Lee Adaptive Large Cap Sector Update

Monthly Commentary

February 2017

February saw a strong continuation of the rally that began shortly before the US elections. For the month, the S&P 500 was up +3.97%[1] on a total return basis. Our Lee Adaptive Large Cap Sector Composite (the "LALCS Composite"), on a net of fee basis, was up +3.67% during February. For more details, please see the performance discussion below.

It is a popular cliché that bull markets climb a wall of worry, that what appears in hindsight to have been a happy and inevitable rise in prices was at the time an anxiety-filled process of a cautiously improving outlook. In contrast, our present market seems to have a case of worry fatigue, transcending wall-of-worry status and entering what-me-worry territory.

The situation reminds us of a favorite scene from The Simpsons, in which the evil and self-absorbed Mr. Burns has a physical. The doctors discover that, although he suffers from a long list of serious maladies, because of a rare medical phenomenon they all cancel each other out. On hearing this Mr. Burns enters into a reverie about his invincibility and immortality, ignoring the doctor's protestations that merely the slightest breeze could upset the fragile equilibrium and kill him.

This market may be one of the best demonstrations of the power of momentum in recent memory. For four months, the economic and political outlook has only become murkier, bad news has dominated the good, and the market has risen anyway. Although there are plenty of worried doctors pointing out how fragile the rally is, they are apparently drowned out by the many Mr. Burnses who reason that if the market can go up through all this then it must be unstoppable.

We may be entering that most dangerous of market situations, when a sizable number of participants start to wonder if perhaps the old rules no longer apply. This danger was recently illustrated by CNBC when its panel of compulsive stock touts discussed the proposition that the best move was now to "just buy everything." (The segment is available on cnbc.com for those who wish to see it for themselves.)

The idea that stock picking is now hopeless, but that the market as a whole is a source of free money, dovetails nicely with a rather silly debate slowly making the rounds on the macro implications of passive investing. It began last summer with a surprisingly serious research note from AB Bernstein entitled "The Silent Road to Serfdom: Why Passive Investing is Worse Than Marxism."

In a nutshell, the argument is that an investor who invests in all companies will not want those companies to compete with each other, but rather would prefer them to maximize collective profit. Ultimately, if index investors control all public companies, we would have a situation akin to a centrally planned economy, in which all firms were run as if they were a single giant firm. Adding to the dismal nature of the theory is a prediction of an active management death-spiral. As the market becomes

[1] Source: FactSet®

dominated by index investors who buy (or sell) all stocks simultaneously, the return differences between stocks will decrease, making it even harder for the remaining active managers to be successful.

We are not sympathetic to this theory. To begin with, the active management death-spiral seems almost exactly wrong. Generally speaking, and this is a basic premise of our Efficiency Factor, as active participants in a market leave, that market gets more volatile and less liquid. In other words, the differences in returns between assets increase and there are more, not fewer, opportunities for the remaining active managers. (We also, it might be pointed out, see no shortage of active investing just now. Indeed, this is an active environment that is crowded and very competitive, making it hard to find profitable opportunities overlooked by others. Hence the "just buy everything" exasperation.)

Further, the premise that passive investors will control the companies that they invest in glosses over the reality of corporate governance. Although shareholders can, in principle, vote out managements that misbehave, in practice a CEO has little to fear on this count. What he or she might fear, and what commonly happens in the real world, is that unhappy shareholders will sell their holdings, depressing the stock price. So who would a CEO listen to, the active manager who wants the firm to compete aggressively with rivals and who will sell his shares if the firm does not, or the passive investor, who can sell his shares only if they are dropped from the index?

The nearly notional voting power held by shareholders has been in the news lately because of the imminent IPO of Snap, Inc., maker of the popular messaging and photo sharing app Snapchat. Its management has decided to remove even the notion of shareholder control, making the common shares they are selling to the public non-voting. As we understand it, management could decide that all profits (should there ever be any) will go to the CEO as compensation and the nominal owners of the company would have no recourse to object. At the high end of the IPO range, the firm, which lost $515M on $405M in revenue in 2016, would be valued at about $22B. As we write this, there are reports that the IPO offering is ten times over-subscribed. Perhaps the old rules are in trouble after all.

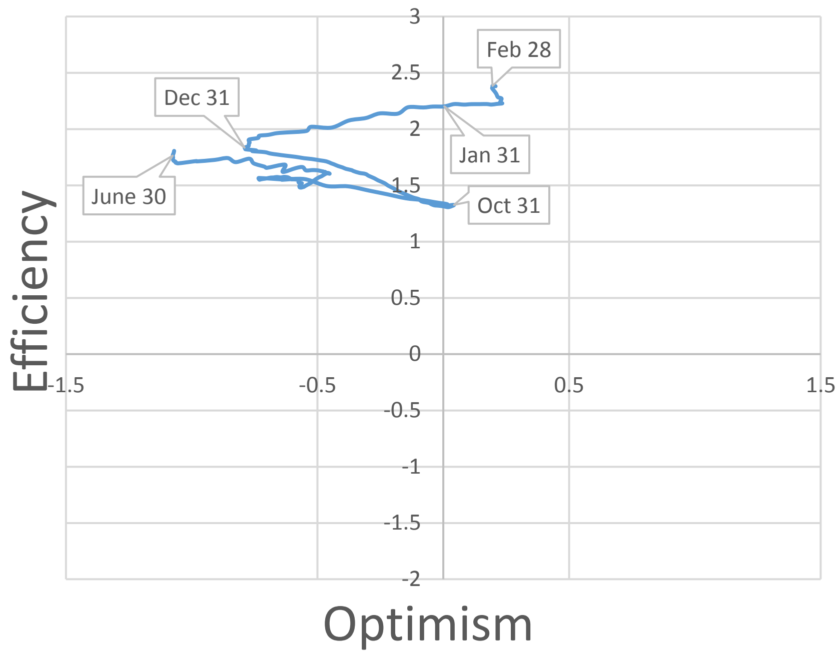
The Market Sentiment Framework

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.

[1] Source: FactSet®

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.



In contrast, Efficiency has been largely stable, maintaining its high level for nearly a year. The second half February saw a further, incremental, gain.

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 February 2017, the LALCS Composite, on a net of fee basis, was up +3.67% for the month. This was in line with the S&P 500, which was up +3.97% on a total return basis. For the year to date, the LALCS Composite gained +5.49% as against +5.95% for the S&P 500 on a total return basis.

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

PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS OR PROFITABILITY. Please read important definitions and disclaimers on pages 4 and 5.

[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 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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