Lee Adaptive Strategies Update

Monthly Commentary

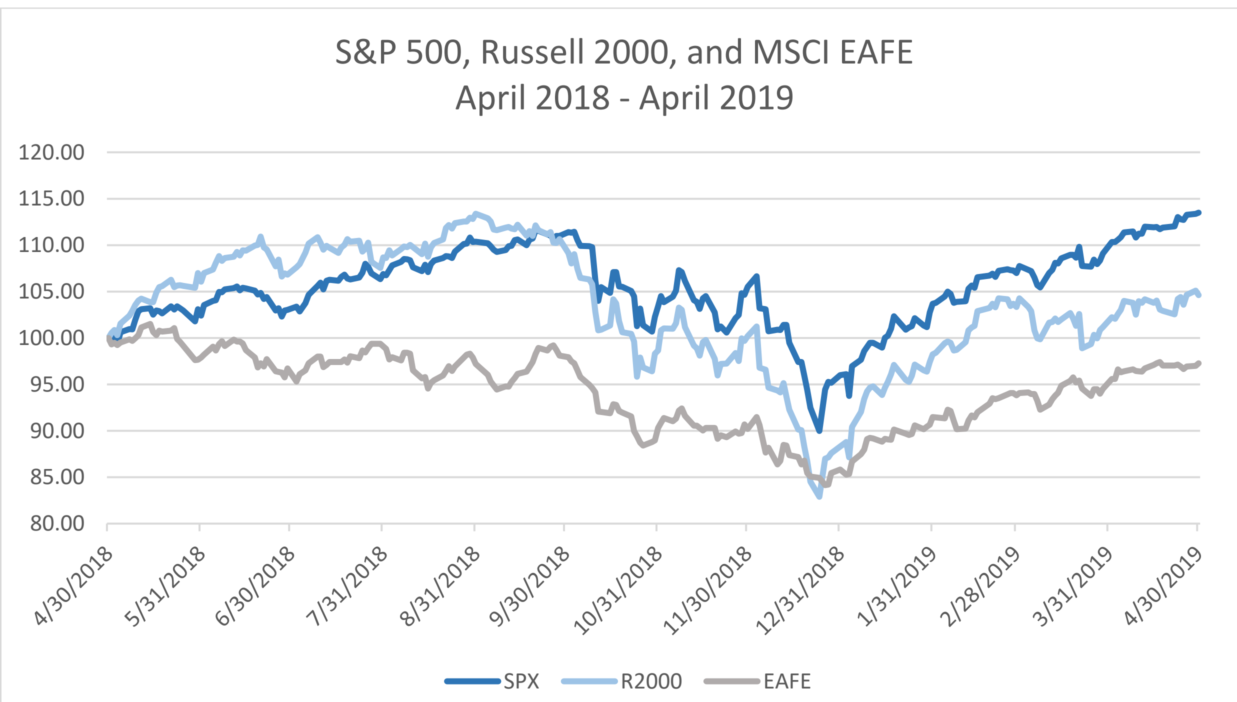
April 2019

The S&P Returns

April was a good month. The S&P 500 was up 4.05% on a total return basis. For the year to date, the index has now gained an impressive 18.25%. With only minor fanfare, new all-time highs were achieved in the last week of April. The plunging equity markets of Q4 2018, if not now forgotten, have been apparently made up for. With the benefit of hindsight, many investors are now wondering what they were so scared of a few months ago.

Of course, the feeling that the market has now recovered completely from an unfortunate episode betrays a certain hometown and large-cap bias. The S&P 500 has hit new highs. Many other indexes have not.

For example, US small cap stocks, as measured by the Russell 2000, have not fared as well. That index has risen alongside the S&P so far in 2019 (up 18.48% vs 18.25%) but gave up much more in Q4 2018 (-20.20% vs -13.52%) and so is still well short of its high. For the twelve-month period ending April 30, it lags the S&P 4.61% to 13.49%.



Source: Factset

MSCI EAFE, the non-US developed world counterpart to the S&P 500, has suffered even more. It is up 13.33% over the first four months of 2019 in dollar terms, trailing the S&P by nearly 5%. It did lose less in late 2018, but it also failed to participate in the US rally earlier in that year. On a twelve-month basis it is down -2.73%.

For what seems like years, thoughtful market observers have been warning that market gains were narrow, and for what seems like years they have only gotten narrower. And it is narrow on many levels. Not all broad equity indexes have rallied together. Within the successful indexes not all sectors have done well and within the sectors only a handful of stocks have prospered.

