LCM
LEE CAPITAL MANAGEMENT

Lee Adaptive Strategies Update

Monthly Commentary

May 2019

Uber Over?

Markets fell in May. The S&P 500 lost -6.35% and the MSCI AC World declined -5.85%, both on a total return basis. And it was a steady decline. The market fell in each of four weeks in a row. There was a motley collection of bad news to take the blame, but there was no particular bombshell, no moment of near-panic when the markets broke. They just floated, inexorably, downward.

For those inclined to worry about such things, it was the banality of the decline that was most worrisome. The S&P has now lost more than 5% in a calendar month three times in the last nine. Is this the new normal?

Chief among the headlines to receive blame for May's decline was the escalating trade dispute between the US and China. It is certainly an authentic cause for concern, but one that we believe is more of a near-term than a long-term issue. Our expectation is that after a few months of both sides showing indignant resolve, a compromise will be reached that will allow President Trump to claim victory and the Chinese to carry on largely as before. By the 2020 elections, the on-going economic impact of the dispute should be nil.

In a more perfect world, markets would not react so strongly to developments that are unlikely to have meaningful long-run effects. In the world that we actually live in, the markets are populated by compulsive extrapolators, investors so focused on this quarter and next that they can only assume that the events of today are bound to be repeated in endless tomorrows. This can lead to exaggerated reactions to news, but it can also lead to a sort of big picture blindness, as attention paid to the near-term crowds out worthwhile reflections on the long-term.

Case in point is the IPO of Uber on May 10. As readers likely recall, it did not go well. After several rounds of expectation diminishing, what was just a few months before projected to be a $120 billion company finished its first full day of trading as a $63 billion company. Commentators remarked that it was Uber's bad luck to go public in such a weak environment. But Uber was just the highest profile member of a group of so-called unicorns to go public this year with disappointing results, and some of those debuted in more buoyant conditions. Indeed, it could be argued that the difficult environment of May was as much an effect of the IPO flops as a cause of them.

Lost in the noise around 2019's uninspiring bumper crop of IPOs were the broader implications for private equity and the public markets. As one unicorn after another fizzles, it becomes increasingly obvious that they stayed too long in what Bloomberg's brilliant Matt Levine calls the Enchanted Forest, that twilight stage of being an all-but-public private company.

A generation ago, companies went public almost as soon as was physically possible, with capitalizations in the hundreds of millions not the tens of billions. Pets.com, to cite an extreme and notorious example, was an on-line retailer of pet supplies that began operations in November of 1998 and raised $82.5M in its IPO in February 2000, before going out of business less than a year later.

What has changed? To be sure, the attractions of being a public company have diminished. Dealing with regulations and activist shareholders is now more onerous for company managements than in previous decades. But the main difference is the tremendous growth in private equity. In years past, being public meant access to cheaper funding. What were then called venture capital funds did not have all that much capital to work with. They felt a certain urgency to cash out of their investments in maturing five-year-old companies so that they could recycle the money into fast growing one-year-old companies. This is no longer the case. With so many institutional investors eager to invest in private equity, why not keep the investments in the five-, or even ten-year-olds and continue to collect not inconsiderable private fund fees? (UberCab was founded in March 2009.)

The reason why not is that you might over do it. It is one thing to maintain enthusiasm for a Next Big Thing while it is just a few years out of the founder's garage, and quite another to keep investors optimistic about a company with thousands of employees and a maturing growth trajectory. Sooner or later the institutions in your fund will start to wonder why they are paying you so much to own such ordinary companies. A round of IPOs in which the public market valuations turn out to be lower than private ones only makes the situation worse.

Ironically, it is possible that this wave of disappointing IPOs will encourage more. Bad outcomes increase the desire to cash out. And that could lead to a meaningful big picture shift from private to public equity. For years we have been saying that the most under-discussed development of our time is the shrinking public equity markets. Year after year, there have been fewer public companies representing less of the global economy. Part of the reason is the tendency of privately held companies to stay that way. Is it possible that the Uber IPO will be the high-water mark of that phenomenon?

If it is, what are the broader implications? Short term, disappointing IPOs are bad news. The discovery that a group of private companies are worth less than was previously assumed cannot be good news for the valuations of all companies, public ones included. Long term, more public and fewer private companies is likely a good thing, both for public equity investors and for the economy.

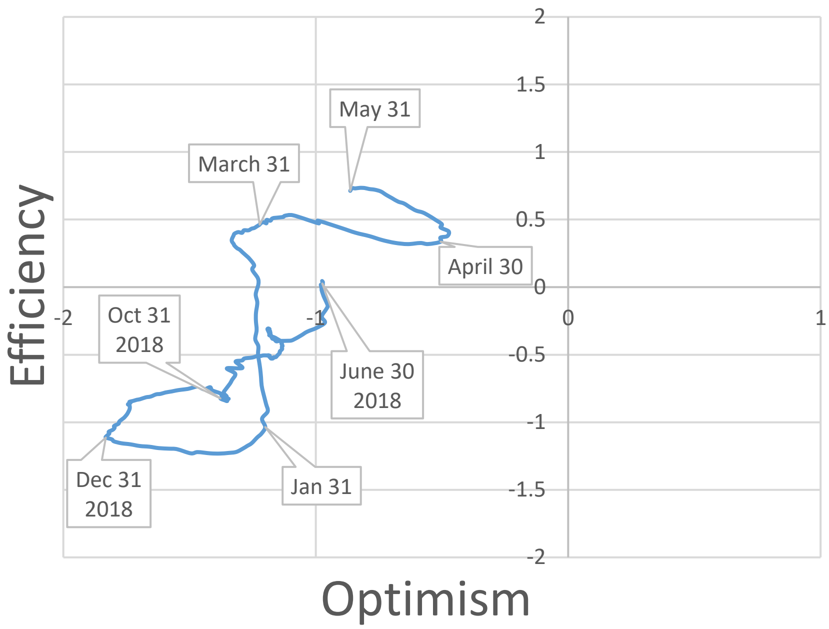
Early June should see another unicorn exit the forest. Chewy, an on-line retailer of pet supplies, is expected to go public at a valuation around $7 billion. It was founded eight years ago and has yet to make a profit.

