Lee Adaptive Strategies Update

Monthly Commentary

January 2018

The new vocabulary word for the month was "melt-up," referring to the idea that the equity markets might rise in an accelerating and uncontrolled manner. For those of us old enough to associate meltdown with its literal meaning, a catastrophic failure of a nuclear reactor's cooling system that results in the reactor overheating and destroying itself, the term melt-up is a bit confusing. It is the "melt" part that is scary, not the "down" bit. Then again, perhaps the unspoken implication is that a melt-up is not a good thing after all.

Experienced investors tend to think of capital markets as being neatly symmetrical. For every buyer there must be a seller and for every long there is a potential short. In this world view all would operate in the same way if multiplied by negative one. A fall of X% in a stock or the market looks and behaves just like a rise of X%, but in reverse. So if a meltdown is a bad thing, then maybe a melt-up would be one too?

At least with regard to the stock market, we do not believe in symmetry. Indeed, we think that believing in market symmetry is one of the great cognitive mistakes that investors can make. Up and down are not the same. People seldom buy in a panic. A margin call that forces a buy is quite rare. The math may be tidy and elegant, but to the humans involved, a loss of 20% is not merely a gain of 20% upside down.

Much real world market asymmetry can be explained by changing perceptions of market riskiness, what is often over-simplified as volatility. No investor likes uncertainty. A sharply and suddenly rising market is also a market that has increasing uncertainty and riskiness. That dampens the enthusiasm investors might otherwise have for rising prices, meaning that to a certain extent a fast rising market will naturally slow itself down.

Significantly, the obverse is not true. A suddenly falling market is, symmetrically, also a market of increasing uncertainty. But that increasing uncertainty is not a damper on price movements. It is an accelerant. As the market falls, perceptions of riskiness increase, encouraging investors to sell, causing the market to fall further. The analogy to a nuclear reactor destroying itself is not inappropriate.

So we are very skeptical of melt-up as a potential phenomenon. But there is one description of seller behavior that we would like to flip around and consider on the buying side: capitulation. This is the idea, beloved of deep value investors, that there comes a time when after a long series of bad news, the last true believer in a stock capitulates and sells. That is the point to buy. Not because the bad news will necessarily stop, but because the supply of sellers has been exhausted.

January seemed to be the month of capitulation buying into the equity markets. After a long string of good news, in particular the implausibly steadily rising markets themselves, more of the dwindling band of equity skeptics threw in the towel, gritted their teeth and joined the party.

[1]Source: FactSet Research Systems Inc.

We have written here before about how little joy and optimism has been associated with what, on paper, is arguably one of the great bull markets of our time. This is a market of unwilling participants, a market driven by investors who feel that equity is the least bad choice and by investors scared of missing out on the next round of inexplicable gains.

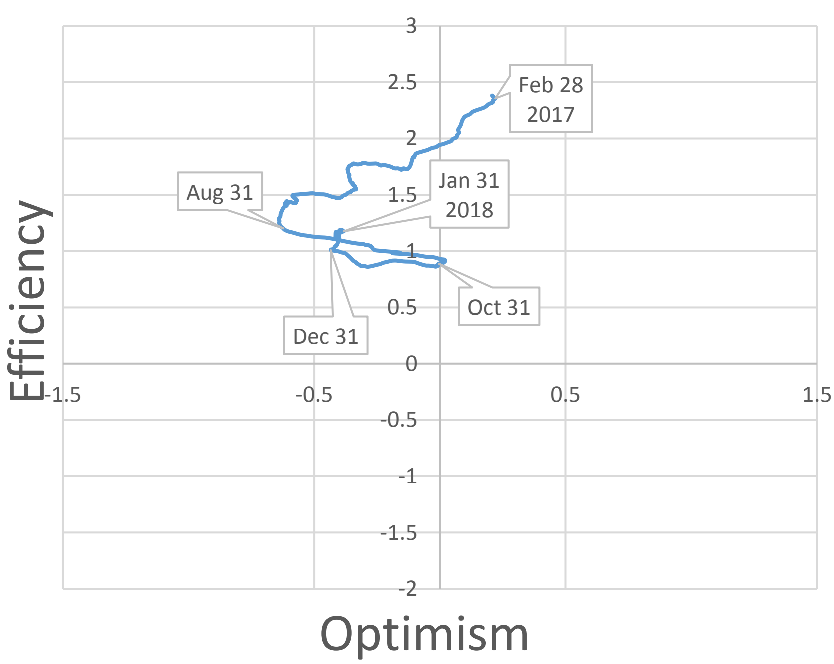
As the weeks and months pass and equity markets continue to combine a seemingly inexorable rise with historically low volatility, it becomes ever harder to make the case for other investments. Treasury bonds in particular had a rough January. This was generally ascribed to the usual suspects, e.g. a tightening Fed and inflation fears, but the bottom line is that equity is looking much more attractive than fixed income these days.

Of course Treasuries can be expected to have lower returns than equities. That is okay, the traditional argument goes, because Treasuries are so much less risky. But are they? Over the 13 months ended 1/31/2018, the SPDR S&P 500 ETF (SPY) had a realized volatility based on daily returns of 6.96%[1]. The iShares 20+ Year Treasury ETF (TLT) came in at 9.73%[1]. To be clear, we are pretty sure that a Treasury bond is safer than equity in the ways that matter, but the comparison is not as obvious as it once was.