At the pinnacle of the narrow pyramid of investments are a very small handful of stocks known to friend and foe as FAANG: Facebook, Amazon, Apple, Netflix, and Alphabet (i.e. Google.) They are up year-to-date 47.53%, 28.27%, 27.76%, 38.44%, and 14.76% respectively.

There is little to say about the FAANG phenomenon that has not been said many times already. (Including in our own July 2018 Commentary.) There is a consensus that this much concentration of value in such a short and undiversified list of companies cannot be a good thing. On the other hand, this kind of concentration has never happened before, so predictions about what happens next are more speculative than usual.

If you believe that the continuous ascent of the FAANG stocks is due to their evident value as near-invincible world-conquering organizations, then you might be fairly sanguine about the future, although even the most enthusiastic fan must believe that there exists some upper limit to their valuations. On the other hand, if you, like us, see the narrowing of the market into a shorter and shorter list of names as a sign that investors are finding it progressively harder to find acceptable investments, then it is hard not to worry.

A not unrelated development in 2019 is a parade of high-profile IPOs, including the much anticipated debuts of ride sharing services Lyft and Uber. Again, as with FAANG, your level of enthusiasm for these companies will color your opinion of the IPO wave. If you are a true believer, you are excited that, finally, ordinary folks can invest in these exciting businesses which until now were being hoarded by private equity firms.

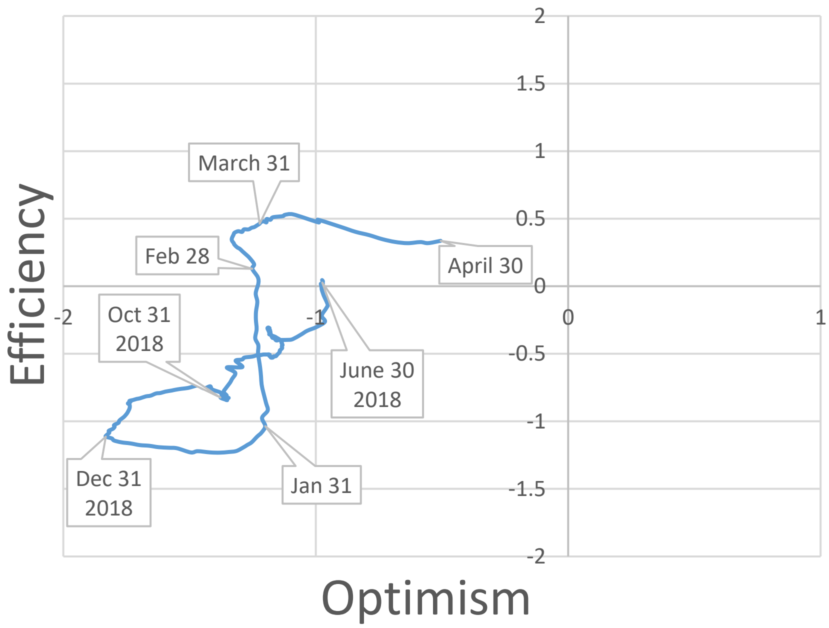
But a non-believer might ask why the private equity firms, who are, we assume, reasonably astute investors, have decided to sell their stakes now. It is not because they anticipate higher prices in 2020. This is not to say that the market will definitely be lower a year from now, only that even a private equity investor clever enough to invest in Uber can get scared. Particularly if, for example, the market experiences a sudden 13% drop over a few weeks.

Now that the S&P has completed its seven month roundtrip, it is time to consider what we public equity investors have learned from the experience. One conclusion, and we think it is the wrong one, is that drawdowns such as what we experienced in Q4 2018 should be ignored. The market is resilient and will naturally heal such unfortunate mistakes. Just fasten your seatbelts and ride it out.

We disagree. To us, the lesson to draw is not about market resiliency but market fragility. Yes, the losses of late last year were largely counterbalanced by gains early this year. And it may even be true that sudden multi-month drawdowns are often followed by gains. But, and we do not need to go far back in history to demonstrate this, they are not always followed by gains. Sometimes they are followed by additional and accelerating losses.

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.



In contrast to March, when Efficiency rose and Optimism held steady, during April Optimism rose while Efficiency was largely flat.

After two months in which Optimism stayed within a narrow band, April saw it rise markedly, from -1.22 to -0.51.

Although still negative in absolute terms, implying a somewhat lower than average outlook, Optimism has now made a significant recovery from its notably low levels of year-end.

Efficiency gave up a little ground, going from 0.45 to 0.34 during April. Over a somewhat longer time horizon, Efficiency has improved quite considerably from 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 less efficient than it could be, with moderate opportunities for relative gains from stock picking as well as from momentum. Optimism has now risen to a level that would suggest courage in market exposure.

