Lee Adaptive Large Cap Sector Update

Monthly Commentary

January 2017

It was a bumpy ride, but January turned out to be another month of respectable gains for the S&P 500, which was up +1.90%[1] on a total return basis. Our Lee Adaptive Large Cap Sector Strategy Composite, on a net of fee basis, was up +1.76% for the month. For more details, please see the performance discussion below.

January brought a new President. A billionaire populist, he is a man of contradictions. Known for his hostility to immigration, he is the child and husband of immigrants and just the second US President not descended from a pre-revolution resident of the thirteen colonies. (Kennedy was the first.)

Similarly, ours is an equity market of contradictions. The emotional tenor of the past three months was dominated by anxiety and confusion. Lee Capital's Optimism score, which measures investors' faith in long-term prospects, what they are willing to pay for uncertain and distant rewards, took a sharp turn for the worse around the election and continued falling through the end of the year, only to sharply reverse again and fully recover in January.

A key driver for market emotions, and much else, was the new President himself. Thought to be pro-business in a general sense, his comments mentioning specific businesses and industries (e.g. Boeing, car makers, pharmaceuticals) seemed to be uniformly negative. And the early days of his administration showed that his radical positions on such things as trade and immigration were not mere campaign rhetoric and are not likely to be implemented with the light touch that businesses might hope for.

And yet, in the face of all this difficulty, the market rose. January was the third up month in a row for the S&P 500. Since Halloween, it has gained +7.18%[1]. This rally, inevitably if not ironically called the Trump Bump, has left many commentators bewildered and searching for a rational explanation of why American corporations, in spite of everything, might be worth one and a half trillion dollars more than they were ninety days ago.

In a related development, the Dow Jones Industrial Average had a rare day in the sun in January. Why that index is still followed and taken as seriously as it is is difficult to explain. It is hard to think of a single purpose for which the S&P 500 would not be more useful. Like Amtrak and the post office, the Dow seems to be kept going by some combination of inertia and nostalgia.

Nonetheless, on January 25, 2017, the venerable index crossed above 20,000 for the first time. That ought to have been a mildly gratifying milestone, similar to watching an odometer roll over. Instead, it was a moment of relief. The Dow had reached the absurdly tantalizing level of 19,999.63 during trading on January 6th. CNBC displayed "DOW 20,000" graphics in anticipation. Confetti was readied. And then it did not happen. In the days and weeks that followed, what had been a meaningless level for a widely

[1] Source: FactSet®

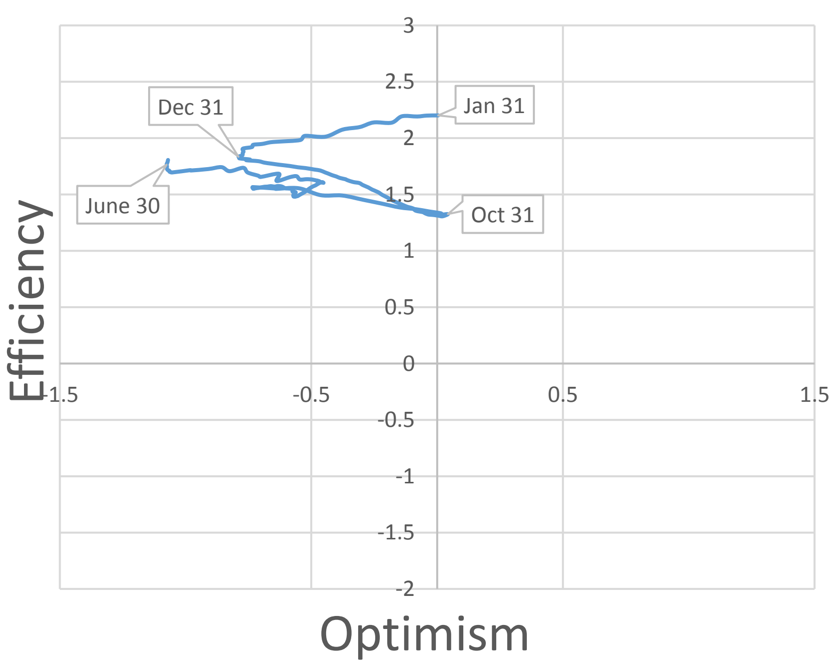
ignored index became an ominous barrier. Perhaps this was it. Perhaps the inexplicable rally at the end of a seven and half year bull market had finally topped out, poetically punishing those who arrogantly assumed a milestone was as good as reached. Thankfully, this particular anxiety turned out to be unfounded.

Meanwhile, another index, arguably a more useful one, quietly hit its own all-time high. The Case-Shiller National Index, which measures US single-family home prices, exceeded its 2007 peak with the November 2016 reading. (The index is quoted two months in arrears.) Of course, the Consumer Price Index has gained about 16% since 2007, so in real terms home prices are still below their peak. But then we do not usually use inflation to move the goalposts for the S&P or Dow, so why should we with houses?

Older readers may recall that in the few years following 2007 we experienced some financial and economic difficultly. At the time, this was partly blamed on an unsustainable and possibly irrational bubble in house prices. Residential real estate, it was thought, had appreciated beyond the range of economic rationality to a level that could only be explained by speculation. Having painfully corrected downwards, house price would not soon, if ever, rise again to such implausible heights.

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 was then

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[1] *Source: FactSet®*

reversed in January, with Optimism once again crossing, barely, into positive territory on the last day of the month.

In contrast, Efficiency has been relatively stable, at a high level, for nearly a year. It ended January at +2.2, its highest level since October of 2015.

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 neutral level, a place that implies neither optimism nor pessimism, but possibly anxiety.

Performance

For the month of January 2017, the Lee Adaptive Large Cap Sector Strategy composite, on a net of fee basis, was up +1.76% for the month. This was in line with the S&P 500, which was up +1.90%[1] on a total return basis.

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

[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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