



Lee Adaptive Large Cap Sector Strategy Update

Monthly Commentary

November 2018

Crossing the Line into Cash

In the end, November 2018 was a month of solid gains, with the S&P 500 up 2.04%, the MSCI AC World up 1.51%, and the Bloomberg Barclays US Aggregate up 0.60%, all on a total return basis. Depending on your outlook and expectations, that could have been an encouraging result, a relief, or a disappointment. October's losses were not fully reversed, but after considerable excitement and volatility November did not, after all, make things worse.

The month saw our portfolios continue to de-risk into a defensive posture, generally including a meaningful cash allocation. Although we are not at the most defensive positioning possible, most of our portfolios are not 100% in cash, as of November 30 our allocations are consistent with the view that in many markets and sectors the risk of loss now outweighs the hope for gain.

The tipping point between invested and not invested is stark, but our reaching that point was a comparatively gradual process. The trends and factors that led us here have been building for months, if not years.

Both scores from our Market Sentiment Framework (see below) have been falling for some time. Efficiency, essentially a measure of the crowdedness and smooth functioning of the market, has reached multi-year lows. This indicates a market environment that is increasingly disorganized and irrational. Anecdotal evidence supports this. For example, near cult-like investment fads such as cryptocurrency and cannabis ETFs strike us as clear signs of creeping irrationality.

The now shattered faith in the magic five stocks known as FAANG is perhaps a more obvious example. As we wrote over the summer, the focus on this very short list of internet-oriented household names always struck us as a manifestation of fear rather than optimism. Investing in less obvious places took more courage than joining the crowd buying the special five. Inevitably, the mundane reality of the underlying businesses caught up with the stocks. Just as they led the market up for most of the year, they have led it down over the past few weeks. Now where are the fearful to invest?

On the other side of the Sentiment Framework is Optimism, which has been receding more or less steadily since last fall. That Optimism has been falling while the markets have been (mostly) gaining may appear to some as counter-intuitive. But there have been signs all year that investors were increasingly shying away from riskier investments and becoming more pessimistic in their longer-term outlook, even as they bid up broad market levels. Credit spreads (the difference between yields of the best and worst rated corporate bonds) have widened. Health care, often considered the least economically sensitive sector, has been the best performing in 2018. Materials and energy have been the worst.

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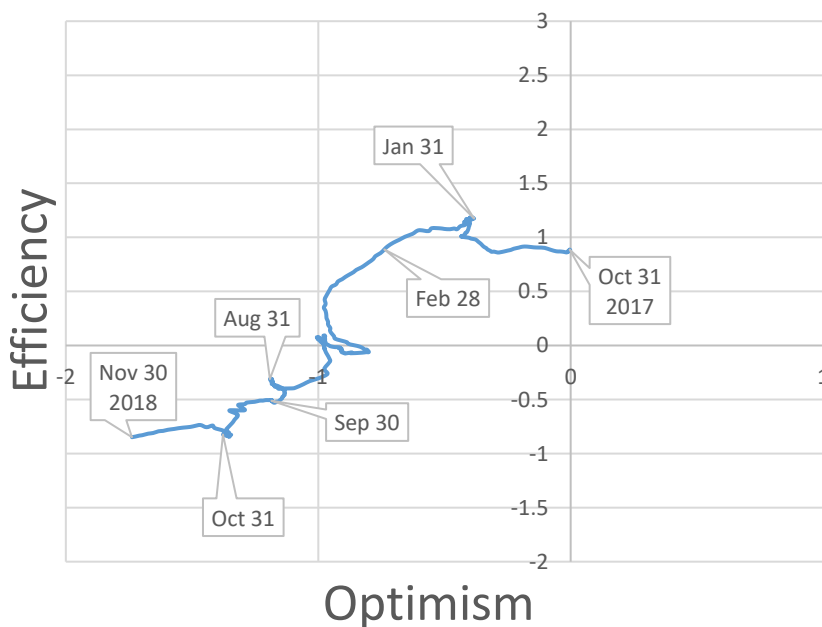
Bit by bit, fear has been gaining on greed. Why is this so? We are not sure there needs to be a good reason. A tightening Fed and a trade war with China are the popular explanations currently, but both are not only widely anticipated developments but are proceeding as predictably as if they were following a script. No, we believe the current malaise is fundamentally psychological. Market participants are suspicious of their own success, concerned that the easy gains of the past few years are unjustified and must be given back.

We have always thought that the term “market correction” was a delightful bit of euphemistic wishful thinking. Not only does it imply that there existed a specific error that led the market astray, but that the fix has now been made and we can get back to work. In reality, it is the rare investor who experiences a 10% decline and then breathes a sigh of relief that things can now return to normal.