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 May the level of Optimism, unsurprisingly, declined, while Efficiency rose slightly.

After an April in which Optimism rose from -1.22 to -0.51, in May it retreated to -0.86.



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

Efficiency rose from 0.34 to 0.71 during May. Over a longer time horizon, Efficiency has improved quite considerably from 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.2

Performance

Lee Adaptive Large Cap Sector (LALCS)

For the month of May 2019, the LALCS composite, on a net of fee basis, was down an estimated -5.92%, ahead of the S&P 500, which was down -6.35% on a total return basis.

The strategy began May holding 10 of 11 sectors, missing only Communications Services. That sector was added to the portfolio May 14th, and the strategy ended the month holding all sectors.

Lee Adaptive Broad Market Sector (LABMS)

For the month of May 2019, the LABMS composite, on a net of fee basis, was down an estimated -6.13%, just ahead of the S&P 500, which was down -6.35% on a total return basis.

The strategy began May holding 11 of 12 sectors, missing only Communications Services. That sector was added to the portfolio May 14th, and the strategy ended the month holding all sectors.

Lee Adaptive Global Equity (LAGES)

For the month of May 2019, the LAGES composite declined an estimated -5.94%. This was in line with the MSCI All Country World Index, which was down- 5.85% 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 55% US equity, 3% Japan, 9% Emerging Markets, 22% Europe, and 11% Asia ex-Japan.

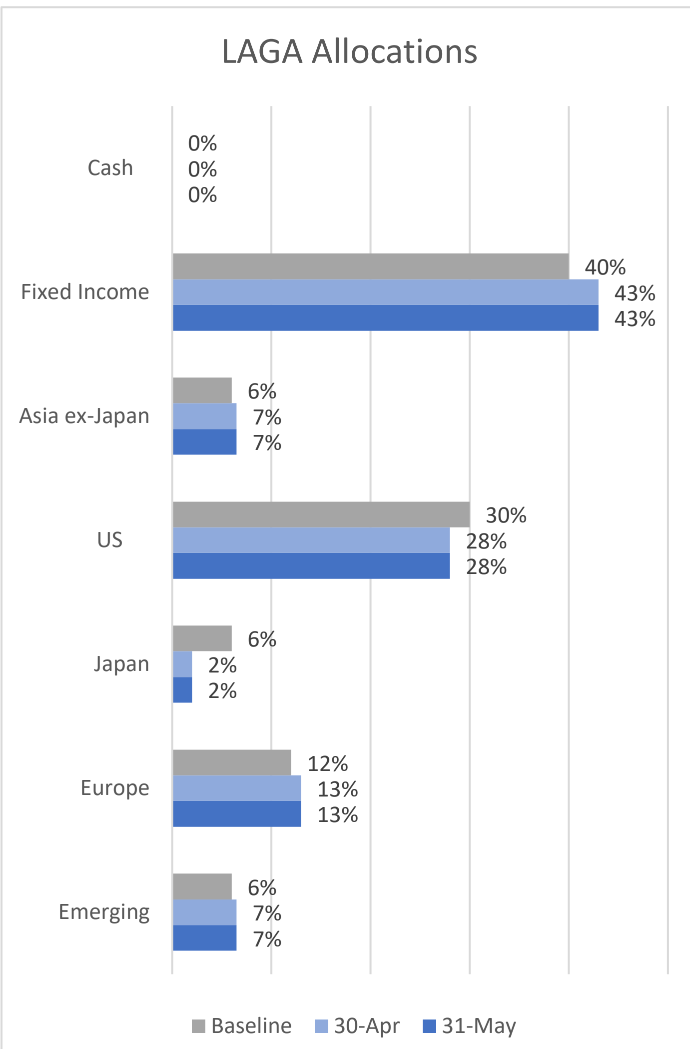
Lee Adaptive China (LACS)

For the month of May 2019, the Lee Adaptive China Strategy composite declined an estimated -7.83% on a net of fee basis. This was ahead of the MSCI China (Net) TR Index, which was down -13.24% on a total return US Dollar basis.

The portfolio began the month fully invested in equity, holding the KraneShares MSCI A Share ETF (KBA), the Invesco China Real Estate ETF (TAO), and the KraneShares One Belt One Road ETF (OBOR). In response to a sharply falling China market score, the portfolio sold these positions and went 100% to cash on May 28th.

Lee Adaptive Global Allocation (LAGA)

For the month of May 2019, the LAGA composite, on a net of fee basis, was down an estimated -2.81%, in line with our blended benchmark, which was down -2.80% on a total return basis.



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

PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS OR PROFITABILIT

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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