Lee Adaptive Large Cap Sector Update

Monthly Commentary

October 2018

No Explanation Needed

October was considerably more exciting than most investors would have preferred. The S&P 500 lost 6.84% on a total return basis, its worst monthly showing in seven years. Non-US markets fared even worse, with the MSCI AC World ex-US declining -8.12%. And as dismal as those declines seem, they were considerably softened by a sharp rally over the final two days of the month. At the close on October 29th, the S&P had been down -9.27%. Had it ended there, October would have been the worst month since the very dark days of February 2009.

Whenever the market moves significantly investors and commentators hasten to supply explanations, a phenomenon that is only intensified if the move is particularly sharp and downward. At times, the flurry of suggested causes of October's declines seemed like the result of a brainstorming session. (No idea too crazy! Just shout them out and we'll write them all down on the whiteboard.)

There were what can fairly be called the usual suspects, rising interest rates and a trade war with China being the most prominent examples. These may be serious challenges, but they are undermined as explanations of the market's drop by the simple fact that they are so obvious and so widely recognized. Why did they have such a negative effect on the markets in October rather than in September or August?

Comparatively original was the explanation that corporate stock buybacks had been suspended during reporting season, thus depriving the market of an important tailwind. It is an interesting theory, but if true would be something that happens every three months. Why would it be particularly troublesome this time?

Explanations that did a better job of making the case that this time is different included arguments that we are now at an economic zenith and it can only be downhill from here. "Peak profits," "peak margins," and "peak GDP growth" all got some play in the media. There may be good reasons to expect some economic cooling in the near future, but the peak explanations seem a bit overly glass-half-empty to us. Sure, peak advocates argue, things are now better than ever before, and better than we expected, but that only means that they will have to return to normal, so this is actually bad news. Similar logic has many investors selling when the market hits new highs. And, as we have pointed out in the past, they are usually wrong to do so.

What may be our favorite market drop explanation came from a wire service on October 11th which attributed the loss that day partly to "systematic selling pressure from CTAs and risk parity funds on technical deterioration and volatility spike." It took us a while to translate this into English, but we are pretty sure it means "Some folks sold because volatility went up." And that is a perfectly rational reason to sell equity. Investing is the balancing of risk and reward and if an investor has revised his risk expectations upward it is only natural that he might reduce his exposure. But in the short run, selling because of a rise in volatility is often a euphemism. It is the rare investor with the stoicism to sell on upward spikes because of increased risk. Generally, selling on rising volatility means selling when the market goes down, just as selling on new highs means selling when it goes up.

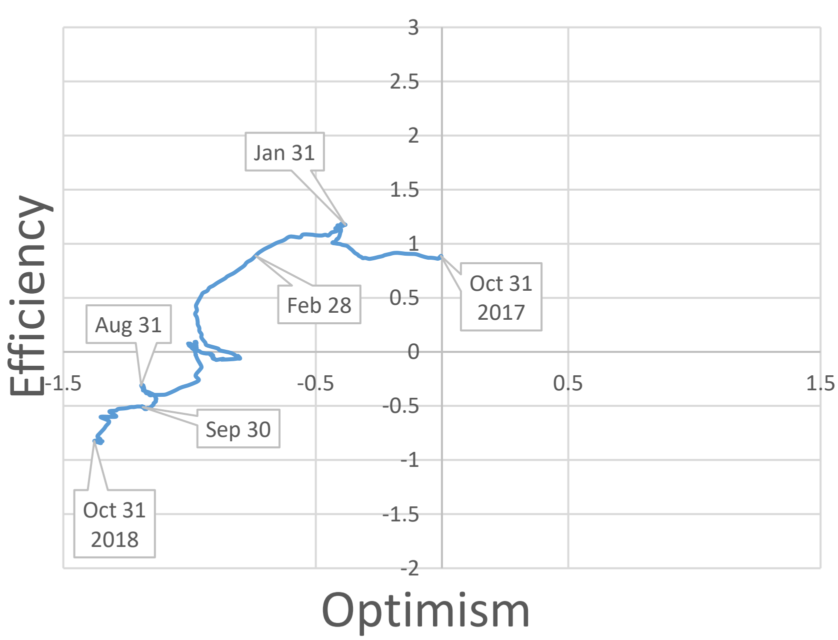
Years ago, we worked in a skyscraper with a sophisticated fire alarm. Among other features, there was a PA system that would allow building security to explain what was going on in detail. We always thought this ran counter to the basic goal of evacuating the building. If the fire alarm goes off without explanation, most sane people get up from their desks, walk down the stairs, and head for the nearest Starbucks. But if the alarm is accompanied by the information that there is a small grease fire in the cafeteria on the 12th floor, some otherwise sane folk will decide they are not in danger and continue working.