Do we think that October was the beginning of a major bear market, similar to 2000-03 or 2007-09? Or is this a false alarm, similar to early 2016 and many other now forgotten passing storms? The honest and uncomfortable answer is that we do not know yet. We trade when the balance tips and we think an asset is more likely to go down or up, not when we become sure of which way it is going. Waiting for certainty can be a very expensive proposition.

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 November.

Optimism is now -1.74, down from -1.34 a month ago. Although not an

unprecedented reading, it was -2.00 as recently as Q1 2016, it is strongly negative and shows a sustained downward trend.

After staying close to zero for most of the second quarter, Efficiency moved downwards during the third quarter, ending September at -0.51. It fell further during October, and then a bit more in November,

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ending at -0.85. Having crossed over into negative territory this spring for the first time since 2012, Efficiency 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 and orderly.

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, something of particular concern in a low optimism environment.

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 and portfolio positioning

Lee Adaptive Large Cap Sector (LALCS)

For the month of November 2018, the LALCS composite, on a net of fee basis, was down an estimated -0.67% behind the S&P 500, which was up +2.04% on a total return basis. For the first eleven months of 2018, LALCS is down -0.24% on a net of fee basis, trailing the S&P 500, which is up 5.10% on a total return basis.

The strategy ended October fully invested in all 11 sectors. This continued until November 13th, when Healthcare was sold. On the 15th, both Consumer Staples and Communications Services were eliminated. On the 23rd, Consumer Discretionary and Financials went. And then finally on the 26th four more sectors, Technology, Industrials, Materials, and Real Estate were sold. This left the portfolio with just two sectors, Utilities and Energy.

Our portfolio construction rules call for cash positions when fewer than five sectors are held. When two are held, we allocate 60% of the portfolio to cash and 40% to those two sectors. Over the five trading days between adding cash to the portfolio and the end of November, the S&P 500 gained 4.91%.

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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.

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Lee Adaptive Global Equity Composite (“LAGE Composite”) Performance. A capital weighted performance composite of the of an investment strategy known as the Lee Adaptive Global Equity strategy (the “LAGE Strategy”). The LAGE Strategy is currently offered by LCM to certain qualified investors through certain accounts managed by LCM on a discretionary basis (“LAGE Managed Accounts”). The LAGE Managed Accounts use the same investment program as the LAGE Strategy. The LAGE Composite performance is based on actual trading profits/losses/expenses net of a management fee of 0.50%. Actual expenses of operating the LAGE Strategy may vary, depending on the investment structure in which the LAGE Strategy is used, which could result in lower returns than those stated for the LAGE Composite. Such expenses may detract materially from the performance of the LAGE Strategy and, consequently, the results shown above may not be fully indicative of the actual performance results of the LAGE 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

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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.

Morningstar US SA Tactical Average: Is the average return of a universe of Tactical Allocation portfolios that seek to provide capital appreciation and income by actively shifting allocations across investments. These portfolios have material shifts across equity regions, and bond sectors on a frequent basis. To qualify for the tactical allocation category, the fund must have minimum exposures of 10% in bonds and 20% in equity.

MSCI All Country World Index. The returns for the MSCI All Country World Index ("ACWI") on a total return basis, that is, with dividends included and does not reflect the deduction of fees and expenses. The returns for the index are provided for comparison purposes only to show how the above composite returns compare to a broad-based index of securities. The MSCI AC World Index is composed of large and mid-capitalization developed and emerging market equities. The index is one of the most widely used benchmarks for global equity performance. You cannot invest directly in this index. It should not be assumed that the strategies above will invest in any specific securities that comprise the index or that the investment program of the strategies above will track the index. Consequently, the returns of the composites above may or may not be highly correlated with those of the index.

Bloomberg Barclays US Aggregate Bond Index. The returns for the Bloomberg Barclays US Aggregate Bond Index ("US Agg") on a total return basis, that is, with dividends included and does not reflect the deduction of fees and expenses. The returns for the index are provided for comparison purposes only to show how the above composite returns compare to a broad-based index of securities. The US Agg is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The US Agg index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and non-agency). The index is one of the most widely used benchmarks for fixed income performance. You cannot invest directly in this index. It should not be assumed that the strategies above will invest in any specific securities that comprise the index or that the investment program of the strategies above will track the index. Consequently, the returns of the composites above may or may not be highly correlated with those of the index.

Blended Benchmark. Is a hypothetical index comprised of 60% MSCI AC World Index and 40% the Bloomberg BarCap US Aggregate Bond Index. You cannot invest directly in this index.

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