LEE CAPITAL MANAGEMENT

Lee Adaptive Strategies Update

Monthly Commentary

October 2019

The Year of the Unicorn

As the calendar makes the home turn towards The Holidays, our thoughts wander to trying to understand what 2019 was all about. Year-to-date equity returns are broadly impressive, but much of it was from the very start of the year, undoing a notably awful end to 2018. Most of this year has been a volatile drift in an approximately upwards direction, a pattern that is far from unique in history.

Obviously, there are still two months of 2019 to go. That is plenty of time for something significant and/or unforgettable to happen that will forever characterize the year. And it is hard to predict what will, in hindsight, seem significant about 2019 several years from now.

But we have a good candidate for what will be remembered about 2019, the high water mark of private equity. More specifically, we may have just seen the apogee of the large privately held tech, or tech-adjacent, companies sometimes called unicorns.

On Halloween the New York Times carried the headline "Lyft Focuses on Profitability as Cash-Burning Companies Lose Luster." We are hoping that the headline's author smirked as he or she typed it. But we are not quite sure how much irony was meant in the implication that until recently burning cash gave off an attractive glow.

Thoughtful investors have always understood there to be conflict between a theoretical, or in-principle, description of the stock market and its practical reality. The way equities would be explained to a child, and the way it was explained to us as children, is that a share of stock is a share in the ownership of a company. That company pays, or will someday pay, its owners a dividend from its profits. So a share of stock is worth the present value of all future dividends.

This explanation can be made somewhat more subtle with the adoption of the idea that there should be no difference to a shareholder if a company retains its earnings rather than distributing them as dividends. Thus, the value of a share is also the present value of all future earnings per share.

It would be unfair to call this view naïve. It is not wrong, exactly, and is probably the only credible justification for why shares ultimately have any value. But we all know it does not explain what goes on in the stock market. As a practical matter, unless you are holding a share for a very long time, the value you receive in the form of dividends, or virtually receive as retained earnings, is trivial compared to what you will receive on the day you sell the share. Thus, the truism that a stock, like any other commercial good, is worth only what somebody else is willing to pay for it.

This conflict between the theoretical and the practical is why the markets are so much less predictable, and so much more volatile, than children and economists expect them to be. The intelligent investor focuses not on what they themselves think a share is worth, but what they think others think it is worth. Or even on what they think others will think that others will think it is worth.

Of course, even the most cynical of investors does not believe that others value stocks based on a random whim. In general, most expect others to value stocks in a way that bears some resemblance to the present value of future profits. But there are exceptions.

For example, you might believe that what investors really like is a company with a vague but visionary plan to make great piles of money in the indefinite future, based on a nifty new product or service. Ideally, that product would involve technology and would appeal to the demographic that includes most fund managers. (E.g. Uber, Lyft, Tesla, Peloton, Netflix, Slack, Spotify, etc.) Having faith yourself in the long-term outlook of the company is preferred, but optional. The point is to invest in something you can sell later at a profit.

This has been a particularly effective approach within the private equity world. The number of decision makers in PE is, when compared to public equity, tiny. It is a small self-referential group dominated by those that have been most successful over the recent past, that is, the most optimistic and daring of the bunch.

The only problem is that, for a variety of reasons, eventually your nifty unicorn company will need to leave the private world and go public. This year has seen a herd of unicorn IPOs, each seemingly a little more disappointing than the last. And then there was WeWork.

For us, what makes the epic failure of WeWork's IPO a signal event is how exceptional the company was not. Yes, its relation to tech was particularly distant, but it had all the other trappings of a typical high-profile unicorn, including a visionary founder who expected to retain control forever, a too-cool-for-school product, and no profits.

And there was nothing uniquely troubling about it. There was no accounting scandal, no revelations of sexual harassment, no regulatory threats. In short, there was no reason to set WeWork aside as atypical and no reason to think that it would have a meaningfully different IPO experience than its predecessors.

And yet WeWork had what may be the biggest IPO failure in history. Public market investors took a good look at the deal and decided that the price being asked was off by at least an order of magnitude. We would find it difficult to explain to a child how a disagreement that large could be possible. Moreover, just as it was hard to differentiate the WeWork IPO from those before, it will be hard to differentiate it from those to come, meaning that WeWork has dire implications for other unicorns and the PE world in general.

It may be wildly premature to label 2019 as the year the PE party ended, but as of the start of November it certainly feels like the music has stopped. What will be the implications for the capital markets we generally care about, that is, the public ones? Again, too soon to tell. A diminishing of PE expectations could buoy public equity prices as institutions shift back from private to public. That is certainly possible.

