Lee Adaptive Strategies Update

Monthly Commentary

September 2019

The Grim Repo

It is said that generals always fight the last war, that they concentrate their efforts on avoiding previous mistakes and, by implication, make new and different ones. We are not sure that is a fair description of military leaders in particular, but it is certainly a familiar phenomenon among decision makers in general.

Investors, for example, tend to obsess over the specific causes of the most recent market disaster, worrying that history will neatly and crudely repeat itself. And to an extent, bear markets do have common drivers, such as the tendency for investors to over-react to bad news. But many investors foolishly go beyond these truisms to focus on details unlikely to be repeated.

Certain as we are that, someday, there will be a nasty bear market similar to the one of 2007-09, we are just as certain that it will resemble the events of 2007-09 in only the broadest sense. This is not merely the belief that lightning is unlikely to hit the same spot twice. We believe that the markets, although imperfect, usually manage to learn the simplest and most painful lessons. No major bank or insurance company will again bet the house writing mortgage CDSs. The tragic mistakes of the next bear market will be new and different.

So we are not quite sure what to make of the troubles experienced in the repo markets during September. On the one hand, the events appear to be unprecedented and ominous. They involve great sums of money in a dark corner of the financial world that we are led to believe is as vital as it is arcane. News reports are full of quotes from experts doing their best to sound reassuring, while sheepishly admitting they are not quite sure what exactly is going on.

On the other hand, a repo crisis sounds an awful lot like the last war. Investors over the age of thirty will recall that the immediate and proximate cause of the Lehman Brothers bankruptcy was that firm's inability to finance itself in a deteriorating repo market. And then that bankruptcy spread havoc to the rest of the financial system using as its conduit repos and other bits of the money market. What are the chances that the next great meltdown will start in the same place?

Of course, the scale of the repo problems this past month and those of eleven years ago are radically different. As are their natures. In 2008 the problem was that certain repo collateral, e.g. mortgage backed bonds, became suspect, locking out some borrowers. This time the problem is (apparently) not enough cash available to lend, even to creditworthy borrowers and against ideal collateral. That may be no less serious a problem, but it is a different one.

We are less concerned about the actual events of the past month than about their implications. The crisis, if it can be called that, appears to have passed. The Fed, somewhat gracelessly, stepped in and provided what appears to be enough liquidity to allow the repo market to return to its normal watching-paint-dry level of excitement.

But how did this happen? On September 17 the Secured Overnight Financing Rate (SOFR) averaged 5.25%. At the same time, larger banks could borrow, unsecured, from the Fed at about 2%. That is as close to free money as you are going to find in finance, borrow at 2%, lend (very nearly) risk-free at 5.25%. Presumably some banks did just that. But not enough of them. The way this is supposed to work is that even a tiny spread between what you can borrow at and what you can lend at is pounced on, literally in seconds, and money keeps flowing until the spread is closed. Somehow, that did not happen on this particular Tuesday.

One explanation floated, and it is one that we think has a ring of truth, is that the banks were not really paying attention. It had been so long since a money-making opportunity like this had appeared that they were not ready to take advantage of it, or at least not on a few hours' notice. If true, this would imply that things should go better in the future as the banks have a strong monetary incentive to get it right next time.

But the implications for the markets of the not paying attention explanation are troubling. Until two weeks ago, the Fed was not in the habit of intervening in the repo markets precisely because it expected the banks to keep repo rates in line by borrowing and lending as necessary. Is the Fed making other reasonable assumptions that will not pan out in reality? It would not be the first time.

Running against the not paying attention explanation is the fact that this was not a one-day event. The Fed had to inject cash into the markets several times over the week that followed. Surely the banks would have caught on by Day 2 that there were easy profits to be made. (Admittedly much smaller ones after the 17th, but still of the no-cost zero-risk variety.)

The other popular explanation of the September repo problem is that it was the inevitable result of post-crisis bank regulation. Large systemically important banks now must hold much larger cash reserves than in the past, making them hoarders of liquidity rather than providers. Further, although they can borrow from the Fed, doing so further increases their required cash levels and brings increased scrutiny from a regulator focused on liquidity.

