LEE CAPITAL MANAGEMENT

Lee Adaptive Strategies Update

Monthly Commentary

December 2018

Goodbye 2018

Global markets saw significant declines in December, with the S&P 500 down -9.03% on a total return basis and the MSCI All Country World Index down -7.00%. For the year, the S&P finished down -4.38% and the MSCI All Country World Index down -8.93%.

When future generations scan the column of annual S&P 500 returns and read the -4.38% for 2018, they will likely imagine a modestly disappointing year in which nothing very exciting happened. Of course, having just lived through it, we remember 2018 not as a dully declining year, but as eleven months of anxiety followed by a few weeks of despair.

The S&P ended the third quarter of 2018 up a satisfying 10.56% for the year. October brought declines, with the S&P giving back -6.84%, but then November, although unsteady, was a yo-yo that ended with a small positive return. Briefly, optimists could tell themselves that the storm seemed to have passed.

And then December. By the time markets closed early for Christmas Eve, the S&P was down -14.72% for the month, -18.93% for the quarter, and -10.36% for the year. In hindsight, that may also have been the day on which the markets took a turn for the strange. Treasury Secretary Mnuchin announced, via Twitter, that he had spoken to the CEOs of the six largest US banks and was told that they had ample liquidity. This struck most observers as odd, if not somewhat alarming, because a) nobody was, until then, worried about bank liquidity and b) looking after the health of the banking system is generally thought to be the job of the Federal Reserve, not the Treasury Department.

Mnuchin also sought to reassure the markets that the President knows that he does not have the power to fire the chair of the Fed, even if he wanted to. Which he doesn't.

The day off on the 25th apparently cheered up investors considerably, as the market had one of its best days ever on the 26th, gaining nearly 5% in light holiday-week trading. The remainder of the year was not nearly as dramatic, but was no less anxiety filled.

Even with the benefit of a quiet week in which to ponder, the sharp bounce of the 26th seems inexplicable. (All media outlets mentioned it was the best day since 2008. Few added the context that the last few months of 2008 saw the S&P gain more than 5% in a day seven times. It lost more than 5% eleven times. It is always healthy to remind ourselves how volatile markets can get.)

As we have written before, it is human nature to search for cause-and-effect explanations for such things as daily stock market returns. Indeed, when markets become volatile and break out of longestablished norms, the urge to explain can become overwhelming. That a sharp move, up or down, could happen without some logical economic cause is just too frightening.

But the truth is that it is almost impossible to imagine an economic justification for why the 500 largest US corporations could ever be worth 5% more (or less) than they were a day before. News items such as earnings announcements, unemployment figures, and tweets from the Treasury Secretary do have meaning, but they are dwarfed by the price movements caused by changes in investor sentiment. And sentiment, although somewhat predictable, is by nature not rational.

It is often said that investing is a trade-off between risk and reward. We like to think of it as almost literally a trade, that investors are paid a fee in exchange for taking on risk. An analogy might be a game in which you are paid $1 to bet $10 on a coin flip. Provided that you can play the game many times, it is a good deal. Traditional buy-and-hold investors aim to get paid for flipping the coin as often and for as long as possible.

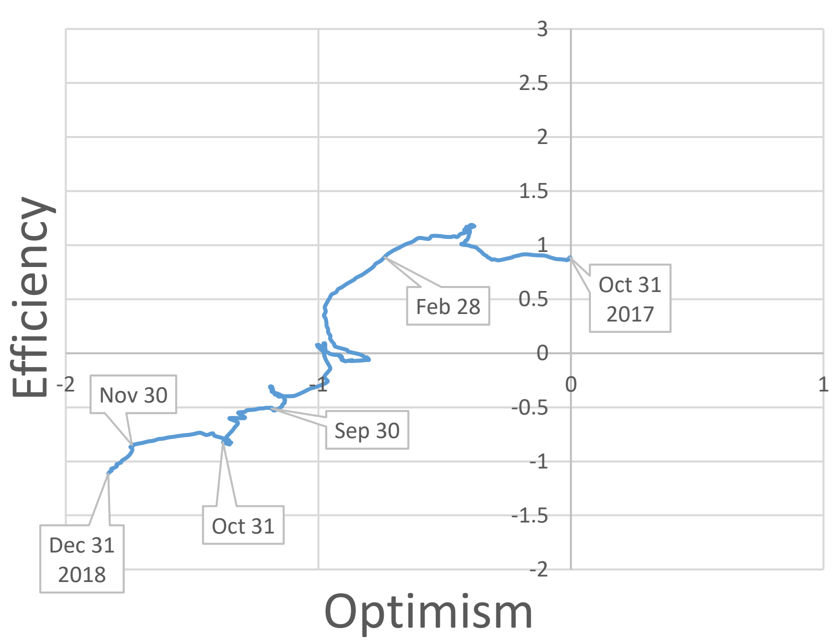
Stretching the analogy a bit further, our view is that the terms of the trade can change. Sometimes the coin flip bet is $50 or $100 rather than $10. Sometimes the fee paid to play is higher or lower, or even disappears entirely. Put another way, although we think investing in the markets is generally a good idea, there are periods in which the reward-for-risk trade on offer is not worth taking.

