Lee Adaptive Large Cap Sector Update

Monthly Commentary

March 2017

March was a nearly flat month in the equity markets, with the S&P 500, on a total return basis, up +0.12%[1], capping a strong gain of +6.07%[1] during first quarter. For the month and quarter the Lee Adaptive Large Cap Sector Composite, on a net of fee basis, was down an estimated -0.12% and up +5.37% respectively. For more detail, please see the performance discussion below.

It was a slow news month. The market started March with a catalog of anxieties, nearly all of which are still extant, unresolved. The Fed raised rates, which seemed to surprise nobody and did not obviously have an impact on equities.

Of particular note, Blackrock announced on the 28th that it was letting seven equity portfolio managers go. That was not especially newsworthy. Indeed, as Blackrock's active equity assets under management have fallen from $317B to $275B (down 13%) over three years in which the S&P 500 has gained +29%, revamping how a slice (about 11%) of those assets are managed seems fairly minimal.

What made it literally front page news was the announcement that the traditional or "fundamental" managers being shown the door would be replaced by quantitative managers. As the Wall Street Journal headline put it "BlackRock Bets on Robots to Improve Its Stock Picking."

The Lee Adaptive Strategies are quantitative, and we are mostly quants here, so we ought to be cheering this on as a win for the good guys. In truth, any mention of robots makes us cringe. Blackrock has replaced one bunch of human managers with another bunch of humans that it hopes will be more successful. The new crew will try to do essentially the same thing that the old one did, but will use different tools.

For as long as we can remember, professional stock market investors have been divided into two warring factions, quantitative and fundamental. The rivalry can be quite bitter, as evidenced by the faction names themselves, both digs at the other camp. Quants like to imply that the other side is non-quantitative and invests on fuzzy intuition. Traditionalists like to imply that the quants ignore fundamental economics and invest on numeric trivia. The more extreme partisans from both groups consider their rivals to be charlatans who might occasionally get lucky but who are nevertheless not "real" investors.

Of course, to an outside observer the factions are not so different. Both are dominated by nerdy introverted types who did well in school and generally prefer numbers and computers to words and people. And although techniques may differ, both camps are trying to accomplish the same goals, e.g. to buy undervalued out-of-favor stocks and then sell them when overvalued at the peak of their popularity.

It would be only a modest trivialization to say that the difference between quantitative and fundamental investing is basically a question of automation. A person might think of the two groups as airline pilots that do and do not use auto-pilot. (The analogy would be better if the users of auto-pilot also designed and built it.)

We believe that beyond the mere time saving of automation, quantitative investing has two significant advantages over the traditional alternative. First, because quantitative investing requires writing computer programs that implement a strategy, it requires the investor to be very explicit about what he is trying to do and why it might or might not work. Many fundamental managers, even very successful ones, have difficulty articulating how they make decisions. That is dangerous, because if you do not understand how you made money in the past, you may not be able to repeat the process in the future. Quants, on the other hand, know exactly why each decision was made and can, with considerable accuracy, simulate how a strategy would have performed in the past.

The second, and more significant, advantage of the quantitative approach is its edge in psychology. By this we do not mean crowd psychology, the often irrational behavior of investors in groups. Taking advantage of that sort of foolishness is a big part of successful investing from both schools. We refer instead to an advantage in managing an investor's own psychology.

Like poker players, successful investors are rational, detached, and cold-hearted. Stock prices are driven up and down by animal spirits and the endless struggle between greed and fear. The less involved an investor is in that emotional maelstrom, the more successful he will be. Quants understand that this is much more easily said than done, that there is a limit to the stoicism of even the most rational introvert.

