Lee Adaptive Strategies Update

Monthly Commentary

January 2019

Fed Up

January was a strong and almost uniformly positive month for the markets, with the S&P 500 gaining 8.01% on a total return basis. The MSCI All Country World index gained 7.93% on a total return basis.

The February 1 headline in The Wall Street Journal read "Stocks Post Best January in 30 Years." It is not clear to us if the writer meant to deliver a back-handed compliment, as if it was a pretty good month considering how cold it was outside, or if he meant that Januarys are usually good but this one stood out even in that exalted company.

In fact, popular wisdom about a so-called "January Effect" aside, over the past 25 years January has been fairly ordinary, being the 8th best (or 5th worst) month for the S&P 500. January 2019 deserves no asterisk. It was just a good month.

Of course, it hardly needs pointing out that this January did not make up for the December that came before. Equity markets were lower on January 31 than they had been on November 30. And it would be churlish to add that November also did not make up for October, that the S&P 500 was lower on November 30 than it had been on September 30. For the four months just ended the S&P has lost -6.59%.

As for January's surge, we are not the sort that insist that a strong market return requires a proximate cause. Indeed, the simple argument that January was a reaction to December strikes us as reasonable an explanation as any.

But there was a more satisfying narrative. The Fed became noticeably more dovish during the month, giving many observers the hope that it has indefinitely halted its program of rate increases. We are, as usual, not quite so optimistic, but must concede that even we now expect much less tightening in 2019 than we did a month ago.

Then again, it seems obvious to us that the Fed's change of heart was significantly influenced by December's market performance. So perhaps January really can be best explained as a reaction to December after all. (And, logically, it would have to be assumed that January's strength will result in a more hawkish Fed sentiment in the near future.)

And then there was the constant undercurrent of the global economy. There seems to be a small bush worth of tea leaves suggesting that a slowdown, if not an actual recession, is on the horizon. These range from the ominous and vaguely mysterious inverted yield curve to poor PMI surveys from Chicago, Beijing, and seemingly everywhere in-between. The theme of corporate earnings reports so far this quarter appears to be numbers that can be described as better than feared, combined with downward guidance.

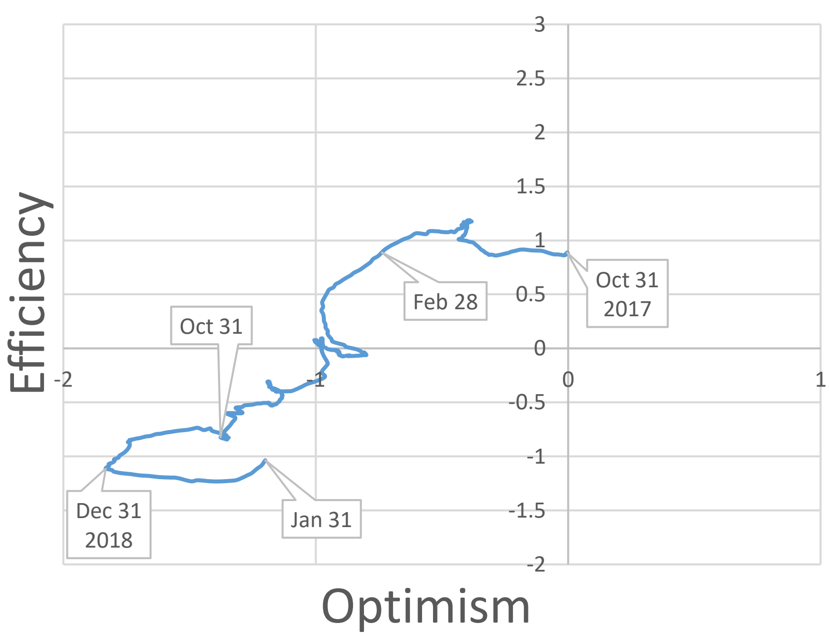
It seems likely that a possibly fading economy also contributed to Fed softening. Thus the somewhat ironic, but common, situation in which bad economic news is greeted by the markets as a positive development, as it makes looser central bank policy more likely.

The naïve view is that what the Fed does affects the economy, which then drives the stock market. In truth, all three interact. Certainly, the market is influenced by the Fed and the economy, but both the Fed and the economy also react to the market. Each of the three acts in response to the other two, creating a sometimes unstable feedback loop. (In principle, the Fed acts as a stabilizer, dampening down the excesses of the others. In practice, it does not always work out that way.)

Our portfolios were defensively positioned during January, with significant cash holdings, and remained so at the end of the month. If the losses of Q4 2018 turn out to be a brief storm that has now passed, we will likely return to the markets in a short while. But it is too soon to tell. A down February would certainly be consistent with recent history.

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.



Breaking with the trend of 2018, both Optimism and Efficiency improved in January.

Optimism particularly improved, from -1.83 at the end of December to -1.20 at the end of January.

Although still low in absolute terms, this is a strong monthly increase in Optimism, returning it to levels last seen in early fall of 2018. January also breaks what had been a downward trend lasting more than a year.

