Lee Adaptive Large Cap Sector Update

Monthly Commentary

November 2016

November saw solid returns for the broad equity indexes that partially hid significant dispersion between sectors. The S&P 500 on a total returns basis finished up +3.70%[1] for the month. Our Lee Adaptive Large Cap Sector Strategy Composite ("LALCS Composite") was just behind it at up an estimated +3.24%. For more details, please see the performance discussion below.

Of course, the big news for the month was an historic US election. The surprising result at the polls was quickly followed by a surprising day in the equity markets. Although bonds were down, the S&P on a total returns basis finished the day up +1.11%[1], a significant contrast to the sharp drop that was widely anticipated and that had been indicated by overnight futures. It is just possible that the market learned the lesson of Brexit, when an unexpected, and to many unwelcome, election result created what turned out to be a short-lived buying opportunity.

The urge to take action in response to momentous news, particularly bad momentous news, is fundamental to human nature. Something big happens and we need to react. Exactly what to do is not always obvious, but whenever a natural disaster, an act of terrorism, or a disturbing election result occurs, investors' sell muscles start twitching.

We have learned from experience to suppress these urges. Like alcohol and driving, adrenaline and investing do not mix well. Indeed, this is one of the best arguments for quantitative strategies. We quants decide what we will do in certain situations well in advance, while it is still an abstract question, rather than waiting for the excitement of unfolding events.

Obviously, the ideal would be to anticipate nasty surprises and sell the day before. This is not a practical strategy for mere mortals. In the real world, the question that usually faces investors is what to do at the moment when everybody, the investor included, gets bad news. And as a rule, the best answer is to do nothing. Not only is it too late to anticipate the market's reaction, markets have a consistent tendency to over-react in the short term, meaning that if anything the best bet would be to buy rather than sell.

To illustrate this, consider the following simple question. Which is a more negative indicator for future market returns, a loss of 5% over a month or a loss of 5% during a single day? Intuitively, a one day drop of 5% seems much more dire, suggesting a bad crisis worth running away from, while losing 5% over the course of a month sounds comparatively normal, if bleak.

[1] Source: FactSet®

In fact, the opposite is true. Since 1950 the S&P 500 has lost more than 5% in a single day just 24 times. On 18 of those occasions, that is, for 75% of them, the market gained the next day. On average, the market was up +1.50%[1] the day after a >5% loss. And that number is skewed downwards by a single outlier. The 1987 crash, in which the S&P lost more than 20%, was preceded the day before by a loss of -5.16%[1]. With that one observation excluded, the average return for the day after a >5% loss is a gain of +2.45%[1].

Even with a longer horizon, big one day drops look like a buy signal. The average return over the four weeks (20 trading days) following a >5% one day loss is +1.18%[1], or +1.76%[1] with the 1987 crash excluded.

But losing 5% or more during a calendar month is a different story. To begin with, it is a much more common phenomenon, having occurred 69 times since 1950, averaging just a bit more often than once a year. But as ordinary as it is, it is a meaningful negative indicator of future returns. On average, in the months following down >5% months the S&P gave up a further -0.48%, against an overall average gain of +0.80%[1] since 1950 for months not preceded by a >5% loss.

Our philosophy is not to worry about the short term volatility brought on by bad news. Indeed, we do everything we can to ignore it. Sudden and sharp sell-offs may capture the attention and imagination of investors, but in the long run they are not particularly harmful to wealth. In general, the market heals the short term in the medium term.