Performance

Lee Adaptive Large Cap (LALCS)

For the month of April 2019, the LALCS composite, on a net of fee basis, was up an estimated +3.33%, behind the S&P 500, which was up +4.05% on a total return basis.

The strategy began and ended April holding 10 of 11 sectors, missing only Communications Services. As that sector, as represented by the XLC ETF, gained 7.04% during April, ahead of the S&P 500, not owning it detracted from performance.

Lee Adaptive Broad Market (LABMS)

For the month of April 2019, the LABMS composite, on a net of fee basis, was up an estimated +3.32%, behind the S&P 500, which was up +4.05% on a total return basis.

The strategy began and ended April holding 11 of 12 sectors, missing only Communications Services. As that sector, as represented by the XLC ETF, gained 7.04% during April, ahead of the S&P 500, not owning it detracted from performance.

Lee Adaptive Global Equity (LAGE)

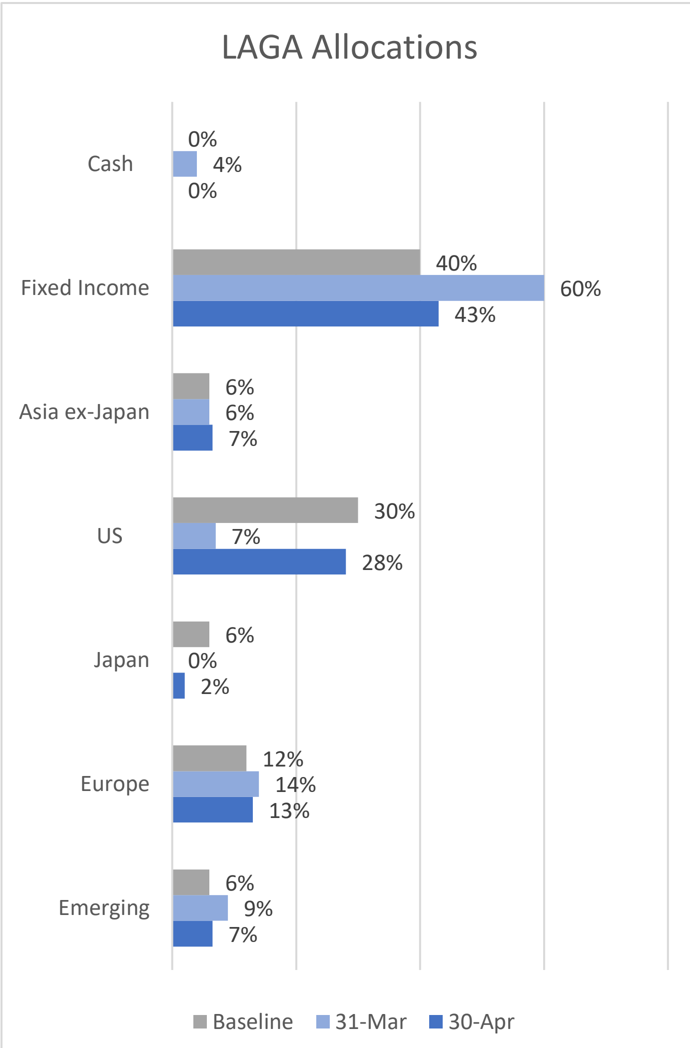
For the month of April 2019, the LAGE composite, on a net of fee basis, gained an estimated +2.65%. This was behind the MSCI All Country World Index, which was up +3.43% on a total return basis.

The portfolio began the month defensively positioned, with 31% in cash, and ended the month fully invested in equity, with no cash holding.

US Equity began the month at 15% and was increased during the month to 50%, its normal weighting. Emerging Markets was reduced somewhat from its maximum holding of 15% to 11%. Europe was reduced from 29% to 23%. Asia ex-Japan held steady at 11%. Japan remained comparatively negative, starting the month unowned and ending it at just a 5% position.

Lee Adaptive Global Allocation (LAGA)

For the month of April 2019, the LAGA composite, on a net of fee basis, was up an estimated +1.27%, behind our blended benchmark, which was up +2.07% on a total return basis.



The strategy began the month with 4% cash and 60% in fixed income. During April it scaled back fixed income to 43% and reduced cash to zero.

US Equity was the primary beneficiary of the shift out of fixed income and cash, as it went from 7% to a 28% allocation during April.

Other asset classes held steady for the month. Japan was increased from zero to 2%.

Overall, the portfolio is now near its normal weightings in all assets. This reflects a meaningful shift away from the defensive positioning the portfolio took in recent months.

PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS OR PROFITABILIT

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.

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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.

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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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