# Lee Adaptive Strategies Update

## Monthly Commentary

November 2017

November was a strong month for equity markets. Buoyed by what were manifestly better than expected developments on Capitol Hill and an upward revision to Q3 US GDP numbers, the S&P 500 Total Return Index finished the month up +3.07%[1]. That makes thirteen consecutive up months for the S&P 500 Total Return Index and an impressive post-election total gain of +26.88%[1].

And all anybody wanted to talk about was Bitcoin. On the last day of the month it was the topic of four of the five most read articles on Bloomberg. The Bitcoin phenomenon is at once astonishing, amusing, and frightening. Suffice it to say that we have grave concerns. As unique and novel as cryptocurrencies are, Bitcoin has the characteristics of a garden variety speculative bubble. Indeed, the most significant difference between Bitcoin and previous history may be its level of abstraction. Even tulip bulbs had some practical use. Bitcoin has neither intrinsic value nor a physical existence.

As the latest manifestation of the madness of crowds, Bitcoin illustrates many principles of financial markets familiar to seasoned and wise investors. Let us review a few of them.

**Prices are Set at the Margin**

The price from the last trade of something, which we generally assume to be the worth of that thing, is merely the price agreed to by the seller most interested in selling and the buyer most interested in buying. We often think of the market capitalization of a company, that is, the last trade price times the number of shares outstanding, as being the value of that company. But of course that is not really true. The entire entity, that is, all the outstanding shares, could not be purchased for that amount any more than all the existing shareholders could simultaneously find buyers for their holdings at the last traded price.

Similarly, the total value of all outstanding Bitcoin quoted in news reports is more ephemeral than it may seem. Although there are plans to trade such things as Bitcoin futures on familiar (and regulated) exchanges, for the time being Bitcoin is traded, thinly, on imperfect and somewhat rudimentary exchanges. Just because the "market cap" of Bitcoin is now notionally about $175 billion, it does not follow that Bitcoin is now a significant part of the world economy.

**No Intrinsic Value is a Two-Edged Sword**

Those of us who were investing in stocks in the late 1990s remember the half-joking argument that it was better for the valuation of a dot com for it to lose money rather than turn a profit. With a positive EPS you get a PE ratio, and if it is too high investors might be scared off. But with a negative EPS you get a nice harmless N/A for your PE. Put another way, earn $1 a share and it will be hard for your stock to go

[1]Source: FactSet Research Systems Inc.

over $100. Lose $1 a share and not only is the sky the limit, but the higher your stock goes the more insignificant the $1 loss appears.

And so it is with a cryptocurrency that has no intrinsic value. Bitcoin selling for $10,000 is no more or less ridiculous than it selling for $1,000 or $100,000. Although originally conceived as a medium of exchange, it should be clear by now that that particular practical use is unlikely to come to fruition. Aside from being much more cumbersome to use than old school alternatives, one of the first requirements of a medium of exchange is that it have a stable value.

So just about the only known use for Bitcoin (other than poorly documented criminal ones) is as what can euphemistically be called a store of value. Bitcoin is bought for no other reason than the hope of selling it again one day, presumably for more than what it cost.

**It's Not What You Believe, it's What You Believe that Others Believe**

The brilliant stock market speculator John Maynard Keynes once explained how asset markets work by drawing an analogy to a form of newspaper beauty contest popular in the early 20th Century. Readers were given a large array of photographs of women and asked to pick the five most attractive. A prize was offered to the reader who picked the five most popular, that is, those most often picked by others.

(Some assume the contest is a hypothetical Keynes invented. Alas, as barbaric as it may sound now, beauty contests were a newspaper staple for decades.)

Of course, to win the prize the smart reader does not pick the women he thinks are prettiest, but the ones he thinks others will think are the prettiest. Indeed, since he might assume that other readers also understand this, he might pick the ones that he thinks others will think that others will pick.

And so it is with stocks and cryptocurrencies. Since a stock or a Bitcoin is bought primarily with the purpose of selling it on at a higher price, the opinions of others trump one's own view. Thus we have a manifest consensus that Bitcoin is at the least very dangerous and is more than likely a full-on speculative bubble, and yet its price continues to climb. This is not driven by true believers who themselves think that Bitcoin is the currency of the future. It is driven by those who believe either that there is an adequate supply of others who are true believers or, alternatively, that there is an adequate supply of others that believe there is an adequate supply of true believers.

**Lower Volatility is not Always a Bull Indicator**

Volatility in prices is an undesirable thing for an investor and, particularly with regard to equities, we generally assume that falling volatility makes an asset more attractive, thus raising its valuation. That may not be the case for Bitcoin.

The expected market reaction to too-high asset prices is that speculators will begin to go short, pushing prices back down. But shorting Bitcoin is presently unattractive, both because of practical difficulties and, significantly, the very high volatility of its price.

