



Lee Adaptive Large Cap Sector Update

Monthly Commentary

December 2016

Equity markets largely continued November's rally into December, as the S&P 500 gained +1.98%¹ on a total return basis for the month. Our Lee Adaptive Large Cap Sector Strategy Composite, on a net of fee basis ("LALCS Composite"), was in line at an estimated +1.99%. For more details, please see the performance discussion below.

If November made sense to you, then December was likely equally as reasonable. Post-election themes continued. Small caps did well and healthcare did poorly. Of course, every market rally is unique, but the movements of US Equity markets over the past two months have been particularly dominated by a limited set of themes: a rise in the dollar, an expectation of reduced financial regulation, predictions of higher inflation, and so on.

In general, markets go up because of an increased appetite for risk, an increase in courage due to an increase in optimism. But this recent rally does not have the feel of being driven by improving expectations. Rather, it seems almost as if the rise in the S&P was a mathematical happenstance, that the stocks being moved upward by the post-election themes merely happened to outnumber those being moved downwards by those same themes. Indeed, the argument could be made that many of the factors driving the market are actually evidence of increasing pessimism. Higher inflation expectations, falling long-term bond prices, a preference for low-growth industries over high-growth ones, and an increase in the value of the US dollar can all be seen as signs of a rising apprehension about the future, rather than a growing faith in it.

Last month we discussed our belief that the market tends to over-react. We also believe that it tends to over-predict. There can be no question that Donald Trump's election as president is a significant event. But how exactly that event will influence equity prices in the long run is largely unknowable. Even if the intentions and priorities of the incoming administration could be correctly divined, successfully forecasting what legislation will result after negotiations with a fractious Congress would be challenging. Then using that prediction to work out the impact on certain industries, or even particular companies, and investing on that forecast, is to assume an unlikely level of accuracy.

In its year-end issue *The Economist* called 2016 a "year of shocks" and it certainly was. But was it meaningfully more shocking than other years? Recent history always seems more eventful than the more distant past. By many objective measures, 2016 was unexceptional. Although there were certainly moments of excitement, market volatility overall in 2016 (as calculated from daily returns) was below the 25-year average and slightly lower than it was in 2015.

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¹ Source: FactSet®

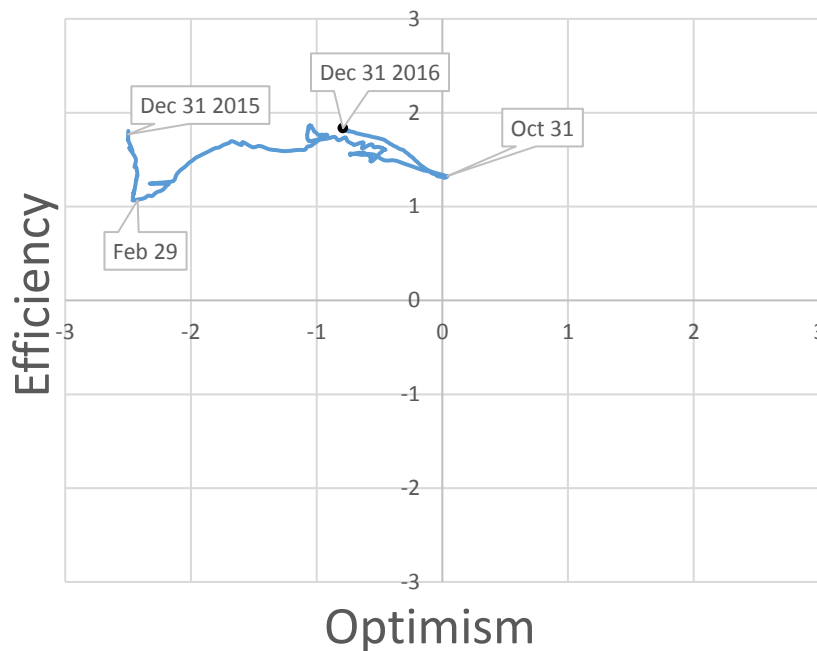
Moreover, when the dust settled the S&P 500 had gained a healthy +11.96%¹ for the year on a total returns basis. That is close to the average calendar year S&P 500 return since 1950 of +12.61%, further supporting the thesis that maybe 2016 was normal after all. On the other hand, near average annual returns are themselves fairly exceptional. The last time that a year's return fell within a percent of the average (that is, between +11.61% and +13.61%) was 1965. At the risk of stating the obvious, with annual returns that have ranged from -37% to +52% in the past, almost any yearly return for the S&P 500 could be considered normal.

And so on to 2017. There are reasons to be hopeful about the stock market. Consumer confidence is up. Holiday sales appear to have been strong. Corporate earnings are growing. And there are reasons to be fearful, most of them familiar. The Fed will continue to tighten. A higher dollar will be a challenge for exporters. The situation in Europe will not be improved by elections due in both France and Germany. And not to sound like a general fighting the last war, but the Case Shiller 20-City Home Price Index is now just 7% below its 2006 peak, something that is particularly worrisome in the context of rising long term rates.

We predict that 2017 will be, like the years before it, mostly unpredictable and occasionally shocking.

Sentiment Model

We use our Market Sentiment Model to adapt the mechanics and weightings of our full quantitative model to changing market conditions. The Sentiment Model 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.

The first two months of 2016 saw Optimism hold steady at strongly negative levels while Efficiency fell meaningfully. This was followed by a period of increasing values for both measures during March and April. May through October saw gradual if not steady improvements in Optimism. On Halloween Optimism crossed, briefly, into positive territory for the first time in five years.

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Since the election, and despite rising equity prices, Optimism has fallen steadily, retracing most of its gains since the summer. As discussed above, the recent rally has been led by comparatively defensive assets, suggesting a dimmer rather than brighter outlook of the future.

Except for a few days at the start of November, the Sentiment Model spent the entire of 2016 in the upper left quadrant of our chart, reflecting comparatively high Efficiency and comparatively low Optimism. This quadrant is arguably the most challenging of market environments for investors. High Efficiency suggests that asset selection strategies (“stock picking”) will be more difficult while low Optimism suggests that risky asset classes are less likely to gain in value.

Performance

As of the end of December the LALCS Composite, on a net of fee basis, was up an estimated +1.99% for the month, +3.32% for the quarter and +6.83% for the year versus the S&P 500 which was up +1.98%¹, +3.82%¹, and +11.96%¹ respectively on a total return basis.

The LALCS Composite was fully invested in equities the entire month. It ended November holding nine of ten possible sectors, adding the missing energy sector on December 14th. During the period in which it was not held, the SPDR Energy ETF (XLE) gained +2.47%¹, almost identical to the gain in the S&P 500, which was up +2.46%¹ over the same period.

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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 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 Lee Adaptive Large Cap Sector 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 Strategy are not expected to be highly correlated with those of the index.

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