This is one of those times. Although we are not at 100% in cash in all our portfolios, we are nearly so. This does not indicate that we are certain the markets will continue to fall, only that we believe the risk that they might fall outweighs the potential that they might not. As December 26th demonstrates, investors can still win a high stakes coin flip.

Of course, we were on the wrong side of the December 26th surge, just as we were on the right side of December as a whole. This is not something we lose sleep over. It is our belief that there are no called strikes in investing. Missed opportunities are not 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.

Continuing the trend of 2018, both Optimism and Efficiency declined further in the month of December.

Optimism is now -1.83, down from -1.18 at the start of the fourth quarter. 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 November, and then significantly added to its decline in December, ending the year at -1.11. Having crossed over into negative territory this spring for the first time since 2012, Efficiency is at a low level when compared to recent history and continues to trend downward. This suggests a market that is coming under stress and that is becoming less crowded and less 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 negative market returns.

Performance and portfolio positioning

Lee Adaptive Large Cap Sector (LALCS)

For the month of December 2018, the LALCS composite, on a net of fee basis, was down an estimated -4.80%, well ahead of the S&P 500, which was down -9.03% on a total return basis. For the year 2018, LALCS was down -4.93% net of fees, versus the S&P at -4.38%.

The strategy ended November holding only two sectors, Industrials and Energy. It ended December holding only 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.

Lee Adaptive Global Equity (LAGE)

For the month of December 2018, the LAGE composite, on a net of fee basis, was down an estimated -0.04%, well ahead of the MSCI All Country World Index, which was down -7.00% on a total return basis. For the year 2018, LAGE is down -5.99%, ahead of the MSCI All Country World Index, which is down -8.93% on a total return basis.

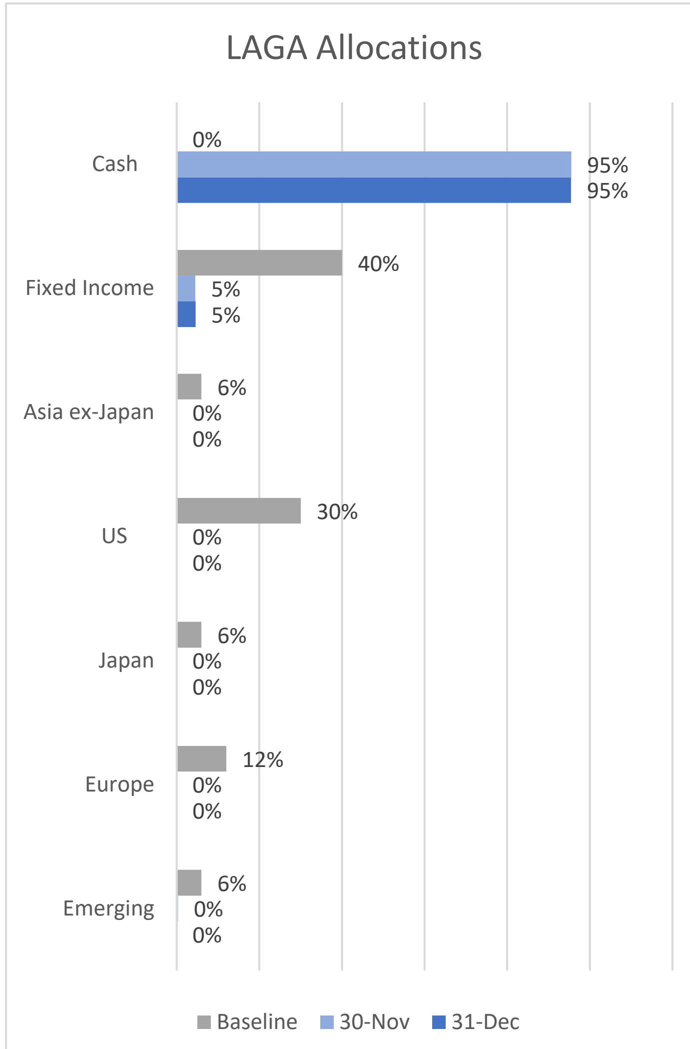
The portfolio spent the entire month of December 100% in cash.

Lee Adaptive Global Allocation (LAGA)

For the month of December 2018, the LAGA composite, on a net of fee basis, was up an estimated +0.01%, almost perfectly flat and well ahead of our blended benchmark, which was down -3.47% on a total return basis. For 2018, the strategy was down -3.74%, as compared to the blended benchmark which ended the year down -5.22% on a total return basis.

The portfolio began and ended the month of December with 95% cash and 5% in fixed income.

This is, of course, a strongly defensive positioning. It reflects our belief that the risk of loss currently outweighs the prospect for gain in most asset classes worldwide.



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 0.55%. 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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Lee Adaptive Global Allocation ("LAGA Composite") Performance. 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

Definitions cont'd

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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