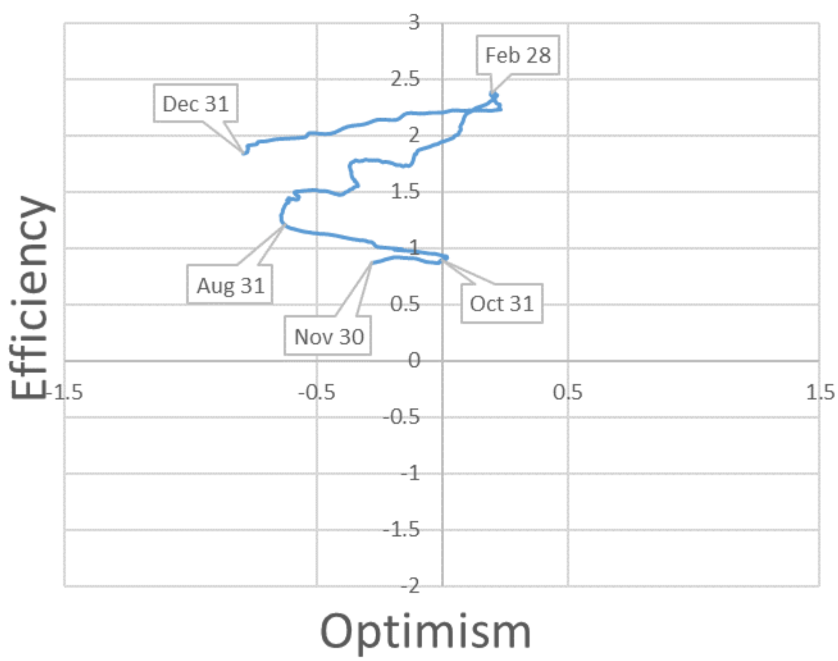
Several well known exchanges, including the CBOE, CME, and Nasdaq have announced plans to trade Bitcoin in the near future. Imagine that happens and that those markets are populated by professional traders who provide liquidity and so naturally dampen volatility. That might encourage investors to take the plunge and buy Bitcoin. Or it might give the bears the courage they need to go short.

[1]Source: FactSet Research Systems Inc.

It should be clear that the current frenzy and confusion that surrounds Bitcoin cannot go on forever. In the long run, there are only two possible ways that the Bitcoin story can end. It could become a permanent part of the world economy, an alternative currency playing approximately the same role as gold, but with more convenience and anonymity. If that happens, we will look back on this time as the golden era in which Bitcoin miraculously rose up out of nothing. Alternatively, Bitcoin could be a speculative bubble that will end as all speculative bubbles do. Let us all think carefully about which outcome is more likely and act accordingly.

**The Market Sentiment Framework**

We use our Market Sentiment Framework to adapt the mechanics and weightings of our full quantitative model 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.




Optimism gained ground through the first two months of 2017 and then gradually retreated, giving up much of its gain for the year, ending August at a modestly negative level. During September and October it rebounded, only to give up about half its advance in November. It remains at an average to slightly negative level.

In contrast, Efficiency has been relatively stable, although falling slowly and steadily, since the end of February. It remains in positive territory, but at a noticeably lower level than it has been over the past several years.

The current positioning of the Sentiment Framework implies a market that is modestly efficient, with fewer opportunities for easy relative gains from stock picking. Optimism, although improved since the start of the year, is in the context of a longer history still at a neutral level, a place that implies neither pessimism nor confidence.

[1]Source: FactSet Research Systems Inc.

**Performance**

*Lee Adaptive Large Cap Sector (“LALCS”)*

For the month of November 2017, the LALCS Composite, on a net of fee basis, was up an estimated +3.12%, slightly ahead of the S&P 500, which was up +3.07%[1] on a total return basis. For the first eleven months of 2017, the LALCS Composite has gained an estimated +18.30% as against +20.49%[1] for the S&P 500 Total Return Index.

The strategy began the month invested in all sectors other than energy. Energy returned to the portfolio on November 20th, having been absent since August 3rd. Over that period the sector, as represented by the SPDR Energy ETF (XLE) gained +2.81%[1], as against +5.11%[1] for the S&P Total Return Index over the same period.

*Lee Adaptive Global Equity (“LAGE”)*

For the month of November 2017, the LAGE Composite, on a net of fee basis, was up an estimated +2.33%, versus the MSCI All Country World Index (“MSCI ACWI”), which was up +1.98%[1] on a total return basis. For the first eleven months of 2017, the LAGE Composite has gained an estimated +22.32% as against +22.61%[1] for the MSCI ACWI on a total return basis.

The strategy spent the entire month of November fully invested in all regions.

[1]Source: FactSet Research Systems Inc.

**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 Strategy is currently offered by LCM to (A.) certain qualified investors through (i) a single account which is a component of the overall strategy offered through a managed account Lee Diversified Opportunities Fund LP ("LDOF"), during the period commencing on December 18, 2015 through July 1, 2016 and (ii) the private fund Lee Adaptive Strategies LP ("LAS"), during the period commencing on June 1, 2016 through current and (B.) certain accounts managed by LCM on a discretionary basis ("LALCS Managed Accounts"). LAS, LDOMF and the LALCS Managed Accounts all use the same investment program as the LALCS Strategy. 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 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 (i) a single account which is a component of the overall strategy offered 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.

The LAGE 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 LAGE STRATEGY AND THE LAGE COMPOSITE ARE NOT INDICATIVE, OR A GUARANTEE, OF FUTURE RESULTS. IT SHOULD NOT BE EXPECTED THAT THE LAGE STRATEGY'S ACTUAL RETURNS WILL REPLICATE THE RETURNS SHOWN IN THE PERFORMANCE MODEL.

**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

[1]Source: FactSet Research Systems Inc.

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 AC World Index.** The returns for the MSCI All Country World Index 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 LAGE 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 LAGE Strategy will invest in any specific securities that comprise the index or that the investment program of the LAGE Strategy will track the index. Consequently, the returns of the LAGE Composite may or may not be highly correlated with those of the index.

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[1] Source: FactSet Research Systems Inc.

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[1]Source: FactSet Research Systems Inc.