Lee Adaptive Strategies Update

Monthly Commentary

April 2018

April was the month that something was supposed to happen. After a bountiful January of new highs, global markets experienced a violent correction, followed by a tepid and disappointing partial rebound. March brought continued volatility and modest losses, but also a sense that the situation was stabilizing.

So we anxiously looked forward to April, expecting that the markets would reveal a new direction and theme. And they revealed nothing. The S&P 500 see-sawed its way through the month to finish up 0.38%[1]. Corporate Q1 earnings were modestly better than expected. There was more saber-rattling on US-China trade, but North Korea suddenly became less threatening.

Perhaps the expectation that the markets would adopt a new clear narrative was foolish. As quantitative investors, we generally see capital markets as fundamentally chaotic and mostly unpredictable. So why assume the existence of a coherent plotline, as if the markets were a very long-running soap opera?

That question has a simple answer: because we are human. We cannot help but to tell ourselves stories about what we see. We observe random events A, B, C, and D, and conclude that C was a logical result of A and B, or maybe that D was a surprise ending.

Sportscasters, and their financial equivalent, the broadcast journalists who must come up with one sentence explanations of the current day's market performance, are the most notorious practitioners of this story telling. Watch CNBC long enough and you will see the talking heads spend all of an afternoon explaining that the market is down because of, for example, hawkish comments in the latest Fed minutes, only to have the market reverse, close up, and cause the same commentators to tell us authoritatively that the market was up because of dovish comments in the latest Fed minutes.

It is tempting to say that investors should do all they can to filter out these invented stories and rely entirely on cold facts and logic. In a way, that is the fundamental philosophy behind value investing, that a person should ignore the irrationality all around and focus only on dollars and cents. There is Benjamin Graham's famous allegory of investing in the stock market, that it is like being business partners with a manic-depressive who occasionally offers to sell some of his stake in the business for too little or offers to buy yours for too much, depending on his unstable mood. Only by not being moody yourself can you profit from your partner's instability.

That world view has a lot of appeal to us. Indeed, protecting investment decisions from an investor's own emotions is probably the strongest single argument for quantitative investing. But the real world is more complex. Graham's crazy partner was lucid on most days and willing to transact at reasonable prices. We are not sure that part is such a good allegory. Ultimately, the capital markets are not governed by cold logic and facts, but by humans who tell stories.

[1] *Source: FactSet Research Systems Inc.*

Much of quantitative research is searching for the after effects of the stories that investors like to tell. One explanation of why momentum investing works so well is the attractively tidy narrative of a market that keeps going up or down. If enough investors believe that a market that has appreciated over the past three months is more likely to go up in the fourth month, then they will be buyers during the fourth month, fulfilling their own expectation.

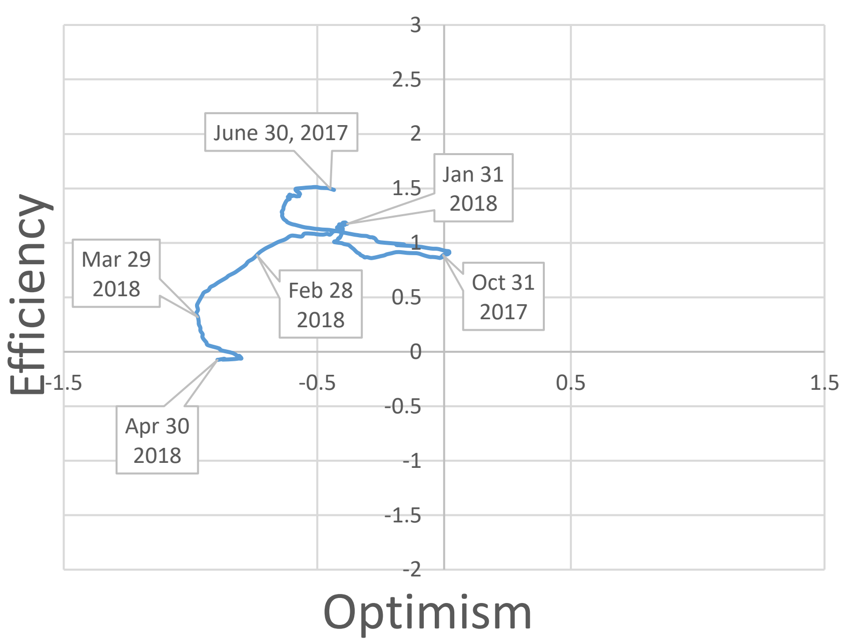
Similarly, if the consensus of investors is that a bear market is likely to begin in May 2018 because (and we think this is not a rational theory) the bull market that began nine years ago is so old, then a bear market is, indeed, more likely to begin. Or maybe the better story is one of renewed advances after a three month period of “consolidation” and “profit taking.” The third alternative, more indecision and sideways movement, seems anticlimactic.