Thus our fear about plausible sounding explanations of market drops. Hearing, and believing, that the 5% drop on October 10th and 11th was in reaction to a specific and reasonable thing is reassuring to investors, particularly if that thing is unlikely to happen again. But perhaps it is too reassuring. Two day 5% drops are supposed to be scary. What is important to keep in mind is not why it happened, if there even is a why, but that it did happen and can easily happen again.

As regards US equity, we have not yet evacuated the building. Outside the US, on the other hand, we are currently enjoying a latte at Starbucks. As of this writing, both our global products have exited all non-US equity markets. It is too soon to tell if we will next hear the alarm in the US or the all clear outside the US. Either way, we will proceed calmly without further explanations needed.

The Market Sentiment Framework

We use our Market Sentiment Framework to adapt the mechanics and weightings of our full quantitative models 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.



Continuing the trend of most of 2018, both Optimism and Efficiency declined in the month of October.

Optimism is now -1.34. Although not an extreme reading, it was -2.00 as recently as Q1 2016, both the absolute level and the longer term trend are strongly negative.

After staying close to zero for most of the second quarter, Efficiency moved downwards during the third quarter, ending September at -0.51. It further fell during October, ending at -0.82. Having crossed over into negative territory in mid-April for the first time since September 2012, this measure remains at a low level when compared to recent history. This suggests a market that is coming under continuing stress and that is becoming less crowded.

Lower Efficiency is good news for value investors who are now more likely to find bargains produced by a less well-functioning marketplace. But it is bad news for momentum investors who now have a smaller crowd to get in front of. Moreover, it raises the danger that in a crisis there would be fewer calmer heads ready to provide liquidity.

The current positioning of the Sentiment Framework implies a market that tends to the inefficient, with moderate opportunities for relative gains from stock picking. Optimism, although not exceptionally low in absolute terms, has been showing a downward trend and is at a level that would suggest muted, if not negative, market returns.

Performance

Lee Adaptive Large Cap (US)

For the month of October 2018, the LALCS composite, on a net of fee basis, was down an estimated -6.38*%,* ahead of the S&P 500, which was down -6.84% on a total return basis. For the first ten months of 2018, LALCS is up +0.44% on a net of fee basis, trailing the S&P 500, which is up 3.01%.

The strategy ended September invested in all sectors other than Healthcare, which was then added to the portfolio on October 23rd. From September 30 to October 23, the Healthcare XLV ETF lost -5.13%, somewhat ahead of the S&P 500, which lost -5.85% over the same period. From October 23 to month-end, XLV lost a further -1.74%, somewhat behind the S&P, which lost -1.04%.

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 "LALCS Strategy") that holds some combination of the U.S. large cap sector ETFs and/or cash, as determined by a proprietary quantitative model. The LALCS 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 a managed account 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 November 30, 2017 and (B.) certain accounts managed by LCM on a discretionary basis ("LALCS Managed Accounts"). LAS, LDOMF and the LALCS Managed Accounts all use the same investment program as the LALCS 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 LALCS 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 LALCS Strategy and, consequently, the results shown above may not be fully indicative of the actual performance results of the LALCS Strategy.

The LALCS Composite is being shown for illustration purposes only and should not be relied upon. No representations or assurance is made that any investor will or is likely to achieve results comparable to those shown above or will make any profit or will be able to avoid incurring substantial losses.
PAST PERFORMANCE OF THE STRATEGY AND THE LALCS COMPOSITE ARE NOT INDICATIVE, OR A GUARANTEE, OF FUTURE RESULTS. IT SHOULD NOT BE EXPECTED THAT THE LALCS STRATEGY'S ACTUAL RETURNS WILL REPLICATE THE RETURNS SHOWN IN THE PERFORMANCE MODEL.

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 LALCS Strategy will invest in any specific securities that comprise the index or that the investment program of the LALCS Strategy will track the index. Consequently, the returns of the LALCS Composite may or may not be highly correlated with those of the index.

Disclaimer: