LEE CAPITAL MANAGEMENT

Lee Adaptive Large Cap Sector Update

Monthly Commentary

August 2018

Ten Years Later

For the markets, there are two kinds of Augusts. Most of them are quiet and pleasantly uneventful. A great time to take a vacation. And some Augusts are very exciting, with volatile markets made worse by thin volumes, possibly due to all those people on vacation.

This August was one of the quiet ones. Markets generally rose calmly. The most memorable news was the near comic Tesla saga. Apple became the first company worth more than a trillion dollars. There was a crisis in Turkey.

And then suddenly it is September and we are all back at our desks. This September may or may not be calm, but it brings an important anniversary. The 15th will be ten years since the bleak Monday morning on which Lehman Brothers filed for bankruptcy.

In the memory of many of us who were investing at the time, the Lehman bankruptcy has become a sort of Pearl Harbor Day for the most recent bear market and recession. Of course, our memories are simplifying history a bit. The bankruptcy was less a cause than an effect of the crisis. Had Lehman's failure been due to something specific to the firm, perhaps an accounting irregularity or a rogue trader, and happened during a normal healthy market, it likely would have been no more meaningful than the failures of Barings or Enron.

There is an often quoted exchange from Hemingway's *The Sun Also Rises* in which a character is asked how he went bankrupt. "Two ways. Gradually and then suddenly." And so it was with Lehman, which at least in retrospect had been sliding towards the precipice for some time. More broadly, September 15 was not a sudden shock to a calm and confident market. The S&P 500 had peaked almost a year before and was already down 20% from the top. And, perhaps more ominously, the Case-Shiller National Home Price Index had peaked in the summer of 2006 and was by September 2008 down 11%.

Bear markets rarely start suddenly. Indeed, 1929 is more exception than rule. They are usually the result of an unwinding of a widely held confidence in the market, and that generally takes months to play out. This is an important lesson from 2007-2009 and one worth repeating ten years later.

There are others. The market can be driven by the economy, but the economy can also be driven by the market. Never assume that the government will step in to save the day, no matter how awful the anticipated disaster if they do not.

A bigger lesson is on the limitations of the wisdom of crowds. Most market participants (ourselves included) believe that a large number of intelligent, hard-working, and self-interested people in a marketplace will do a good job of setting prices and allocating capital. Most of the time. There are exceptions, and in hindsight those exceptions are often nearly inexplicable.

Much of the mortgage backed security fiasco that set the Great Recession in motion can be traced to a simple mistake apparently made over many years by, it would seem, nearly all the highly compensated professionals involved in mortgage bonds. The bonds were considered very low risk because although any given mortgage in the underlying pool might default because the borrower went bankrupt, it was a big pool and the chances of more than a handful turning out to be bad credits was very low. Somehow non-obvious at the time was the possibility that house prices might decline, reducing the credit-worthiness of all the mortgages simultaneously.

More fundamentally, it is impossible to believe that the stock market crowd had wisdom both in the fall of 2007 and the spring of 2009. Yes, there were some very bad developments in between the two periods. But stocks in 2009 were at about half their 2007 prices. It is hard to imagine any scenario in which half the value of American public companies might dissipate. Either the crowd was mad in 2007, wildly over paying for dangerous securities, or mad in 2009, unwilling to buy at fire-sale prices.

Ten years on, it is natural to say that 2009 was the time of madness. Looking back, stocks in 2007 do not look unreasonably priced at all. Indeed, in 2018 it is not easy to remember what all the fuss was about. Even 2006 house prices look reasonable. Sure, a few over-leveraged financial institutions went under. That happens. But the economy’s long-term fundamentals were unchanged.

Arguably the most obvious lesson from the financial crisis of 2007-09 is that all will be forgiven. With the passage of enough time, even the steepest and most frightening of market drops will be cured with new all-time highs. In theory, if this lesson were learned then we would no longer have steep drops, as all would rest assured that the bad news of the day will pass, which would mean that the consensus confidence in the market would never unwind.

