Lee Adaptive Strategies Update

Monthly Commentary

December 2017

2017 was a very good year. It may not have felt like it at the time, and in the bitter cold of January 2018 may still not feel like it, but 2017 was what equity investors hope for, the kind of occasional outcome that justifies being an equity investor. With the S&P 500 Total Return Index up +1.11%[1] for the month, December was a fitting finish to a year that saw SPXTR rise +21.83%[1].

Low Volatility

It was a year dominated by a handful of themes, chief among them the historically low volatility of the market. While an annual gain north of 20% is satisfying, it is hardly a rarity. 2013 and 2009 both clocked higher returns than 2017. But 2017 was not just a good year, but a very good, or a great, or, dare we suggest, the greatest year, was its stunning lack of volatility. It was a best-case scenario that nobody had dared to hope for: A slow and steady gain in prices all year long.

By just about any measure, on a relative to volatility basis (which implies a relative to risk basis) 2017 was one of the best years on record. To take a simple if not entirely scientific measure of volatility, the S&P gained or lost more than 1% on just 8 days in 2017. In 2013 it did it on 38 occasions and in 2009 it happened no fewer than 117 times. Certainly, eight 1% days in a year is not entirely unprecedented, it last happened in 1965, but the average annual count since 1928 is 60.

In June we devoted a monthly commentary to the low volatility phenomenon and expressed the worry that it was a result of an over-popularity of shorting the VIX, that is, of writing options on the S&P index. That possible situation, and what might happen were it to suddenly unwind, still worries us. But as an explanation of why volatility was so low in 2017 it falls short. Index options have been available, and have on average been profitable to write, for decades.

Bitcoin

There are those who call themselves investors but are actually gamblers, seeking rather than avoiding risk. With equity markets so dull in 2017, where were these players to find some action? In Bitcoin, of course. Not only was it satisfyingly volatile, there was the added thrill of primitive markets and the always present danger that your holdings might be stolen by hackers.

There is little to be said about Bitcoin that is not already a cliché. Indeed, what is most remarkable about the Bitcoin phenomenon is how so many people can so blissfully ignore the obvious similarities between it and any number of speculative bubbles from the past. It is the “this time is different” folly writ very large.

We think that this can partially be explained by the dominance of non-finance people, and in particular technology people, in the Bitcoin world. Earlier in the year there was considerable attention to

[1]Source: FactSet Research Systems Inc.

management problems within certain otherwise successful tech companies, Uber in particular. The corporate culture at Uber, and we assume many similar places, is one that values challenging assumptions, ignoring rules, and, as necessary, reinventing institutions. The motto might be “just because it’s always been done this way, it doesn’t mean it’s the best way.” That helped Uber reinvent the taxicab, but it also led it to very expensively discover that boring old corporate traditions like HR departments were a good idea after all.

And so it is with Bitcoin. If you start with the premise that the government issued money that mankind has been making do with for the past few millennia could use a rethink, then you are much less likely to take seriously the lessons of tulip bulbs, sub-prime mortgage CMOs, and everything in between.

The T** Rally**

It is true that successful years like 2017 are best appreciated in hindsight. Rising markets are said to climb a wall of worry, meaning that they are typically times of stress and anxiety rather than joy. Still, our recollection is that when the Champagne was popped at the end of 2013 there was more rejoicing than now. And there was even more at the end of 2009, although admittedly the joy that year had a passing-freighter-spots-lifeboat aspect to it.

The tenor of this market is not confidence nor optimism but foreboding, guilt, and a stubborn refusal to admit that these are the best of times. Why is this? The widespread feeling (and it is largely emotional) that the market is over-valued undoubtedly plays a big role, but that sentiment has been a common one throughout all rallies, celebrated or not.

Another reason why market participants, particularly the subset that are likely to write commentaries, are reluctant to acknowledge the strength of the stock market is the positive association that might then devolve on the current resident of the White House. After all, this rally began almost exactly on the day That Man was elected. (In fact, it began the day before, when the world assumed he would lose badly and the S&P ran up +2.22%[1].) Imagine the shame in acknowledging a golden era that coincided with his presidency, or worse yet, admitting to have profited from it.

But there were good reasons for equity investors to be encouraged in 2017 that have nothing to do with politics. The US economy continues to expand nicely, and continues to somehow avoid an uptick in inflation. Corporate profits rose faster in 2017 than in any year since 2011, something particularly impressive so late into an expansion. And the quiet prosperity has been uniquely global. All 45 OECD members are expected to post GDP gains for 2017, something that has not happened in a decade.

Tax Reform

Perhaps the only meaningful surprise to come out of Washington in 2017 was the passage of a bill that could, just plausibly, be called tax reform. Nearly all the proposals that would have been more appropriately labelled reform, that is, actual rule changes such as doing away with the deduction for mortgage interest, eliminating the Alternative Minimum Tax for individuals, forcing investors to use FIFO on tax lots, etc., wound up on the cutting room floor. In the end, the new law largely maintained the existing structure with changes to some numbers. We still have seven individual tax brackets, but the rates are lower and they start at higher income levels. Local taxes are still deductible, but with a cap, and so on.

