LCM
LEE CAPITAL MANAGEMENT

Lee Adaptive Strategies Update

Monthly Commentary

February 2019

A Powell Put?

February continued January's strong gains, with the S&P 500 up 3.21% on a total return basis, and the MSCI AC World gaining 2.72%.

There is something essentially foolhardy (or is it courageous?) about writing a market commentary that will be read a week or two after it is written. The winds can shift suddenly and sometimes drastically. That said, as of the brisk morning of March 1st, it appears that the storm has passed. There are still some clouds here and there, and still some cleaning up to do, but what briefly looked like the storm of the century seems to have evaporated.

We are still below the all-time highs of last September, but not by that much. The S&P 500 ended February just -4.11% below its peak and being just short of a new high is a bit reassuring. After all, new highs bring anxiety about over-bought conditions. Being under the old high, we have some room to grow. And the two-month year-to-date return of the S&P, up 11.15%, certainly makes up for 2018's -4.38% loss.

This sharp rally has two simple explanations, a Fed "pivot" to dovishness and a warming of US-Chinese trade relations. These are particularly appealing as rally justifications if you believe, as many do, that a hawkish Fed and a looming US-Chinese trade war were responsible for the fourth quarter downdraft.

We are instinctively skeptical of all simple explanations, and do not accept the implied premise that large stock market movements must have causes that can be explained. But recent weeks have indeed seen authentically positive news on both the Fed and China that ought to have driven markets upwards.

In particular, the Fed's recent actions (or lack thereof) are perhaps more significant, and more significantly positive, than generally discussed. To be clear, we do not think the Fed has had a fundamental change of heart. Nor do we believe that it has meaningfully changed its broad policy nor even its economic outlook. The pivot is likely a temporary stay.

However, the specifics of the pivot are much less important than its cause. It seems clear that the Fed's loss of tightening resolve was substantially due to the fourth quarter declines in capital markets. In other words, this is the return of the "Greenspan Put" the idea that the Fed can be relied on to undo any market losses that might occur. Thus investors should load up on equity, up to and including the point of irrational exuberance. It is a logical sounding strategy, provided you believe that the Fed understands its job to be bailing out the stock market. It just hinted that it does.

Speaking of irrationality, one of the more unlikely developments of past weeks has been the apparently serious suggestion, made by a few Senators, that corporate share repurchases should be prohibited, or at least strongly discouraged. There has been no parallel objection to paying dividends. For those of us who consider it intuitively obvious that buying back $1M in shares and paying $1M in dividends are economically identical acts[1], objections to one but not the other are hard to take seriously. And given the lack of any kind of market reaction to this discussion, it seems that we are not alone not taking it at face value.

When confronted with an argument too absurd to be taken seriously, most of us roll our eyes and ignore it. That often works, but not always. A case in point being what happened mid-month to the Long Island City section of New York City, when one of the largest companies in the world withdrew its decision to build a massive second headquarters there.

As we understand the Amazon foundation myth, Jeff Bezos wrote his business plan for the company while moving from New York to Seattle. In other words, not being in New York was one of the first decisions Amazon made.

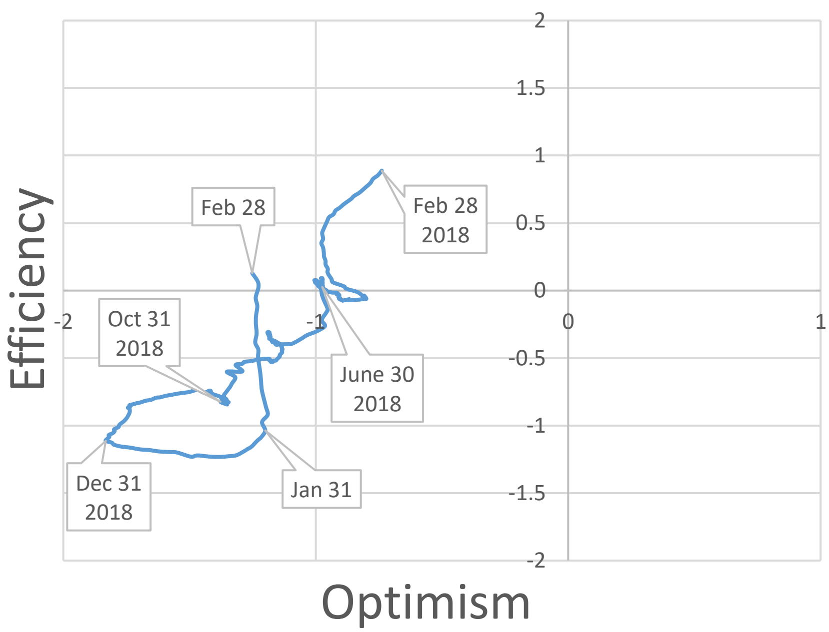
And yet for a few weeks Amazon was apparently sincere in its plan to locate between 25,000 and 40,000 high paying jobs in Queens. Then there were protests by fringe groups and anti-Amazon posturing from some lower level politicians. That was enough for Bezos to come to his senses and shut the whole thing down, much to the shock and horror of the many New Yorkers who had assumed that not wanting Amazon in Long Island City was too absurd a position to be taken seriously.

