Lee Adaptive Large Cap Sector Update

Monthly Commentary

August 2017

August brought modest gains in most markets, with the S&P 500 Total Return Index up +0.31%[1] for the month and +11.93%[1] for the year on a total return basis. Our Lee Adaptive Large Cap Sector Composite ("LALCS Composite"), on a net of fee basis, was up an estimated +0.45% in August and an estimated +10.70% year-to-date. For more detail, please see the performance discussion below.

At the opening bell on August 31st the S&P 500 was just inside negative territory for the month, but with what passes for a modest rally these days (and would in the past have been considered a quiet and mostly flat day) the index managed to finish the month in the green.

By our reckoning, that makes ten consecutive up months, tying the record set over December 1994 – September 1995. We seem to be nearly alone in this observation. Most media outlets, if they acknowledge a monthly gain streak at all, count just five months. The difference, of course, is this past March, when the S&P 500 gained slightly on a total return basis but lost a very modest amount on a price only basis.

We concede that to the literal minded, the S&P 500 Index, as displayed prominently on cable TV screens, ended trading on March 31 at a number that was 0.04% lower than where it ended the day on February 28, and that therefore it could be argued it went down that month. But in almost every context other than the results of a single day's trading, when the return of the S&P 500 is quoted it is usually quoted in total return terms, that is, including dividends. No self-respecting mutual fund manager would ever compare the returns of his fund to that of the price-only S&P 500.

It is possible that the lack of acknowledgement of the ten month streak is merely laziness or sloppiness on the part of market commentators. We are not so sure. It sounds like a reasonably good story in an environment with little else to comment on. And it is hard to believe that nobody has noticed.

There may be a reluctance to discuss it because of the happenstance that the streak began just before the election of President Trump. We know a few people who would, as a matter of principle, not want to ascribe any positive developments to this President's election. Moreover, even the President's supporters would have difficultly explaining what, exactly, he has done since the election that would have inspired a market like this.

Indeed, we believe the difficulty in finding a reasonable and non-frightening explanation for the streak is exactly why it goes undiscussed.

The cumulative return for the S&P over the ten months is +18.37%[1]. That is strong, but hardly extreme for the S&P. It is the steady nature of the gains over the period, which is to say the lack of volatility, that is remarkable. And lack of volatility in the market is a topic that has been widely discussed, although

[1]Source: FactSet Research Systems Inc.

often indirectly and generally with an unspecific sense of foreboding. We have yet to hear even a single brave soul make the bull case for low volatility, that we have now entered into a new era where market risk is permanently a half or even a third of its former level.

Conventional wisdom holds that "this time is different" is the most dangerous phrase in the stock market. And like much conventional wisdom, it is essentially true. To it we will add a corollary, that when the market really is different, this time it is dangerous.

There were two days of relative excitement in August, both losses of about -1.5%, both occasioned by revelations of an increased threat of mass destruction from North Korea. Is a reduction of 1.5% in the value of the S&P an appropriate pricing of the increased threat of nuclear Armageddon? The answer is that it is impossible to know. It is hard to project what the worst-case scenario with regard to North Korea actually is, and it is even harder to understand if the likelihood of that outcome has increased to 1% or to 0.001%. Any catastrophe coming out of North Korea would be completely unprecedented, thus it is hard to make rational judgements about the risk involved.

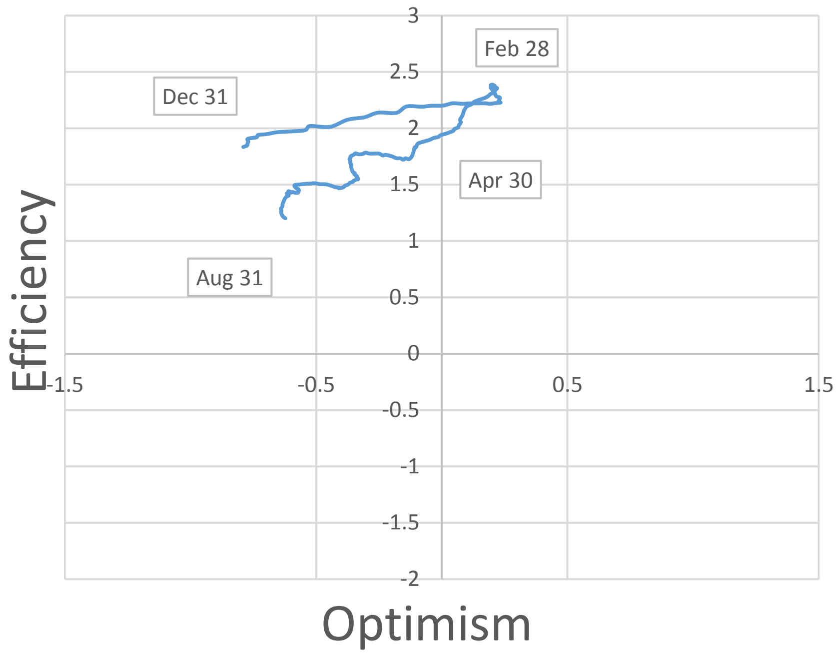
When bad news hits the market, the "price discovery" mechanism works by balancing out panicked sellers with calm headed buyers who know a bargain when they see one. The danger of unique and unprecedented bad news is that the higher level of uncertainty makes the case for panic seem more compelling, and contagious, while the calm calculations of the bargain hunters become more difficult. Different can be very dangerous.

We have already written here of our theory that the recent depression of market volatility is, essentially, the result of a speculative bubble on the short side of index options. Discounting the possibility that we have just witnessed a permanent downward shift in market volatility, this is a bubble that is bound to unwind at some point in the indefinite future. What will that unwinding look like? We do not know. Nothing like that has ever happened before. Which is exactly what worries us.

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.

[1]Source: FactSet Research Systems Inc.



After falling during the closing weeks of 2016, Optimism gained ground through the first two months of 2017. Since then it has more gradually retreated, giving up much of its gain for the year, to end August at a modestly negative level.

In contrast, Efficiency has been largely stable, although it has also been falling steadily, if slowly, since the end of February. It remains at a relatively high level.

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 somewhat improved relative to the past few years, is in the context of a longer history at a below neutral level, a place that implies modest pessimism and lower confidence.

Performance

For the month of August 2017, the LALCS Composite, on a net of fee basis, was up an estimated +0.45%, slightly ahead of the S&P 500 Total Return Index, which was up +0.31%[1]. For the first eight months of 2017, the LALCS Composite has gained an estimated +10.70% as against +11.93%[1] for the S&P 500 Total Return Index.

The strategy began the month fully invested in all sectors. However, on the second day of the month the energy sector was sold, with the proceeds distributed amongst the other sectors. From the 2nd to the end of August the energy sector, as represented by the XLE ETF, declined (5.11%), while the S&P 500 was unchanged on a total return basis over the same period.

[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 "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 (A.) 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 and (B.) certain accounts managed by LCM on a discretionary basis ("Managed Accounts"). LAS, LDOMF and the Managed Accounts all 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 0.55%. 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 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 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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[1]Source: FactSet Research Systems Inc.

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