Lee Adaptive Large Cap Sector Update

Monthly Commentary

October 2016

Although not quite as soporific as the late summer, October was relatively quiet in equity markets. The S&P 500 on a total returns basis eased down -1.82%[1], bringing it to up +5.88%[1] for the year, and the MSCI All Country World Index gave up -1.77%[1], making it up +2.92%[1] for the year. The Lee Adaptive Large Cap Sector Strategy Composite ("LALCS Composite") was down -1.84% for the month. A more detailed discussion of performance can be found at the end of this Update.

A combination of calm markets and an economy that grows steadily, if modestly, might be mistaken for a halcyon period of normalness, what might in the future be referred to as the Good Old Days. But however the current situation is characterized by future generations, it feels less than halcyon now. The comparative inaction of the markets inspires not confidence but anxiety. Like entrenched soldiers waiting for an attack, investors are scanning the horizon in nervous apprehension of the next unpleasant surprise.

Most obviously, after a campaign season that felt like it lasted a lifetime but actually took just a few years, the presidential election loomed at the start of November. The widely held consensus that Mrs. Clinton would prevail was shaken during the week of Halloween, then reinforced the day before the election, only to be smashed to pieces when the unthinkable happened.

As widely as a Clinton victory had been expected, a sharp market drop in reaction to a Trump victory was a foregone conclusion. And then there was a further surprise when that did not happen. The Wednesday after the election actually saw a tidy rise in US equity markets, although the bond market did retreat.

The most elementary of capital market principles is that widely expected events do not move prices. To this might be added the wisdom that unexpected events sometimes bring unexpected reactions. Anticipating market reactions to events can be as challenging as anticipating those events themselves. This is particularly true for developments that are unprecedented, for which there are few similar examples to learn from.

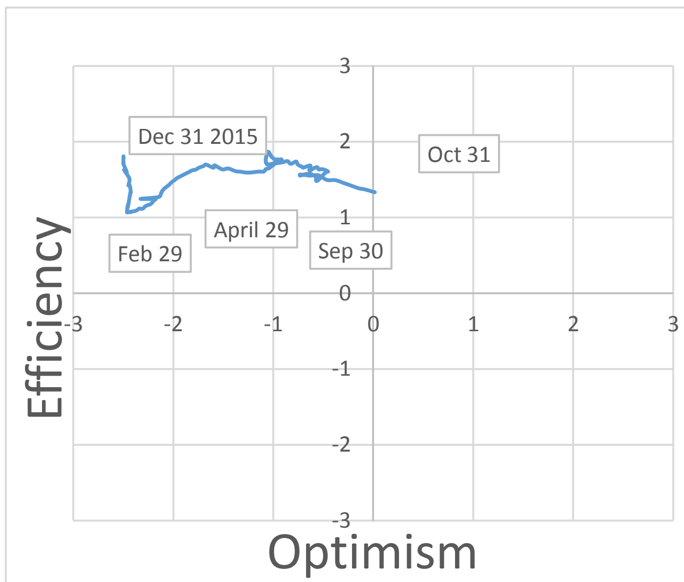
And particularly with regard to monetary policy, it is worth reminding ourselves that we have been exploring uncharted territory for some time now. Outside the US, negative interest rates have gone from a theoretical novelty to an unremarkable fact of life. In Europe, the ECB's continued quantitative easing efforts will soon face the hitherto unimaginable practical problem of exhausting the supply of sovereign bonds to buy.

We are instinctively skeptical of any suggestion of a "new normal" and Sir John Templeton's quip about "this time is different" being the most dangerous words in investing is one of our favorite maxims. But once in a while, things actually are different. It is just possible that the rules that we all learned about money, interest rates, and inflation really are changing.

The monetary new normal may not be any worse than the old. Indeed, it very well could be better. But changing rules are a challenge for markets. Events are harder to anticipate. And reactions to those events harder still.

Sentiment Model

We use our Market Sentiment Model to adapt the mechanics and weightings of our full 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.

Until the last day of October, the Sentiment Model had 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. The recent increase in optimism, although to a historically neutral position, suggests that market participants are gradually becoming less risk adverse and more confident in the future.

Performance

For the month of October 2016, the LALCS Composite declined -1.84%, in line with the S&P 500, which lost -1.82%[1] on a total return basis.

The LALCS Composite was fully invested in equities the entire month and held all ten sectors for most of the period. The exception was October 12th through 21st, when Energy was not held. During this period the SPDR Energy ETF lost -0.58%[1], against a gain of +0.13%[1] for the S&P 500.

For the year to date, the LALCS Composite is up modestly, +1.55% versus +5.88%[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.

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. 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 STRATEGY'S ACTUAL RETURNS WILL REPLICATE THE RETURNS SHOWN IN THE PERFORMANCE MODEL.

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 LALCS Composite 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

LALCS Composite will invest in any specific securities that comprise the index or that the investment program of the LALCS Composite will track the index.

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 Lee Adaptive Large Cap Sector 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 Strategy are not expected to be highly correlated with those of the index.

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