Much of what we do as investors is to try to understand, and to a certain extent predict, the actions of businesses and business people. We spend even more time trying to anticipate our fellow investors. Those are challenging tasks, but they pale in comparison to trying to understand the actions of government, politicians, and bureaucrats. Business people and investors may be inconsistent and emotional, but at least there is the overriding logic of profit to keep them roughly on track. The same is not true for government people, be they New York City Council Members, US Senators, US and Chinese trade negotiators, or members of the Federal Reserve Board.

[1] There is a minor tax difference. A shareholder paid a dividend must pay taxes on it for the year in which it is received, while a shareholder who benefits from an identical increase in share price because of a buyback will not have to pay taxes on it until he sells the shares, potentially years later.

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.



Following a January in which Optimism rose, but Efficiency held steady, in February Efficiency rose sharply, while Optimism held steady.

Optimism was very nearly unchanged, falling from -1.20 to -1.25.

Although still low in absolute terms, Optimism is much improved from levels of last December, having now returned to the region it last inhabited in early fall 2018.

Efficiency made a marked improvement during February, rising from -1.04 to +0.13. This is a notably strong one month improvement which goes counter to a downward trend in Efficiency that had lasted more than a year. At just over zero, Efficiency has now returned to its level of last summer. While the change in Efficiency is an indication of healing markets that are increasing in orderliness, the absolute level is still comparatively low by historical standards.

Lower Efficiency is good news for value investors who are more likely to find bargains produced by a less well-functioning marketplace. But it is bad news for momentum investors who have a smaller crowd to get in front of.

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, although not exceptionally low in absolute terms, and despite a strongly positive January, is still at a level that would suggest caution.

Performance

Lee Adaptive Large Cap (LALCS)

For the month of February 2019, the LALCS composite, on a net of fee basis, was up an estimated +0.80%, behind the S&P 500, which was up +3.21% on a total return basis. This relative underperformance can be explained almost entirely by the defensive cash holding in the portfolio.

The strategy ended January holding only two sectors, Consumer Staples and Utilities, and a 60% allocation to cash. On February 6, the portfolio added Real Estate, reducing cash to 40%. On the 25th Healthcare was added, and on the 26th both Financials and Technology entered the portfolio, bringing the owned sector count to six and the cash level to zero.

The strategy ended the month fully invested in equity, holding Healthcare, Consumer Staples, Utilities, Real Estate, Financials, and Technology. It does not hold Energy, Consumer Discretionary, Industrials, Materials, or Communications Services.

Lee Adaptive U.S. Equity (LAUSE)

For the month of February 2019, the LAUSE composite, on a net of fee basis, was up an estimated +0.81%, behind the S&P 500, which was up +3.21% on a total return basis. This relative underperformance can be explained almost entirely by the defensive cash holding in the portfolio.

The strategy ended January holding only two sectors, Consumer Staples and Utilities, and a 60% allocation to cash. On February 6, the portfolio added Real Estate, reducing cash to 40%. On the 25th Healthcare was added, and on the 26th both Financials and Technology entered the portfolio, bringing the owned sector count to six and the cash level to zero.

The strategy ended the month fully invested in equity, holding Healthcare, Consumer Staples, Utilities, Real Estate, Financials, Technology, and Small Cap (R2000) sectors. It does not hold Energy, Consumer Discretionary, Industrials, Materials, or Communications Services.

