Lee Adaptive Strategies Update

Monthly Commentary

October 2017

October was a big month for anniversaries. Perhaps most significantly, it was the 500th anniversary of Martin Luther's 95 Theses. It was also nominally the 100th anniversary of Russia's October Revolution, although that actually began in November by Western (Gregorian) reckoning.

Financial anniversaries included the 30th birthday of the Crash of 1987, still the worst single day in US market history. Those of us around at the time remember thinking that it was an event of great significance, although at the distance of three decades it is hard to articulate any lasting effects or lessons learned. If thought about at all today, most investors consider October 19, 1987 to be an operational malfunction of some kind, not an example of something that a person might worry about happening again in today's sophisticated financial environment.

A bit more obscurely, this past month was the 110th anniversary of the Panic of 1907. That particular episode at least had the lasting effect of increasing support for the controversial idea that the United States needed a central bank of some kind. The Federal Reserve was launched in 1913.

Perhaps the least observed milestone this month was the fact that October 9th was exactly ten years after the pre-financial crisis peak for the S&P 500. As most of us remember quite well, in the seventeen months following October 2007 the S&P lost more than half its value. It would be 65 months until the index regained its high in March of 2013.

Of course, unlike October's other anniversaried events, the October 9, 2007 peak was not, at the time, especially newsworthy. It was a new all-time closing high, but it was the ninth new high for the S&P in 2007 and brought the index to up +10.3%[1] for the year, hardly an unprecedented advance.

We are certain that if we had the patience to shift through ten-year-old market commentaries we would find a vocal minority that warned that the market was then too expensive and likely to decline. We know this is so, because it is always so. Whatever the state of the equity markets there are always thoughtful and articulate bears making compelling cases. And arguments that equity prices are too rich are both more common and more appealing when the market is higher than it ever has been before. Investors who heeded the too high warnings in October 2007 profited from them. Those that listened after the eight earlier highs in 2007 were less fortunate, at least in the short run.

By our count, October 27th saw the 50th new high for the S&P 500 in 2017. On at least 49 of those occasions, selling in reaction to the new high was a mistake. That is not proof that selling because of number 50 is sure to be an error, only that the fact that the market is at a higher level than it has ever been before is not much of an indicator.

[1]Source: FactSet Research Systems Inc.

Our immediate reaction to statements that the market is over-valued is to ask "as compared to what?" Valuation is an inherently comparative measure. And with regard equity markets, there are really only two possible comparisons: current prices can be related to historical prices or equities can be compared to other asset classes.

Comparing the market to its own past is more problematic than it may seem. There are several sound reasons why current prices might be higher than those of years ago that do not imply over-valuation. Companies grow, they retain earnings, and they buy back shares. Most significantly, the fundamental risks associated with owning equities have been in a long-term secular decline, just as investor's tolerance for equity risk has increased.

Comparing equities to other asset classes is not much more definitive. Such comparisons always have an apples-to-oranges aspect. There is no established calculus that would allow us to say that if bonds are worth X then stocks must be worth Y.

Nevertheless, a quick tour of the other asset classes does not suggest that equites are uniquely expensive. Negative interest rates for high quality sovereign debt is now commonplace. Even Uncle Sam can borrow for 30 years at less than 3%. Inflation protected 30 year bonds yield less than a single percent.

Risks that bond owners are forced to assume to achieve yields that previous generations once expected from safe bets can be significant. The government of Iraq recently issued bonds with a six year maturity at 6.75%. Argentina, which only a year ago finalized settlement of its most recent default, was successful in floating a 100 year bond at under 8%. (What, one might ask, is the probability of Argentina *not* defaulting at some point between now and 2117?)

Perhaps real estate? There seems to be a construction site on every block of Midtown Manhattan. Publicly traded REITs have risen along with the equity markets. And the Case Shiller US National Home Price Index quietly started hitting new all-time highs of its own at the start of 2017. This eclipsed the peak from summer 2006, a level that was not that long ago considered to be the apex of an unsustainable bubble.

