Lee Adaptive Strategies Update

Monthly Commentary

July 2019

What Was That?

July was a positive month in the markets. The S&P 500 gained 1.44% for the month on a total return basis, bringing it to up 20.24% for the year. The MSCI All Country World gained 0.33%, up 16.98% year to date.

It is a commonplace observation that investing is hard because it involves predicting the future. That may understate the difficulty. In our world, even explaining the recent past can be a challenge.

Take the very recent past as an example. July had been a meaningfully better month just a few hours before it ended. The Fed announced its decision to lower rates a quarter point mid-afternoon on the 31st. The S&P lost about 1.5% in the next twenty minutes. This was a bit odd. Generally, we associate rate drops with market rises.

Fed Chairman Powell's press conference did not help. He called the cut "a mid-cycle adjustment to policy" and warned that this was "not the beginning of a long series of rate cuts" but did clarify that it was not necessarily a one-off either. He did not define the term "long series." Nor did he explain what a mid-cycle adjustment to policy was. Bloomberg deadpanned that Powell has "drawn criticism for not living up to his commitment to use plain English."

It is a basic principle of finance that the markets do not react to news so much as they react to the difference between news and expectations. So equity markets falling in reaction to a rate drop is not necessarily as crazy as it sounds. The drop was anticipated and so was a non-event. The Fed and/or Chairman Powell could have said or done something else that was disappointing.

Of course, the difficulty here is that market expectations are never known for certain. You can listen to the talking heads on CNBC and Bloomberg, but theirs are not the opinions that matter. It is the beauty of capitalism that prices are determined not by a simple average of opinions but by a weighted average, where the weights are based on the willingness and ability of participants to risk money. It is not a perfect system, but it works pretty well and sure beats central planning.

Amongst the system's frustrating imperfections is that, even after the fact, the market never explains itself. Prices just change, leaving commentators like us to infer what expectations must have been. Sometimes the inference is obvious. A company reports $1.00 in earnings, as everybody thought everybody else expected, but the stock goes down sharply. So it turns out the market expected more.

But working out what expectations must have been to cause the market reaction to the Fed announcement is near impossible. It seems quite unlikely that the rate cut itself could have been bad news.

More likely, the bad news was buried somewhere in the Fed's recession tea leaf reading that inspired the rate cut. And it is here that things get murky. An obvious explanation would be that the Fed appeared more worried about an oncoming recession than the market was, and as the Fed are presumably experts on this topic, the market adjusted its outlook downward and prices fell.

That is plausible, but it neglects the subtext for which all Fed pronouncements are read. Mostly, investors are looking for hints as to future Fed interest rate moves. And in that context, the perception of increased Fed pessimism about the economy would be good news as it would suggest further rate reductions. Conversely, it is plausible to believe that the market fell on the 31st not because the Fed's views on the economy appeared to be more pessimistic than expected, but because they were more optimistic, which implied higher future rates.

Like many investors, we are in the uncomfortable position of hoping for rate decreases, because we are long equity, while simultaneously having skepticism that they are warranted. Signs of an approaching recession are indistinct. And the argument in favor of not lowering rates, or indeed raising them, is as simple as it is compelling. The Fed should keep rates higher now so that when there is a recession or liquidity crisis in the future, it can provide stimulus by lowering them.

The key issue, as it always seems to be with the Fed, is inflation. The US economy needs some. Having, for example, inflation at a steady 3% would allow nominal interest rates that were plenty high enough to allow for stimulating rate cuts when needed and allow low enough real rates to keep the economy purring. It would also weaken the dollar, which would help with international trade. And, although few would publicly cite this as an advantage, it would reduce the burden of the national debt by reducing its value in real terms.

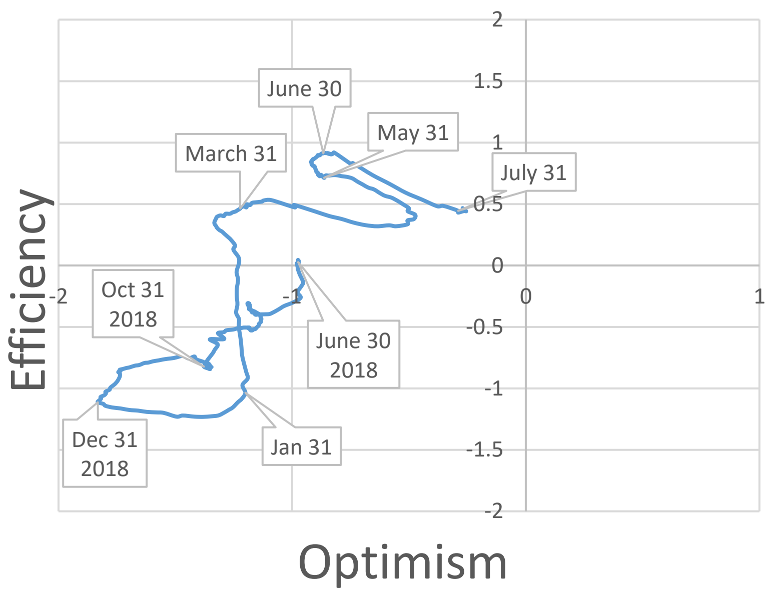
And how can the Fed increase inflation? That is easy. All it has to do is increase the money supply. Do not let the fact that it has been doing this furiously for the past decade or so to no apparent effect confuse you. Inflation is always and everywhere a monetary phenomenon. All the Fed needs to do is lower rates some more.

