher. Some of the market gains since 1977 have been due to economic growth, but a significant portion has been due to the increased desire and willingness of investors to own stocks, that is, their improving opinion of what the stream of future S&P profits might be worth.

That improving opinion, what might otherwise be called an increasing tolerance for market risk, has been a tremendous long term benefit for equity investors. But it comes at a cost. Because what investors are willing to pay for a comparatively stable stream of earnings varies so much, by its nature the market lacks a valuation anchor that it might more ideally have. Although it is reassuring to realize that there is no logical proof that an S&P 500 level above 2,500 is unjustified, so there is equally no proof that 2,000 or 1,500 is not equally appropriate.

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.



Optimism gained ground through the first two months of 2017and then gradually retreated, giving up much of its gain for the year, ending August at a modestly

[1]Source: FactSet Research Systems Inc.

negative level. During September it rebounded somewhat, but still lower that its first quarter level.

In contrast, Efficiency has been relatively stable, although it has also been falling steadily, if slowly, since the end of February. It remains at a relatively high level, but noticeably lower than it has been over the past several years.

The current positioning of the Sentiment Framework implies a market that is modestly efficient, with few opportunities for easy relative gains from stock picking. Optimism, although somewhat improved recently, is in the context of a longer history still at a below neutral level, a place that implies modest pessimism and lower confidence.

Performance

For the month of September 2017, the LALCS Composite, on a net of fee basis, was up an estimated +1.33%, behind the S&P 500 Total Return Index, which was up +2.06%[1]. For the first nine months of 2017, the LALCS Composite has gained an estimated +12.17% as against +14.24%[1] for the S&P 500 Total Return Index.

The strategy spent the entire month invested in all sectors other than energy, which remained out of the portfolio. During September the energy sector, as represented by the XLE ETF, returned +10.18%[1] on a total return basis.

[1]Source: FactSet Research Systems Inc.

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. PAST PERFORMANCE OF THE STRATEGY AND THE LALCS COMPOSITE ARE NOT INDICATIVE, OR A GUARANTEE, OF FUTURE RESULTS. IT SHOULD NOT BE EXPECTED THAT THE STRATEGY'S ACTUAL RETURNS WILL REPLICATE THE RETURNS SHOWN IN THE PERFORMANCE MODEL.

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.

[1]Source: FactSet Research Systems Inc.

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