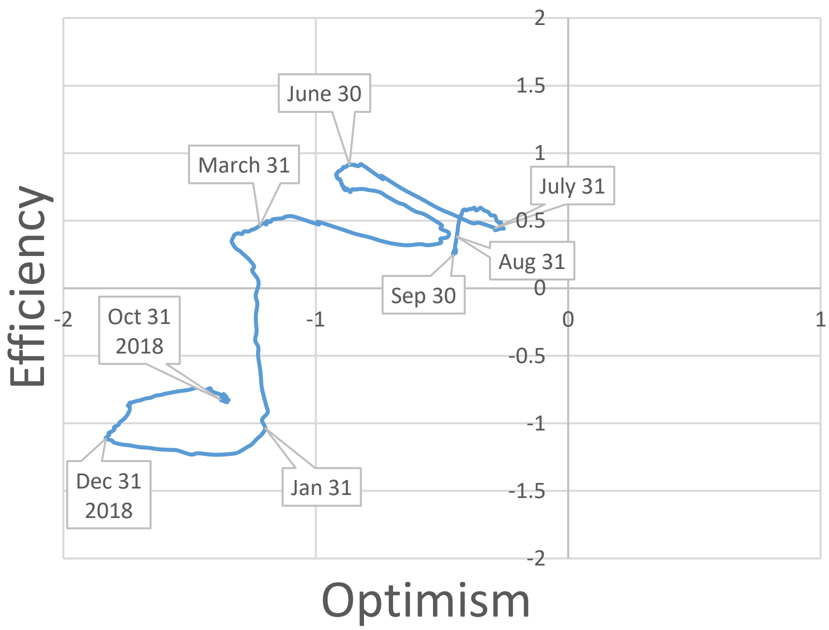
Further, it must be pointed out that in absolute terms the amount of free money available is small relative to the business risk. The profit from borrowing a billion dollars overnight at 2% and loaning it at 5.25% is about $125,000. Not a bad payday for pressing a few buttons on a computer, but not tremendously motivating for a large bank.

We do not expect that the repo market will be ground zero for the next bear market, if only because of the attention now being paid to it. But it is a near perfect example of the result of fighting the last war. In a thoughtful effort to increase the stability of the banking system, liquidity requirements for large banks was increased, something that would have been a great help in 2008. Alas, this is 2019.

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.

During September, as during August, both measures barely moved.



After a summer in which Optimism see-sawed, and an August in which it receded a bit from highs at the end of July, Optimism remained essentially unchanged in September at -0.45.

Although still slightly negative in absolute terms, implying a somewhat lower than average outlook, Optimism is still far above its levels of late 2018.

Efficiency also held steady during September, moving from 0.38 to 0.26. Over a longer time horizon, Efficiency is still much above the levels seen in January, which suggested a market under meaningful stress.

Middling levels of Efficiency, as we currently have, are neither good nor bad news for value and momentum investors, suggesting that some opportunities exist for both.

The current positioning of the Sentiment Framework implies a market that is functioning well but is still 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

Lee Adaptive Large Cap Sector (LALCS)

For the month of September 2019, the LALCS composite, on a net of fee basis, was up an estimated +2.11%, ahead of the S&P 500, which was up 1.87% on a total return basis. For the quarter ending September 30th the LALCS composite, on a net of fee basis, was up an estimated +2.24%, ahead of the S&P 500, which was up +1.70% on a total return basis.

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

Lee Adaptive Broad Market Sector (LABMS)

For the month of September 2019, the LABMS composite, on a net of fee basis, was up an estimated +2.10%, ahead of the Russell 3000, which was up +1.76% on a total return basis. For the quarter ending September 30th the LABMS composite, on a net of fee basis, was up an estimated +1.74%, ahead of the Russell 3000, which was up +1.16% on a total return basis.

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

Lee Adaptive Global Equity (LAGES)

For the month of September 2019, the LAGES composite gained an estimated +2.11%. This was in line with the MSCI All Country World Index, which gained +2.15% on a total return basis. For the quarter ending September 30th the LAGES composite, on a net of fee basis, was down an estimated -0.34%, behind the MSCI All Country World Index, which was up +0.10% 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 meaningfully away from US equity in favor of non-US equity. Ending positions were approximately 34% US, 9% Japan, 14% Emerging Markets, 28% Europe, and 14% Asia ex-Japan.

Lee Adaptive Global Allocation (LAGAS)

For the month of September 2019, the LAGAS composite, on a net of fee basis, gained an estimated +0.93%, just behind our blended benchmark, which was up +1.08% on a total return basis. For the quarter ending September 30th the LAGAS composite, on a net of fee basis, was up an estimated +0.12%, behind the blended benchmark which was up +1.00% on a total return basis.

The strategy remained fully invested during September, although it did shift away from US equity in favor of the other asset classes. Fixed income ended the month overweighted, at 52%, while US equity was significantly underweighted at 16%.

Lee Adaptive China (LACS)

For the month of September 2019, the LACS composite was up an estimated +1.11% ahead of the MSCI China Index, which was down -0.03% on a total return Net US Dollar basis. For the quarter ending September 30th the LACS composite, on a net of fee basis, was down an estimated -3.67%, ahead of the MSCI China Index, which was down -4.74% 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, and 25% in TAO, the real estate ETF. In mid-September it sold a 25% position in PGJ, the US-listed (or N Share) ETF, in favor of OBOR, the transportation infrastructure ETF.

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 0.55%. 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.

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 0.55%. 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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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.

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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