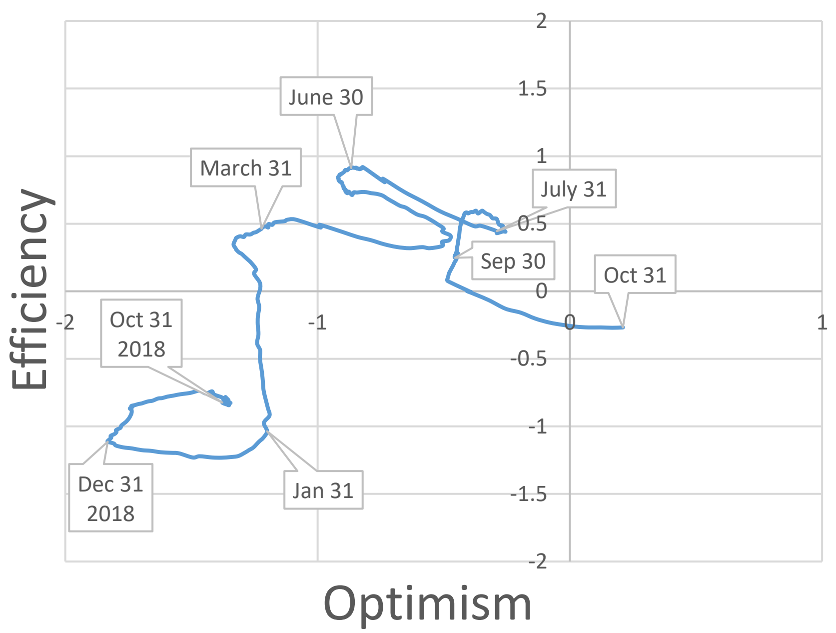
On the other hand, a collapse in unicorn valuations could lead to problems with the valuations of similar bellwether public companies. A downwards adjustment in the prices of certain high-multiple household names might be limited to just those names. Or perhaps not.

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.

After two months in which both measures barely moved, October saw Efficiency fall and Optimism rise.

Optimism had a strong spring, a back and forth summer, and now a positive fall. During October it crossed into positive territory for the first time since October 2017, going from -0.45 to 0.21.



Although just barely positive, Optimism is far above its levels of late 2018, implying a meaningfully more rosy outlook, or at a minimum a less pessimistic outlook, than we had a year ago.

Efficiency, on the other hand, declined during October, from 0.26 to -0.27. Although the trend is not distinct, the falling levels over the past four months do suggest a market quietly coming under more stress.

The current positioning of the Sentiment Framework implies a market that is still functioning fairly well but is less efficient than it could be, with moderate opportunities for relative gains from stock picking as well as from momentum. Optimism holds at a level that would suggest courage in market exposure.

Performance and Portfolio Positioning as of October 31, 2019:

Lee Adaptive Large Cap Sector (LALCS)

For the month, the LALCS composite, on a net of fee basis, was up an estimated +1.24%, behind the S&P 500, which was up +2.17% on a total return basis. The three month return for the LALCS composite, on a net of fee basis, was up an estimated +2.06%, behind the S&P 500, which was up +2.43% on a total return basis.

The strategy began and ended October holding all sectors and did not make any trades.

Lee Adaptive Broad Market Sector (LABMS)

For the month, the LABMS composite, on a net of fee basis, was up an estimated +1.38%, behind the Russell 3000, which was up +2.15% on a total return basis. The three month return for the LABMS composite, on a net of fee basis, was up an estimated +1.80%, just behind the Russell 3000, which was up +1.83% on a total return basis.

The strategy began and ended October holding all sectors and did not make any trades.

Lee Adaptive Global Equity (LAGES)

For the month, the LAGES composite, on a net of fee basis, gained an estimated +2.87%. This was just ahead of the MSCI All Country World Index, which gained +2.76% on a total return basis. The three month return for the LAGES composite, on a net of fee basis, was up an estimated +2.94%, ahead of the MSCI All Country World Index, which was up +2.53% on a total return basis.

Although the portfolio began and ended the month invested in all equity geographies with no cash in the portfolio, it did shift back towards US equity and away from non-US equity in the early part of October. Ending positions were approximately 48% US, 7% Japan, 11% Emerging Markets, 22% Europe, and 11% Asia ex-Japan.

Lee Adaptive Global Allocation (LAGAS)

For the month, the LAGAS composite, on a net of fee basis, gained an estimated +1.77%, in line with our blended benchmark, which was up +1.78% on a total return basis. The three month return for the LAGAS composite, on a net of fee basis, was up an estimated +2.20%, behind the blended benchmark, which was up +2.50% on a total return basis.