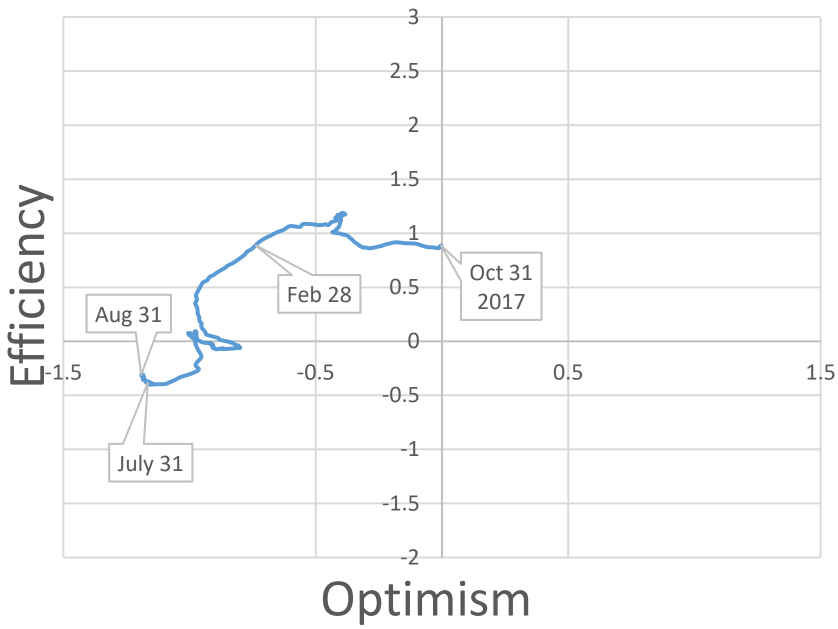
We doubt it.

The Market Sentiment Framework

We use our Market Sentiment Framework to adapt the mechanics and weightings of our full quantitative models 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.

August saw almost no change in either Optimism or Efficiency, breaking from a year-long trend of both measures falling.

Optimism is now -1.14. Although not an extreme reading, it was -2.00 as recently as Q1 2016, both the absolute level and the multi-month trend are clearly negative.



After staying close to zero for most of the second quarter, Efficiency made a more decisive movement downwards to end July at -0.38 and ended August at -0.40. Having crossed over into negative territory in mid-April for the first time since September 2012, this measure remains at a low level when compared to recent history. This suggests a market that is coming under continuing stress and that is becoming less crowded.

Lower Efficiency is good news for value investors who are now more likely to find bargains produced by a less well-functioning marketplace. But it is bad news for momentum investors who now have a smaller crowd to get in front of. Moreover, it raises the danger that in a crisis there would be fewer calmer heads ready to provide liquidity.

The current positioning of the Sentiment Framework implies a market that tends to the inefficient, with moderate opportunities for relative gains from stock picking. Optimism, although not exceptionally low in absolute terms, has been showing a downward trend and is at a level that would suggest muted, if not negative, market returns.

Performance

Lee Adaptive Large Cap Sector (LALCS)

For the month of August 2018, the LALCS composite, on a net of fee basis, was up an estimated +2.18%, behind the S&P 500, which was up +3.26% on a total return basis. For the first eight months of 2018, LALCS is up +7.27% on a net of fee basis, vs the S&P 500, which is up +9.94%.

The strategy began and ended August invested in all sectors other than Healthcare.

PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS OR PROFITABILITY.

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 November 30, 2017 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.

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 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.

Disclaimer:

PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS OR PROFITABILITY.

This document (this "Update") does not constitute an offer to sell or a solicitation of an offer to purchase, interests in any investment vehicles or securities. This Update is not, and under no circumstances is it to be construed as, a prospectus, advertisement or an offering of any interests in the Strategy or other instrument. This Update is intended for informational purposes only, it does not constitute investment advice, or a recommendation, with respect to investment in the LALCS Composite, LAS, LAGA Composite, LAGE Composite, LDOF, the LALCS Strategy, the LAGA Strategy, the LAGE Strategy or any other or other instrument.

Lee Capital Management LP ("LCM") has relied upon and assumed in the LALCS Strategy, without independent verification, the accuracy and completeness of all information available from public sources. No assurance can be given that an investor will receive a return of all or a part of his or her initial investment, and investment results may vary substantially over any given time period. An investment is not a deposit and is not insured or guaranteed by the FDIC or any other government agency or by LCM, its affiliates or subsidiaries.

This Update and the material contained herein are confidential and may not be distributed in whole or in part to anyone other than the intended recipients. By accepting receipt of this Update the recipient will be deemed to represent that they possess, either individually or through their advisers, sufficient investment expertise to understand the risks involved in any purchase or sale of any financial instruments discussed herein. Unauthorized reproduction or distribution of all or any of this material or the information contained herein is strictly prohibited.

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 the LALCS 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.