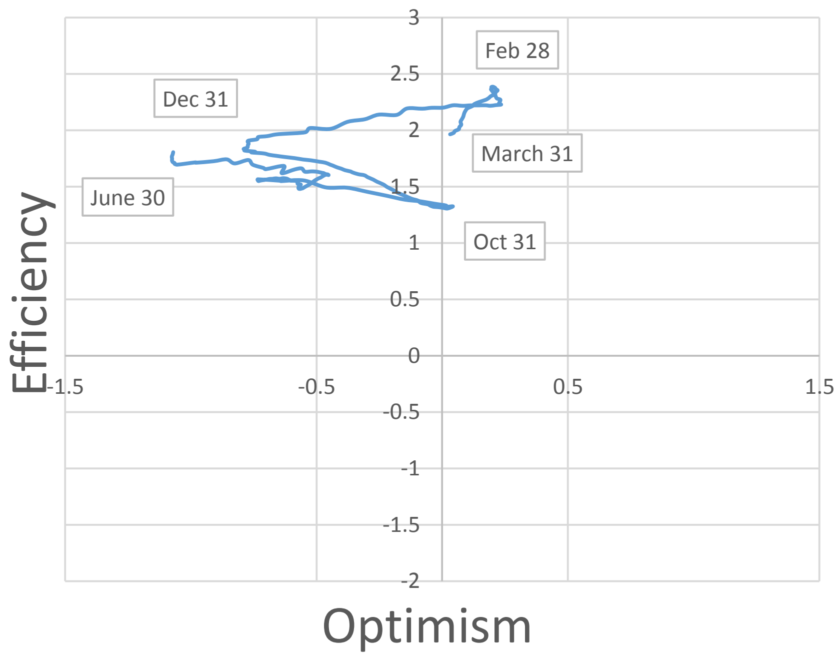
Quants construct strategies in the abstract, when what to do in a certain set of circumstances is a question of general principle rather than the crisis of the day. They then take this a step further and enshrine their strategies in computer code, arranging for a machine to gather appropriate data in real time and precisely implement the established plan.

Of course, humans are still involved. They develop the strategy. And they must have the nerve to stay the course, to keep doing what they told the computer to tell them to do. In times of stress that can be hard, as the urge to believe that "this time is different" can be overwhelming. But most quants have learned the hard way that the day they most want to override their strategy's automated decision is the day it is most important not to.

Quants usually call the computer based decision tools that they construct and use models. Calling them robots strikes us as both an exaggeration of their sophistication and an understatement of their role. Models are not substitutes for human portfolio managers as much as they are powerful tools for their use. But like many such tools, auto-pilots, chainsaws, and sewing machines among them, they do not merely save time but change and improve the nature of production and ultimately the product itself.

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 scores increased steadily through much of 2016, rising from significantly pessimistic levels during the winter of 2015-16, to neutral levels by October. On Halloween Optimism crossed, briefly, into positive territory for the first time in five years.

From the election in early November through the end of 2016, despite rising equity prices, Optimism fell steadily, retracing most of its gains since the summer. This trend then reversed in January and February, with Optimism once again crossing into positive territory at the end of January and increasing modestly above zero in February. March saw Optimism back off slightly, while still staying above zero.

In contrast, Efficiency has been largely stable, maintaining its high level for nearly a year.

The current positioning of the Sentiment Framework implies a market that is crowded and efficient, with few opportunities for easy relative gains from stock picking. Optimism, although much improved relative to the past few years, is in the context of a longer history merely at a slightly above neutral level, a place that implies neither optimism nor pessimism, but possibly anxiety.

Performance

For the month of March 2017, the Lee Adaptive Large Cap Sector Composite, on a net of fee basis, was down and estimated -0.12%, in line with the S&P 500, which was up +0.12%[1] on a total return basis. For the first quarter, the Lee Adaptive Large Cap Sector Composite gained an estimated +5.37% as against +6.07%[1] for the S&P 500 on a total return basis.

The strategy was fully invested in all sectors for the entire month and quarter.

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 "Strategy") that holds some combination of the U.S. large cap sector ETFs and/or cash, as determined by a proprietary quantitative model. The 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 the private fund 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. Both LDOF and LAS use the same investment program as the Strategy. The LALCS Composite performance is based on actual trading profits/losses/expenses net of a management fee of 0.50%. Actual expenses of operating the 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 Strategy and, consequently, the results shown above may not be fully indicative of the actual performance results of the 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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S&P 500 Total Returns. 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 Strategy will invest in any specific securities that comprise the index or that the investment program of the Strategy will track the index. Consequently, the returns of the LALCS Composite may or may not be highly correlated with those of the index.

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