Lee Adaptive Large Cap Sector Update

Monthly Commentary

September 2016

It is sometimes said that the stock market climbs a wall of worry. This market seems to have met its wall, and to be full of worry, but apparently lacks the will to climb.

For the month of September, the Lee Adaptive Large Cap Sector Strategy Composite ("LALCS Composite") gained +0.03%. The S&P 500 was up almost +0.02%[1] on a total return basis, a result even more inert than August's positive +0.14%[1]. To be fair, daily price movements were somewhat more exciting than they were before Labor Day, but the overall effect and tone was largely identical. A more detailed discussion of performance can be found at the end of this Update.

Principal sources of market anxiety were unchanged. Indeed, as time goes by and our obvious and well-worn worries continue to keep from progressing into full blown crises, fear of them naturally tends to recede. Familiarity breeds contempt.

As it has been for what seems like forever, but is actually just a few years, worry number one is the prospect that the Fed will raise interest rates. Our current near-zero environment is widely assumed to be abnormal and transient, thus an increase would be merely the inevitable return to normal. And yet, the Fed has actually raised rates just once in the past ten years. Stern rhetoric and sober Congressional testimony aside, from their actions it should be clear to all observers that decision makers at the Fed are very reluctant to return to normal. Like an unpleasant dental procedure, any available excuse will be used to postpone it.

The danger, of course, is complacency. Just because we have worried about this for so long, and for so long nothing much has happened, it does not follow that we should stop worrying. The Fed will likely raise rates sooner or later, if only to salvage credibility, which will greatly upset a market that learned to ignore the possibility of an increase. The alternative, that the Fed will allow the new normal of low rates to become the actual normal, could be an even worse outcome if the Fed then lacks the ability to provide liquidity during the next crisis.

Then there is the long running worry over oil, another saga that has become tedious. All the markets desire is a happy medium. Oil prices should be high enough that energy producing companies (and countries) can pay their bills, but not so high that the broader world economy is harmed. How wide that Goldilocks range in the price of oil is, or if it in fact exists, is not clear.

Hopes were raised in late September that OPEC will cap production and stabilize prices. Anything is possible, but the days in which OPEC had disciplined control over the world's marginal capacity and could set prices are long past. There may not yet be a new normal in energy, but the old normal is no more

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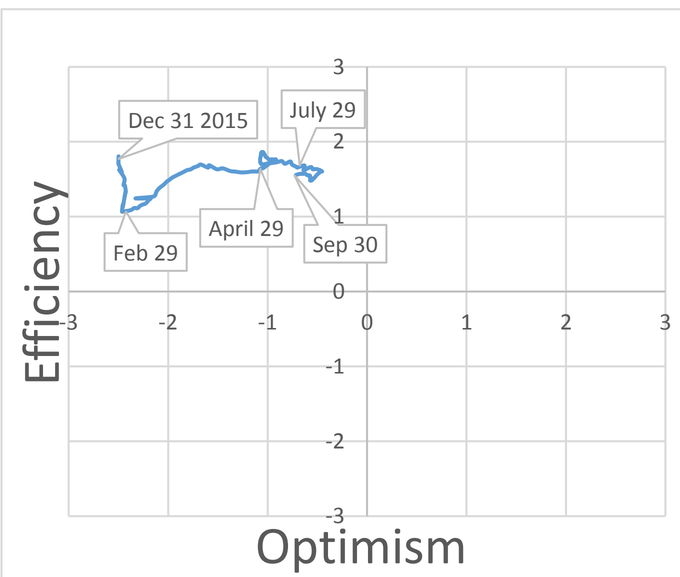
[1] ***Source: FactSet®***

The US Presidential election is another long-running source of uncertainty. Unlike some other causes of worry, this one has a finite end. Certainty will arrive the night of November 8th, barring hanging chads or science fiction level cyber-attacks. It seems clear that the markets would strongly prefer that Mrs. Clinton win, which is to say that they strongly prefer that Mr. Trump not win. Indeed, that preference seems so universal that it is worth considering if the markets have accounted at all for the possibility of a Trump victory. A probability less than 50% is not necessarily zero. As we learned recently from the Brexit referendum, unthinkability bias can be a very dangerous thing.

Rounding out our survey of old dull worries, what could be more passé than anxiety over the strength of banks? It is a worry that is as old as modern finance, although it does suddenly come into fashion from time to time. The latest specific concern is over Deutsche Bank, which recently suffered the rumor that savvy clients were “reducing collateral on trades,” apparently a euphemism for taking money out of their accounts while they still can. We do not have a strong opinion on DB’s health, but we do think it transcends “too big to fail” to “too German to fail.” Despite protestations to the contrary, it seems very unlikely that a German government willing to bail out Greece would allow anything too nasty to happen to its national champion bank. The American analogy is General Motors not Lehman Brothers.

Of course, dodging this bullet does not mean that European banks are in good shape after all. Nor do the years that have passed since our last serious banking problem mean that we cannot have another one. The health of banks may be an obvious, if not clichéd, concern, but fatigue and boredom is not a good reason to stop worrying.

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.

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[1] Source: FactSet®

August saw a modest improvement in optimism which was reversed in September. Broadly speaking, the Sentiment Model has shown little movement since mid-summer. And although Optimism is now much higher than it was at the start of the year, it is still somewhat below its ten-year average level.

Moreover, 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 September 2016, the LALCS Composite was nearly unchanged at +0.03%, essentially flat to the S&P 500, which was also nearly unchanged at +0.02%[1]. The portfolio was fully invested in equities and held all sectors in the universe the entire month.

There were no trades based on signal changes. However, mid-month the S&P indexes spun out Real Estate from the Financials sector, which resulted in our position in the Financials ETF becoming a position in a smaller Financials ETF as wells as a new position in a Real Estate ETF. Henceforward, with the addition of Real Estate, the universe of sectors and ETFs for the product will number ten rather than nine.

For the year to date, the LALCS Composite is up modestly, +3.46% versus +7.84%[1] for the S&P 500. 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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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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