Lee Adaptive Global Equity (LAGE)

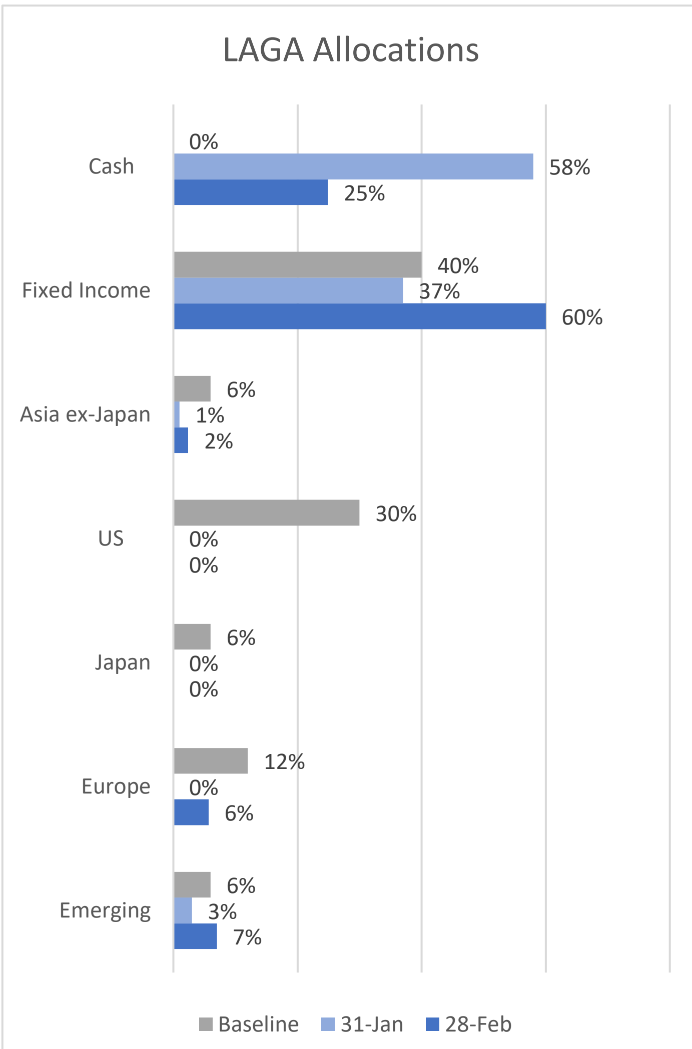
For the month of February 2019, the LAGE composite, on a net of fee basis, gained an estimated +0.02%. This was behind the MSCI All Country World Index, which was up +2.72% on a total return basis. The portfolio was defensively positioned throughout the month, beginning with a cash allocation of 88% and ending with an allocation of 69%.

The strategy increased its holding in Emerging Markets from 9% to 15% on February 25th. The portfolio began the month with no exposure to Europe and then entered Europe at 9% on the 19th. Asia ex-Japan began February at 3% and was added to on the 19th, to bring it to 4%.

Lee Adaptive Global Allocation (LAGA)

For the month of February 2019, the LAGA composite, on a net of fee basis, was down an estimated -0.17%, behind our blended benchmark, which was up +1.61% on a total return basis.

The portfolio began the month of December with 58% cash and 37% in fixed income. During January the fixed income allocation was significantly increased, to its maximum allowed at 60%. The portfolio also added to Asia ex-Japan and Emerging Markets equity, as well as starting a position in Europe at 6%. Cash was reduced to 25%.



Since the start of the year, the porfolio has been becoming progressively less defensive. Cash began the year at 95% of the portfolio and now stands at 25%, while equity exposure has grown from nothing to 15%.

Trends aside, the portfolio is still postioned on the cautious side, with 85% in either cash or fixed income. The reflects our view that markets are still in a dangerous state.

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 US Equity Composite ("LAUSE Composite"). A capital weighted performance composite of an investment strategy known as the Lee Adaptive US Equity Strategy (the "LAUSE 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 LAUSE Composite performance is based on actual trading profits/losses/expenses net of a management fee of 0.55%. Actual expenses of operating the LAUSE 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 LAUSE Strategy and, consequently, the results shown above may not be fully indicative of the actual performance results of the LAUSE 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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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.

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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