So maybe something will happen in May.

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.

Optimism rose slightly in April, from -0.97 to -0.89, a fairly trivial improvement. 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.



Of greater significance, Efficiency continued its 2018 decline, crossing over into negative territory in mid-April for the first time since September 2012. This suggests a market that is coming under continuing stress and that is becoming less crowded. And it comports well with anecdotal evidence of a narrowing market that concentrates attention on a short list of very large technology stocks.

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 specter 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 sustained 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 April 2018, the LALCS composite, on a net of fee basis, was up an estimated +0.48%, ahead of the S&P 500, which was up +0.38%[1] on a total return basis. For the year to April 30, LALCS is down an estimated -1.17%, trailing the S&P 500 which is down -0.38%[1] on a total return basis.

The strategy spent nearly the entire month invested in all ten sectors. On Friday the 27th it eliminated Energy and distributed the proceeds to the remaining nine sectors.

Lee Adaptive Global Equity ("LAGE")

For the month of April 2018, the LAGE composite, on a net of fee basis, was up +0.61%, behind the MSCI All Country World Index, which was up +1.09%[1] on a total return basis. For the year to April 30, LAGE is up an estimated +0.44%, ahead of the MSCI All Country World Index, which is up +0.16%[1].

During April, the strategy reduced exposure to US equity and increased exposure to the other regions, particularly Europe, which had ended March significantly underweight. It ended the month 33% US, 25% Europe, and 14% in each of Japan, Asia ex-Japan, and Emerging Markets.

Lee Adaptive Global Allocation ("LAGA")

For the month of April 2018, the LAGA composite, on a net of fee basis, was up +0.27%, ahead of our blended benchmark, which was down -0.20%[1] on a total return basis. For the year to April 30, LAGA is up +0.17%, ahead of the MSCI ACWI, which is down -0.71%[1].

The strategy began and ended April significantly underweight Fixed income and holding about 30% in cash. It also shifted weight from US to Europe during the month, ending with 2% in fixed income, 24% in US equity, 16% in Europe, and 9% in each of Japan, Asia ex-Japan, and Emerging Markets equity, and 31% in cash.

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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.
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Lee Adaptive Global Equity Composite ("LAGE Composite") Performance. A capital weighted performance composite of the of an investment strategy known as the Lee Adaptive Global Equity strategy (the "LAGE Strategy"). The LAGE Strategy is currently offered by LCM to certain qualified investors through certain accounts managed by LCM on a discretionary basis ("LAGE Managed Accounts"). The LAGE Managed Accounts use the same investment program as the LAGE Strategy. The LAGE Composite performance is based on actual trading profits/losses/expenses net of a management fee of 0.50%. Actual expenses of operating the LAGE Strategy may vary, depending on the investment structure in which the LAGE Strategy is used, which could result in lower returns than those stated for the LAGE Composite. Such expenses may detract materially from the performance of the LAGE Strategy and, consequently, the results shown above may not be fully indicative of the actual performance results of the LAGE Strategy.

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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.

MSCI All Country World Index. The returns for the MSCI All Country World Index ("ACWI") 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 above composite returns 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 strategies above will invest in any specific securities that comprise the index or that the investment program of the strategies above will track the index. Consequently, the returns of the composites above may or may not be highly correlated with those of the index.

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Blended Benchmark. Is a hypothetical index comprised of 60% MSCI AC World Index and 40% the Bloomberg BarCap US Aggregate Bond Index. You cannot invest directly in this index.

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