The improvement in Efficiency was much smaller, to -1.03 from -1.11, but, as with Optimism, the gain breaks a downward trend. And, as with Optimism, the absolute level of Efficiency remains low. Although the level of stress and disorganization may have abated in January, the markets are still less orderly than they have been in recent years.

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. 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, and despite a strongly positive January, is still at a level that would suggest negative market returns.

Performance and positioning

Lee Adaptive Large Cap Sector (LALCS)

For the month of January 2019, the LALCS composite, on a net of fee basis, was up an estimated +3.39%, behind the S&P 500, which was up +8.01% on a total return basis. This relative underperformance can be explained almost entirely by the defensive cash holding in the portfolio.

The strategy ended 2018 holding only two sectors, Energy and Utilities. On January 8th it replaced Energy with Consumer Staples, which is how the portfolio ended the month.

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 U.S. Equity (LAUSE)

For the month of January 2019, the LAUSE composite, on a net of fee basis, was up an estimated +5.08%, behind the S&P 500, which was up +8.01% on a total return basis. This relative underperformance can be explained almost entirely by the defensive cash holding in the portfolio.

The strategy ended 2018 holding only three sectors, Small Cap, Energy and Utilities. On January 8th it replaced Energy with Consumer Staples and exited Small Cap, which is how the portfolio ended the month.

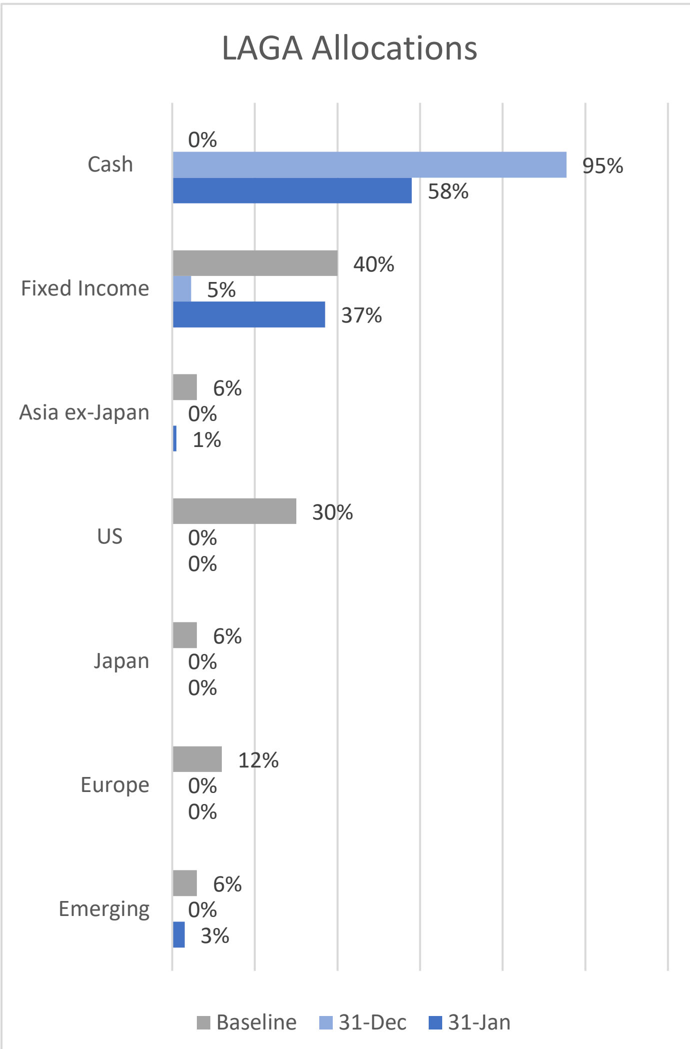
Our portfolio construction rules call for cash positions when fewer than five sectors are held. When two are held, we allocate 60% of the portfolio to cash and 40% to those two sectors.

Lee Adaptive Global Equity (LAGE)

For the month of January 2019, the LAGE composite, being entirely in cash for much of the month, gained an estimated +0.10%. This was behind the MSCI All Country World Index, which was up +7.93% on a total return basis.

The portfolio was 100% in cash through January 24, when it started small positions in Emerging Markets and Asia ex-Japan. It ended the month 88% in cash, 9% in Emerging Markets, and 3% in Asia.

Lee Adaptive Global Allocation (LAGA)



For the month of January 2019, the LAGA composite, on a net of fee basis, was up an estimated +0.39%, behind our blended benchmark, which was up +5.18% on a total return basis.

The portfolio began the month of December with 95% cash and 5% in fixed income. During January the fixed income allocation was significantly increased, to 37%. Coupled with modest increases in Emerging Markets and Asia ex-Japan, this brought the cash allocation down to 58%.

Although this positioning is less defensive than it was a month before, it is still meaningfully cautious and reflects our belief that the risk of loss still outweighs the prospect for gain in most asset classes worldwide.

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 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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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 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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