[1]Source: FactSet Research Systems Inc.

So the Great Tax Reform of 2017 became the Pretty Decent Sized Tax Cut of 2017. In at least one respect, however, the tax bill is significant, and particularly to equity investors. It contains a meaningful reduction in corporate taxes. Corporate taxes may not be that important to the overall economy, they raise about a tenth of what the government gets from individuals, but they mean a lot for corporate profits, and corporate profits are thought to be important for stocks.

In mid-December Bloomberg surveyed Wall Street strategists on how much higher they thought the S&P 500 profits in 2018 would be due to the tax cut. The seven (of 12) that gave an answer averaged 8.8%. The naïve investor might argue that, everything else equal, the S&P 500 should be up 8.8% on this news.

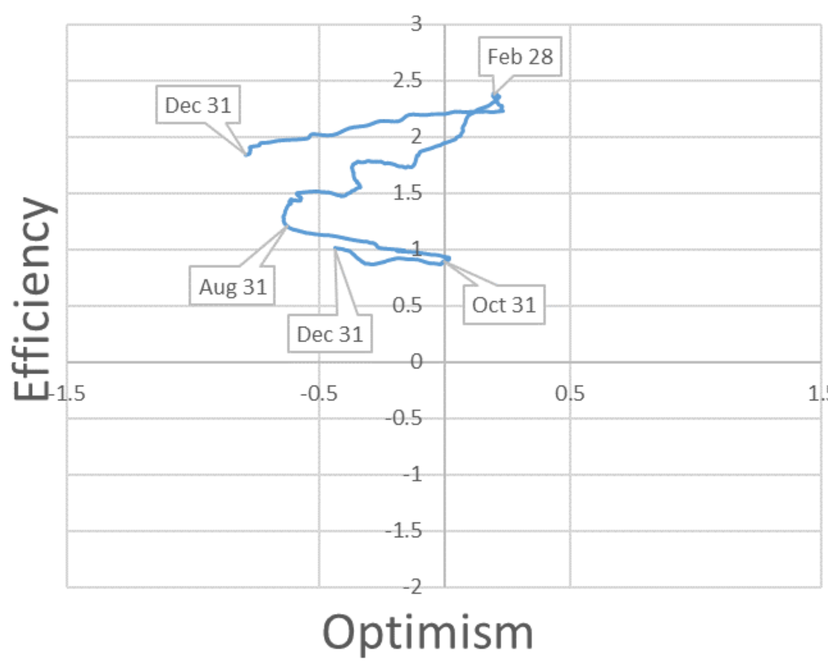
True to 2017's low volatility habits there was no single day in which the reality of the corporate tax cut became clear. But the market did not rally 8.8% as the bill gained momentum. Over November and December, the market was up less than half that, and roughly in-line with the rate of gain for the rest of the miraculous year of 2017.

Will 2018 be just as miraculous? It seems unlikely that the same themes will dominate, but then again, perhaps it is just as likely as any other outcome. For the time being we find ourselves cautiously optimistic about the near future. It will take 12 months to find out what 2018 is about.

The Market Sentiment Framework

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

Optimism gained ground through the first two months of 2017 and then gradually retreated, giving up much of its gain for the year, ending August at a modestly negative level. During September and October it rebounded, only to give up most of its advance over the remainder of the year. It remains at an average to modestly negative level.



[1]Source: FactSet Research Systems Inc.

In contrast, Efficiency has been relatively stable, although falling slowly and steadily, since the end of February. It remains in positive territory, but at a noticeably lower level than it has been over the past several years.

The current positioning of the Sentiment Framework implies a market that is modestly efficient, with fewer opportunities for easy relative gains from stock picking. Optimism, although somewhat improved since the start of the year, is in the context of a longer history still at a neutral level, a place that implies neither pessimism nor confidence.

Performance

Lee Adaptive Large Cap Sector ("LALCS")

For the month of December 2017, the LALCS composite, on a net of fee basis, was up an estimated +1.05%, versus the S&P 500, which was up +1.11%[1] on a total return basis. For the year, the LALCS composite gained an estimated +19.54% against +21.83%[1] for the S&P 500 on a total return basis.

The LALCS strategy spent the entire month invested in all ten sectors.

Lee Adaptive Global Equity ("LAGE")

For the month of December 2017, the LAGE composite, on a net of fee basis, was up an estimated +1.37%, modestly behind the MSCI All Country World Index, which was up +1.58%[1] on a total return basis. For the year, the LAGE composite has gained an estimated +24.07% as against +24.54%[1] for the MSCI All Country World Index.

The LAGE strategy spent the entire month of December fully invested in all regions.

[1]Source: FactSet Research Systems Inc.

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.

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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[1]Source: FactSet Research Systems Inc.

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 AC World Index. The returns for the MSCI All Country World Index 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 LAGE 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 LAGE Strategy will invest in any specific securities that comprise the index or that the investment program of the LAGE Strategy will track the index. Consequently, the returns of the LAGE Composite may or may not be highly correlated with those of the index.

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[1]Source: FactSet Research Systems Inc.

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[1]Source: FactSet Research Systems Inc.