The strategy remained fully invested during October, although it did shift back towards US equity and away from the other asset classes at the start of the month. Fixed income ended the month somewhat overweighted, at 42%, while US equity was somewhat underweighted at 27%.

Lee Adaptive China (LACS)

For the month of October 2019, the LACS composite, on a net of fee basis, gained 3.48%. This was behind the MSCI China Index, which was up 4.04% on a total return Net US Dollar basis. For the three month return the LACS composite, on a net of fee basis, was up an estimated +1.18%, ahead of the MSCI China Index, which was down -0.34 on a total return Net US Dollar basis.

The portfolio began and ended the month fully invested in equity. It held 50% in KBA, the broad market A Shares ETF, 25% in TAO, the real estate ETF, and 25% in OBOR, the transportation infrastructure ETF.

PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS OR PROFITABILITY.

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 Composite performance is based on actual trading profits/losses/expenses net of a management fee of 0.50%. 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.

Lee Adaptive Broad Market Composite ("LABMS Composite"). A capital weighted performance composite of an investment strategy known as the Lee Adaptive Broad Market Strategy (the "LABMS Strategy") that holds some combination of the U.S. large cap sector ETFs, a small cap ETF and/or cash, as determined by a proprietary quantitative model. The LABMS Composite performance is based on actual trading profits/losses/expenses net of a management fee of 0.50%. Actual expenses of operating the LABMS 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 LAUSE Composite. Such expenses may detract materially from the performance of the LABMS Strategy and, consequently, the results shown above may not be fully indicative of the actual performance results of the LABMS Strategy.

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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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Lee Adaptive Global Allocation ("LAGA Composite"). A capital weighted performance composite of the of an investment strategy known as the Lee Adaptive Global Equity strategy (the "LAGA Strategy"). The LAGA Strategy is currently offered by LCM to certain qualified investors through certain accounts managed by LCM on a discretionary basis ("LAGA Managed Accounts"). The LAGA Managed Accounts use the same investment program as the LAGA Strategy. The LAGA Composite performance is based on actual trading profits/losses/expenses net of a management fee of 0.50%. Actual expenses of operating the LAGA Strategy may vary, depending on the investment structure in which the LAGA Strategy is used, which could result in lower returns than those stated for the LAGA Composite. Such expenses may detract materially from the performance of the LAGA Strategy and, consequently, the results shown above may not be fully indicative of the actual performance results of the LAGA Strategy.
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Lee Adaptive China Equity Composite ("LACS Composite") Performance. A capital weighted performance composite of the of an investment strategy known as the Lee Adaptive China strategy (the "LACS Strategy"). The LACS Strategy is currently offered by LCM to certain qualified investors through certain accounts managed by LCM on a discretionary basis ("LACS Managed Accounts"). The LACS Managed Accounts use the same investment program as the LACS Strategy. The Composite performance is based on actual trading profits/losses/expenses net of a management fee of 0.35%. Actual expenses of operating the LACS Strategy may vary, depending on the investment structure in which the LACS Strategy is used, which could result in lower returns than those stated for the LACS Composite. Such expenses may detract materially from the performance of the LACS Strategy and, consequently, the results shown above may not be fully indicative of the actual performance results of the LACS Strategy.

The LACS 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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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.

Russell 3000 Index. The Russell 3000 Index is a market-capitalization-weighted equity index maintained by FTSE Russell that seeks to be a benchmark of the entire U.S. stock market. It measures the performance of the 3,000 largest publicly held companies incorporated in America as measured by total market capitalization and represents approximately 98% of the American public equity market. The returns for the Russell 3000 index are provided for comparison purposes only to show how the LABMS Composite compares to a broad-based index of securities. The index is not subject to any of the fees or expenses to which the LABMS Composite is subject. It is not possible to invest in this index. It should not be assumed that the LABMS Strategy will invest in any specific securities that comprise the index or that the investment program of the LABMS Strategy will track the index. Consequently, the returns of the LABMS Composite may or may not be highly correlated with those of the index.

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.

MSCI China Index Net. The returns for the MSCI China Index Net on a total return basis, that is, with net dividend tax withholding 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 China Index represents large and mid-capitalization across H shares, B shares, Red chips, P chips and foreign listings (e.g. ADRs). With 495 constituents, the index covers about 85% of this China equity universe. Currently, the index also includes Large Cap A shares represented at 5% of their free float adjusted market capitalization**.** It should not be assumed that the LACS strategy will invest in any specific securities that comprise the index or that the investment program of the LACS strategy will track the index. Consequently, the returns of the composite 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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