The difficulty in using capitulation as an investment thesis is that as an event it is only obvious in hindsight. Months after the fact you can look back and point to the moment that the last possible seller sold or buyer bought. January could have been the month that the last hold out surrendered to the inevitable. Or it could have merely been another in a long series of months that saw a steady stream of white flags.

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



[1]Source: FactSet Research Systems Inc.

rewards. Higher levels of optimism imply a better outlook for risky asset classes. Optimism lost ground through much of the spring and summer of 2017, ending August at a modestly negative level. During September and October it rebounded, only to give up most of its advance over the remainder of the year. After almost no change in January, it remains at an average to modestly negative level.

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

The current positioning of the Sentiment Framework implies a market that is modestly efficient, with fewer opportunities for easy relative gains from stock picking. Optimism, although somewhat improved over its lowest levels of last summer, is in the context of a longer history still at a neutral level, a place that implies neither pessimism nor confidence.

Performance

Lee Adaptive Large Cap Sector ("LALCS")

For the month of January 2018, the LALCS composite, on a net of fee basis, was up an estimated +4.75%, behind the S&P 500, which was up +5.73%[1] on a total return basis.

The LALCS strategy spent the entire month invested in all ten sectors.

Lee Adaptive Global Equity ("LAGE")

For the month of January 2018, the LAGE composite, on a net of fee basis, was up an estimated +4.46%, behind the MSCI All Country World Index, which was up +5.66%[1] on a total return basis.

The LAGE strategy spent the entire month of January fully invested in all regions.

Lee Adaptive Global Allocation ("LAGA")

For the month of January 2018, the LAGA composite, on a net of fee basis, was up an estimated +2.91%, in line with the benchmark of 60% MSCI All Country World Index and 40% Barclays Capital Aggregate Bond Index, which was up +2.94%[1] on a total return basis.

The LAGA strategy continued to reduce its exposure to fixed income during the month, ending with an approximate weight of 27%, as against the fully invested level of 40%. Funds taken from fixed income were reallocated proportionately to the other equity sectors.

[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 "LALCS Strategy") that holds some combination of the U.S. large cap sector ETFs and/or cash, as determined by a proprietary quantitative model. The LALCS 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 a managed account 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 November 30, 2017 and (B.) certain accounts managed by LCM on a discretionary basis ("LALCS Managed Accounts"). LAS, LDOMF and the LALCS Managed Accounts all use the same investment program as the LALCS 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 LALCS 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 LALCS Strategy and, consequently, the results shown above may not be fully indicative of the actual performance results of the LALCS 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 LALCS STRATEGY'S ACTUAL RETURNS WILL REPLICATE THE RETURNS SHOWN IN THE PERFORMANCE MODEL.

Lee Adaptive Global Equity Composite ("LAGE Composite") Performance. A capital weighted performance composite of the of an investment strategy known as the Lee Adaptive Global Equity strategy (the "LAGE Strategy"). The LAGE Strategy is currently offered by LCM to certain qualified investors through certain accounts managed by LCM on a discretionary basis ("LAGE Managed Accounts"). The LAGE Managed Accounts use the same investment program as the LAGE Strategy. The LAGE Composite performance is based on actual trading profits/losses/expenses net of a management fee of 0.50%. Actual expenses of operating the LAGE Strategy may vary, depending on the investment structure in which the LAGE Strategy is used, which could result in lower returns than those stated for the LAGE Composite. Such expenses may detract materially from the performance of the LAGE Strategy and, consequently, the results shown above may not be fully indicative of the actual performance results of the LAGE Strategy.

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[1]Source: FactSet Research Systems Inc.

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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 LALCS Strategy will invest in any specific securities that comprise the index or that the investment program of the LALCS Strategy will track the index. Consequently, the returns of the LALCS Composite may or may not be highly correlated with those of the index.

MSCI All Country World Index. The returns for the MSCI All Country World Index ("ACWI") on a total return basis, that is, with dividends included and does not reflect the deduction of fees and expenses. The returns for the index are provided for comparison purposes only to show how the above composite returns compare to a broad-based index of securities. The MSCI AC World Index is composed of large and mid-capitalization developed and emerging market equities. The index is one of the most widely used benchmarks for global equity performance. You cannot invest directly in this index. It should not be assumed that the strategies above will invest in any specific securities that comprise the index or that the investment program of the strategies above will track the index. Consequently, the returns of the composites above may or may not be highly correlated with those of the index.

Bloomberg Barclays US Aggregate Bond Index. The returns for the Bloomberg Barclays US Aggregate Bond Index ("US Agg") on a total return basis, that is, with dividends included and does not reflect the deduction of fees and expenses. The returns for the index are provided for comparison purposes only to show how the above composite returns compare to a broad-based index of securities. The US Agg is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-

[1]Source: FactSet Research Systems Inc.

rate taxable bond market. The US Agg index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and non-agency). The index is one of the most widely used benchmarks for fixed income performance. You cannot invest directly in this index. It should not be assumed that the strategies above will invest in any specific securities that comprise the index or that the investment program of the strategies above will track the index. Consequently, the returns of the composites above may or may not be highly correlated with those of the index.

Blended Benchmark Is comprised of 60% ACWI and 40% the US Agg.

[1]Source: FactSet Research Systems Inc.