Lee Adaptive Large Cap Sector Update

Monthly Commentary

April 2017

April saw a modest rise in equity markets, with the S&P 500 up +1.03% on a total return basis, its sixth consecutive monthly gain. For the month, the Lee Adaptive Large Cap Sector Strategy Composite ("LALCS Composite"), on a net of fee basis, was up +0.89%. For more detail, please see the performance discussion below.

For the second month in a row, the markets were largely directionless, ending slightly above where they began. This could be interpreted as a sign of calm, that the market and the economy have settled into a quiet period of low-anxiety prosperity. Yet in the opinion of many investors, now is a time of high anxiety, of rising interest rates, of radical but inchoate tax reform, and of European disunion. To these observers the market's lack of movement is a sign of confused indecision, a deer frozen in the fear of oncoming headlights.

That other market participants are apparently unworried about the market, and may be lulled into a feeling of security by low volatility, only intensifies the anxiety of the pessimists. Unfounded optimism can evaporate suddenly, and if the optimism was widespread, bear markets can ensue.

A recent cause of considerable head-scratching, if not hand-wringing, has been the low level of the VIX, more properly called the CBOE Volatility Index, and often unhelpfully labelled the "fear index" by journalists. The VIX closed at a low of 10.36%[1] on April 27th, a level that, ominously, has not been sustained since the first quarter of 2007. (It has closed below 10.50% on just 45 of 6,886 days in its 27-year history[1].)

The VIX is widely misunderstood. It is not a direct measure of current market volatility, nor is it a particularly useful predictor of future volatility. It is a measure of the volatility that is implied by prices for S&P 500 index options, based on a set of reasonable mathematical assumptions that should not be taken literally. In as much as high prices for S&P 500 options imply a high demand for insurance against market losses, VIX is a fear index, although it bears pointing out that half the options used in the calculation are calls, meaning that the VIX is also based on the price of insurance against market gains.

Nevertheless, a very low VIX can be seen as a sign of investor complacency about market volatility, a belief that S&P 500 options are not worth buying because the S&P is not likely to do much of anything anytime soon. And compared to its own history, the current very low level of VIX does imply a widespread expectation of smooth sailing.

However, compared to the actual, experienced, market volatility, the VIX implies relative uneasiness rather than complacency. Based on a rolling 63-trading-day (i.e. three month) window, actual S&P 500 volatility ended April at 7.05%[1], well below the 10.82%[1] level of the VIX. A year ago those numbers were

14.62%[1] and 15.70%[1] respectively. The VIX is usually higher than experienced volatility, but the recent ratio between the two measures has been exceptional. Current VIX levels are not evidence that the options markets are naively assuming continued calm so much as evidence that they are discounting recent experience as an anomaly.

Anomalous or not, recent lows in actual volatility have been historic. The 63-day volatility of the S&P 500 hit a low of 6.43%[1] on April 11, a level last seen for about a week in October 1995. Prior to that, it had not been that low since January 1969.

Does this drop in volatility mean anything? Is it an indication of a permanent change in the nature of the market or merely random happenstance? Probably a little of both. Like relating the weather to climate change, it is hard to resist the natural tendency to extrapolate a small amount of recent data into a long-term trend. But the argument for a long-term trend can be made. Actual S&P 500 volatility this decade (i.e. since January 1, 2010) has been 15.26%[1], as against 22.23%[1]for the decade before.

Assuming that there is a secular decline in volatility, what could be driving it? It would be nice to imagine that investors have learned to reduce their overreactions to the news of the day. Or perhaps the economy has matured such that the earnings of public companies are more stable, which would lead to a greater stability in share prices.

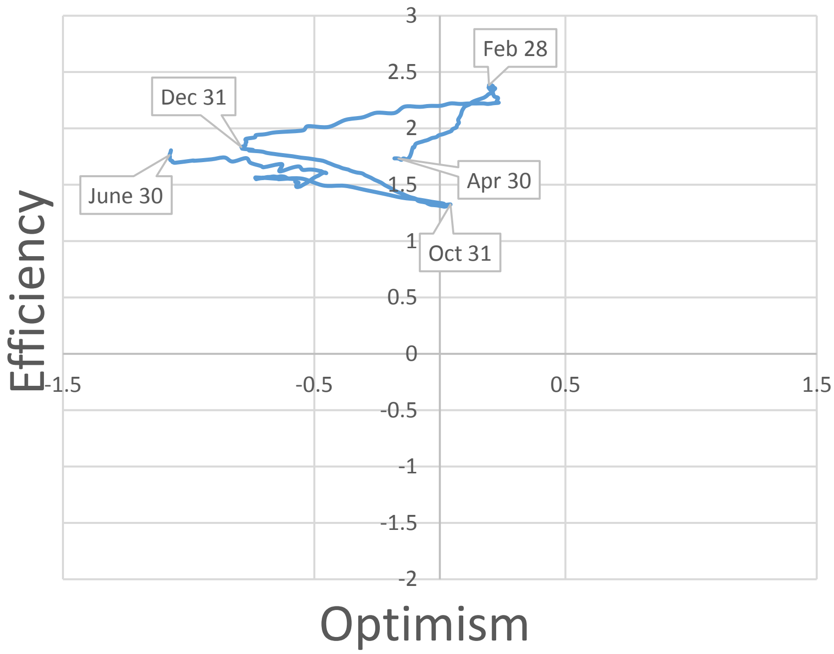
Or earnings of public companies might be more stable for a more subtle reason. A recent research note from Credit Suisse, "The Incredible Shrinking Universe of Stocks" highlights an under-reported long-term equity market trend. In 1996 there were 7,322 publicly listed companies in the US. By 2016 there were just 3,671 of them.

Where are all those missing companies? In a nutshell, they stayed private. The rate of delistings, due to M&A activity, bankruptcies, etc., has held fairly steady. But the rate of new listings, IPOs, has collapsed. Why this happened is an interesting question, and the Credit Suisse note provides some possible explanations. But the net result is that, in comparison to twenty years ago, today's public companies are larger, with earnings that represent 8.9% of GDP vs. 6.2% in 1996, and older, with an average age of 18.4 years vs. 12.2 in 1996. So the 2016 stock market might be more stable than it was in 1996 merely because it is made up of a more stable slice of corporate America.

Does this mean that the average investor can be less concerned about his equity investments than he was ten or twenty years ago? Probably not. The natural reaction to declining equity volatility for most investors is not to sleep better, but to increase the allocation to equity. Lower volatility makes equity more attractive, which increases its popularity, which further increases its value and size in investors' portfolios.

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 scores increased steadily through much of 2016, rising from significantly pessimistic levels during the winter of 2015-16, to neutral levels by October. On Halloween Optimism crossed, briefly, into positive territory for the first time in five years.

From the election in early November through the end of 2016, despite rising equity prices, Optimism fell steadily, retracing most of its gains since the summer. This trend then reversed in January and February, with Optimism once again crossing into positive territory at the end of January and increasing modestly above zero in February. March and April saw Optimism decline gently back into negative territory.

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 much improved relative to the past few years, is in the context of a longer history merely at a slightly above neutral level, a place that implies neither optimism nor pessimism, but possibly anxiety.

Performance

For the month of April 2017, the LALCS Composite, on a net of fee basis, was up +0.89%, in line with the S&P 500, which was up +1.03% on a total return basis. For the year to date, the LALCS Composite, net of fees, gained +6.30% as against +7.16% for the S&P 500 on a total return basis.

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

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 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. Both LDOF and LAS 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 0.50%. 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.

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S&P 500 Total Returns. 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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