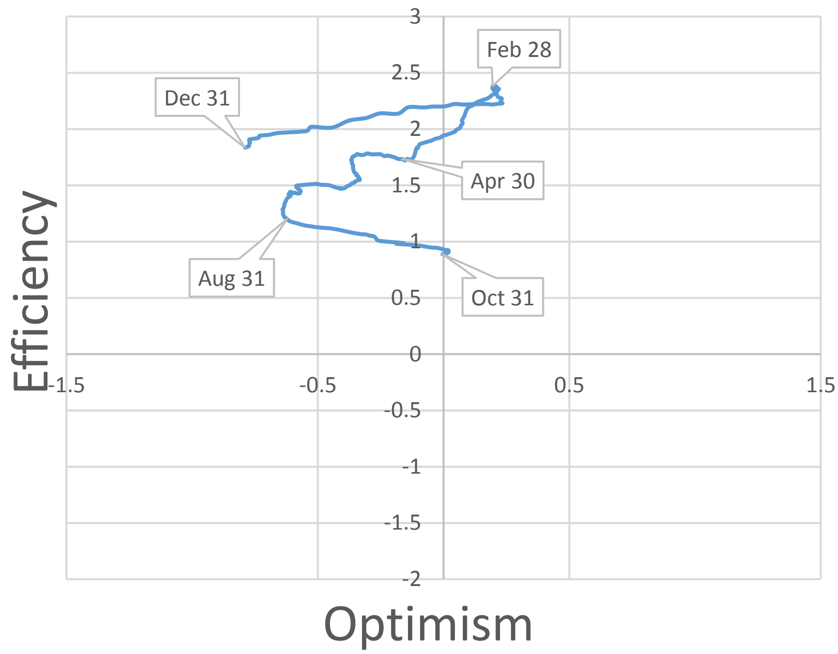
Just about the only asset class that currently looks inexpensive is equity index options, a state of affairs that is, we believe, itself a product of widespread shorting of volatility, that is, a bet that happy days will continue.

The S&P may or may not hit a 51st new high in 2017. If it does, we predict the event will be greeted with the same lack of enthusiasm and resigned protestations from the bears that the previous 50 inspired. This may be an eerily calm market, but it is also a reluctant one. Investors are holding stocks, and occasionally buying more, less out of a conviction that this is a good thing to do as out of a lack of viable alternatives. That is not irrational, but it does make for a fragile situation. It would not take much of a dislocation, perhaps in an asset class other than equity, to inspire a meaningful decline. If it does, we will get several new anniversaries to observe.

[1]Source: FactSet Research Systems Inc.

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 2017and 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, but is still lower than its first quarter level.

In contrast, Efficiency has been relatively stable, although it has also been falling steadily, if slowly, 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 few opportunities for easy relative gains from stock picking. Optimism, although improved recently, 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 October 2017, the LALCS composite, on a net of fee basis, was up an estimated +2.28%, even with the S&P 500, which was up +2.33%[1] on a total return basis. For the first ten months of 2017, the LALCS composite has gained an estimated +14.73% as against +16.91%[1] for the S&P 500.

The LALCS strategy spent the entire month invested in all sectors other than energy, which remained out of the portfolio. During October the energy sector, as represented by the XLE ETF, declined -0.83%[1].

Lee Adaptive Global Equity ("LAGE")

For the month of October 2017, the LAGE composite, on a net of fee basis, was up an estimated +1.74%, modestly behind the MSCI All Country World Index, which was up +2.10%[1] on a total return basis. For the first ten months of 2017, the LAGE composite has gained and estimated +19.53% as against +20.22%[1] for the MSCI All Country World Index.

The LAGE strategy spent the entire month of October 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.

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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.

[1]Source: FactSet Research Systems Inc.

Notwithstanding anything set forth herein, each recipient of this document (and each of the employees, representatives or other agents of such recipient) may disclose to any and all persons, without limitation of any kind, the tax treatment and tax structure of (i) the LALCS Strategy or LAGE Strategy and (ii) any of their transactions, and all materials of any kind (including, without limitation, opinions or other tax analysis) that are provided to each recipient relating to such tax treatment and tax structure.

[1]Source: FactSet Research Systems Inc.