Let's recap. Our understanding of what happened yesterday is that the market reacted negatively to a rate cut possibly because the Fed's economic outlook was more pessimistic than expected or possibly because it was more optimistic than expected. And a reasonable argument in favor of that cut is that the Fed should lower rates now, so it can raise them in the future, so that when necessary it can lower them after that.

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.

During July Efficiency fell modestly while Optimism increased.



After a June in which markets rose strongly but Optimism largely held steady, in July markets rose less broadly but Optimism increased from -0.87 to -0.27, its highest level since the fall of 2017.

Although still slightly negative in absolute terms, implying a somewhat lower than average outlook, Optimism is still far above its levels of late 2018.

Efficiency fell moderately from 0.91 to 0.46 during July, essentially returning to its level at the start of the second quarter. Over a longer time horizon, Efficiency is still much above 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 still less efficient than it could be, with moderate opportunities for relative gains from stock picking as well as from momentum. Optimism holds at a level that would suggest courage in market exposure.

Performance and positioning

Lee Adaptive Large Cap Sector (LALCS)

For the month of July 2019, the LALCS composite, on a net of fee basis, was up an estimated +1.47%, in line with the S&P 500, which was up +1.44% on a total return basis.

The strategy began and ended July holding all sectors, however Healthcare spent a week out of the portfolio from July 3 to 10th. As healthcare somewhat underperformed the broader market during this period, XLV was down -0.99% while the S&P 500 lost -0.05%, these trades had a small positive effect on returns.

Lee Adaptive Broad Market Sector (LABMS)

For the month of July 2019, the LABMS composite, on a net of fee basis, was up an estimated +1.36%, modestly behind the S&P 500, which was up +1.44% on a total return basis.

The strategy began and ended July holding all sectors, however Healthcare spent a week out of the portfolio from July 3 to 10th. As healthcare somewhat underperformed the broader market during this period, XLV was down -0.99% while the S&P 500 lost -0.05%, these trades had a small positive effect on returns.

Lee Adaptive Global Equity (LAGES)

For the month of July 2019, the LAGES composite, on a net of fee basis, was down an estimated -0.35%. This was behind the MSCI All Country World Index, which gained +0.29% on a total return basis.

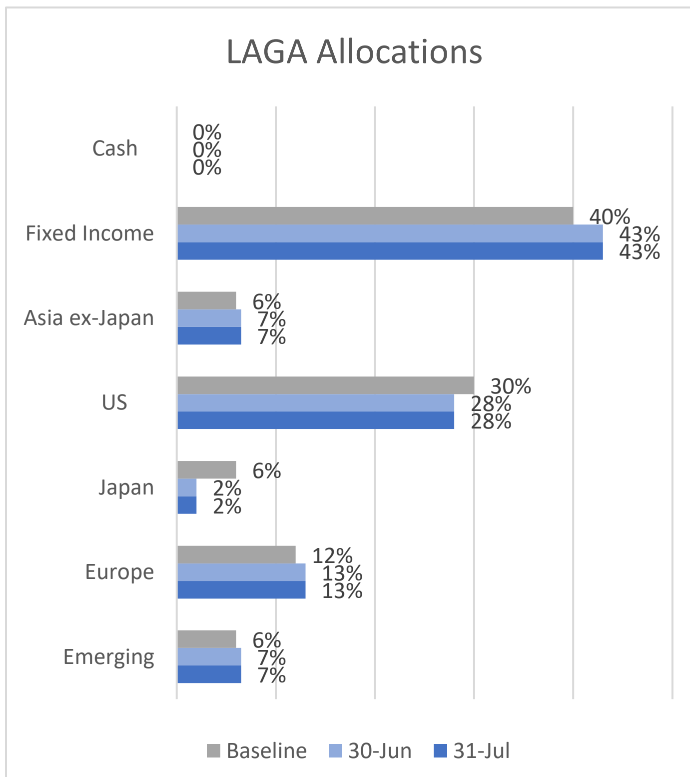
The portfolio began and ended the month invested in all equity geographies with no cash in the portfolio. Ending positions were approximately 54% US equity, 2% Japan, 11% Emerging Markets, 22% Europe, and 11% Asia ex-Japan.

Lee Adaptive Global Allocation (LAGA)

For the month of July 2019, the LAGA composite, on a net of fee basis, was down an estimated -0.26%, behind our blended benchmark, which was up +0.26% on a total return basis.

The strategy remained fully invested during July at levels near its baseline weights. Fixed income was slightly overweighted, at 43%, and both US and Japanese equity were underweighted.

Overall, the portfolio is maintaining a cautiously optimistic stance, which is a meaningful shift away from the defensive positioning it had a few months ago.



Lee Adaptive China (LACS)

For the month of July 2019, the LACS composite, on a net of fee basis, was down an estimated -1.45%. This was behind the MSCI China Index, which was down -0.54% on a net return US Dollar basis.

The portfolio began and ended the month fully invested in equity. It held 50% in KBA, the broad market A Shares ETF, and 25% in PGJ, the US-listed (or N Share) ETF, throughout the month. The remaining 25% of the portfolio began the month invested in KURE, the healthcare ETF, before that position was swapped for TAO, a real estate ETF, on July 29th.

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

MSCI China Index. The returns for the MSCI China 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 China Index represents large and mid-capitalization across H shares, B shares, Red chips, P chips and foreign listings (e.g. ADRs). With 495 constituents, the index covers about 85% of this China equity universe. Currently, the index also includes Large Cap A shares represented at 5% of their free float adjusted market capitalization**.** It should not be assumed that the LACS strategy will invest in any specific securities that comprise the index or that the investment program of the LACS strategy will track the index. Consequently, the returns of the composite 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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