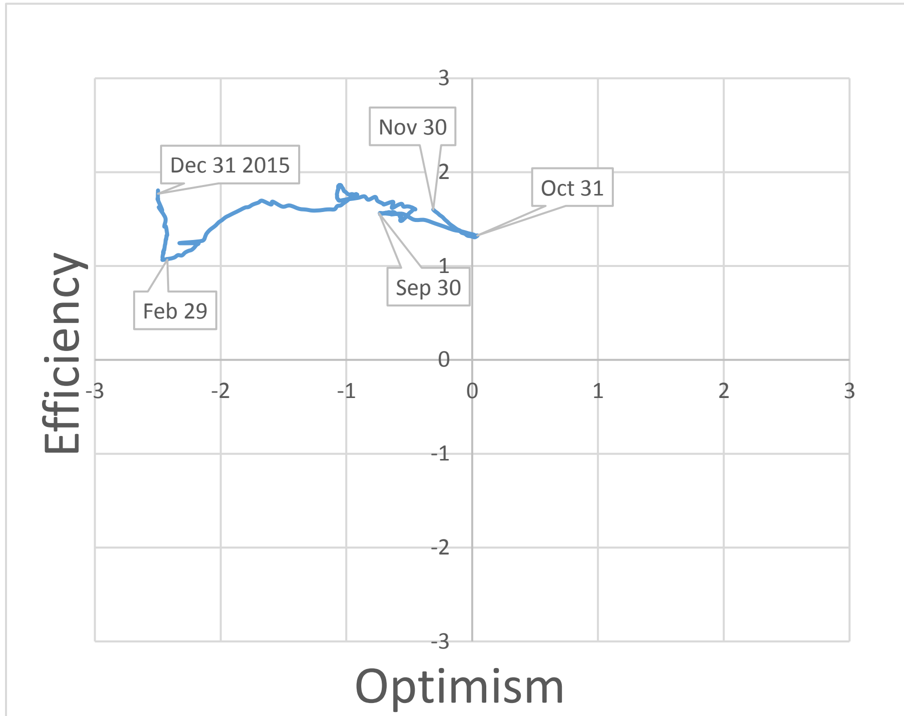
Thus our focus is not on trying to avoid the bad days, but on sidestepping the bad months and quarters. For it is the sustained bear markets, when repeated price declines inspire not bargain hunting but reevaluations of risk exposures, that are harmful to wealth. These are the declines that can take years to make up, the sort of declines that can seriously endanger financial plans.

Conveniently, the same characteristic that makes losses over the medium term more damaging, that they tend to continue rather than reverse, makes them easier to predict and avoid than short term unpleasantness. By definition, nobody can anticipate surprises. But we can anticipate bear markets.

[1] Source: FactSet®

Sentiment Model

We use our Market Sentiment Model to adapt the mechanics and weightings of our larger quantitative model to changing market conditions. The Sentiment Model 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.



The first two months of this year saw Optimism hold steady at strongly negative levels while Efficiency fell meaningfully. This was followed by a period of increasing values for both measures during March and April. May through July saw gradual if not steady improvements in Optimism.

After a range bound August and September, October saw Optimism increase steadily, crossing, although just barely, above zero for the first time in five years on Halloween. That visit above zero lasted just five days, as it re-entered negative territory on the eve of the election and continued to fall gently all month, retracing about half its October rise.

Except for those five days, the Sentiment Model has spent the entire of 2016 in the upper left quadrant of our chart, reflecting comparatively high efficiency and comparatively low optimism. This quadrant is arguably the most challenging of market environments for investors. High efficiency suggests that asset selection strategies (“stock picking”) will be more difficult while low optimism suggests that risky asset classes are less likely to gain in value.

Performance

For the month of November 2016, the LALCS Composite gained an estimated +3.24%, just short of the S&P 500, on a total return basis, which added +3.70%[1].

The LALCS Composite was fully invested in equities the entire month and held all ten sectors for most of the period. The exception was the last day, November 30th, when Energy was sold.

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[1] ***Source: FactSet®***

For the year to date, the LALCS Composite is up, an estimated +4.85% versus +9.03%[1] for the S&P 500 on a total return basis. Although it would be hard to describe this relative performance shortfall as intentional, it is the occasional unfortunate side-effect of our core strategic goal of protecting investors from significant losses in toxic markets. As the markets deteriorated earlier this year in January and February, the portfolio exited equities. It then waited for conditions to improve and for the rally to solidify before re-entering in March. In so doing it missed a portion of the rapid run-up after the fall. This, we believe, is a worthwhile (occasional) sacrifice.

Without the benefit of hindsight, there was no reason to believe in February that the market could not have extended its 10% loss into 20% or 30%. In keeping with our investment philosophy, our first priority is to take our investors out of harm's way in exactly those kinds of situations.

[1] Source: FactSet®

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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