Lee Adaptive Strategies Update

Monthly Commentary

February 2018

It could have been much worse. The Magic Market that went up, calmly, month after month, came to an abrupt end in February. For investors with very short memories it was an inexplicable shock. For the rest of us, it was a return to the less pleasant but more familiar markets we once knew.

Is the bull market over? It is too early to tell. But it is clear that the past few weeks represent a meaningful break in the rhythm of the markets, a regime shift from one set of rules and habits into another. Two months ago we pointed out that in the entire of 2017 the S&P 500 gained or lost more than one percent in a day just eight times. February saw it move by more than a percent 12 times over just 19 trading days.

The S&P also set a record for the fastest loss of 10% off an all-time high, at nine days. It is the sort of record that sports announcers are fond of, invented to dramatize current events and never used again. (It was not, of course, the fastest drop of 10%, which happened over a few hours on October 19, 1987, nor the worst nine day period. The S&P lost just under 25% from September 26 to October 9, 2008.)

As upsetting as February was for nearly all investors, we find ourselves encouraged by what happened, or to be more precise, what did not happen. February ignited two powder kegs that had been worrying us and, so far, the damage appears to be contained.

The first powder keg was the massively popular short volatility trade. As we have discussed in the past, it is our belief that the dramatically muted equity price movements seen in 2017 were at least partly due to the large-scale shorting of volatility, that is, the writing of options on the S&P 500. This maneuver was a self-fulfilling prophesy in the same way that investors that believe a stock will go up in price will buy it and drive the price up. Because the shorting created so many outstanding S&P options that needed to be dynamically hedged, every small up or down movement in the index was instantly met with countervailing buys and sells that severely dampened volatility, further encouraging those who would short it.

The danger was that the guardrails that kept the market in a narrow track, although strong, were brittle. When, inevitably, the market experienced a sudden price movement and a spike in volatility, investors who were short volatility would run for cover, reducing the need for hedging so many options, which would reduce the dampening of volatility, increasing it further. The market might then smash through the guardrail and over the cliff.

The guardrails seem to be gone now, but, as of the start of March, there has been no cliff. The VIX index, which spent much of 2017 in the 10 to 12 range, closed at 37.32[1] on February 5th and stayed above 15 all month. Our worry had been that sudden and massive losses for volatility sellers would have systemic

[1]Source: FactSet Research Systems Inc.

effects, possibly even a "Lehman moment," for example when a large bank was revealed to have been on the wrong side of the trade.

Although it is always possible that there is some vital institution that has been quietly but mortally wounded by the spike in volatility, so far it appears not to have been a serious blow for the financial system as a whole. Yes, two short volatility ETFs that once held billions of dollars did essentially vaporize, but the fallout from that appears to be limited to what we are sure will be lengthy lawsuits. In hindsight, we might have been less worried about a violent end to the short volatility trade had we remembered a fundamental difference between capital and derivatives markets. If the prices of stocks or bonds decline, wealth is destroyed. If the prices of derivatives go down (or up) wealth is transferred from the unfortunate to the more fortunate, in this case from the sellers of volatility insurance to the buyers.

The other powder keg that exploded but appears to have done less damage than feared was simply the unavoidable end of the low volatility bull market itself. Although just about everybody claimed to believe that the low volatility appreciation experienced over the past year or so was an unsustainable fluke, and so should not be relied on, there must have been some investors who thought that the financial laws of gravity had been repealed, or at least suspended. For a while there, the equity markets looked like a source of wealth creation only a bit more risky than compound interest.

Of course, the danger was that all those optimistic fools would sell in a panic when markets returned to more typical levels of volatility, and especially if the markets, for example, went down by more than 10% in nine days. Clearly, there were disillusioned equity sellers in February, hence the 10% drop. But as it turned out there were not enough of them, or they were not spooked easily enough, to turn retreat into rout. And that is, modestly, encouraging.

For many, the issue of what happened in February is less interesting than why it happened. And on that question we do not have an enlightening answer. Indeed, we think the natural human inclination to assume that there must be a logical reason should be resisted.

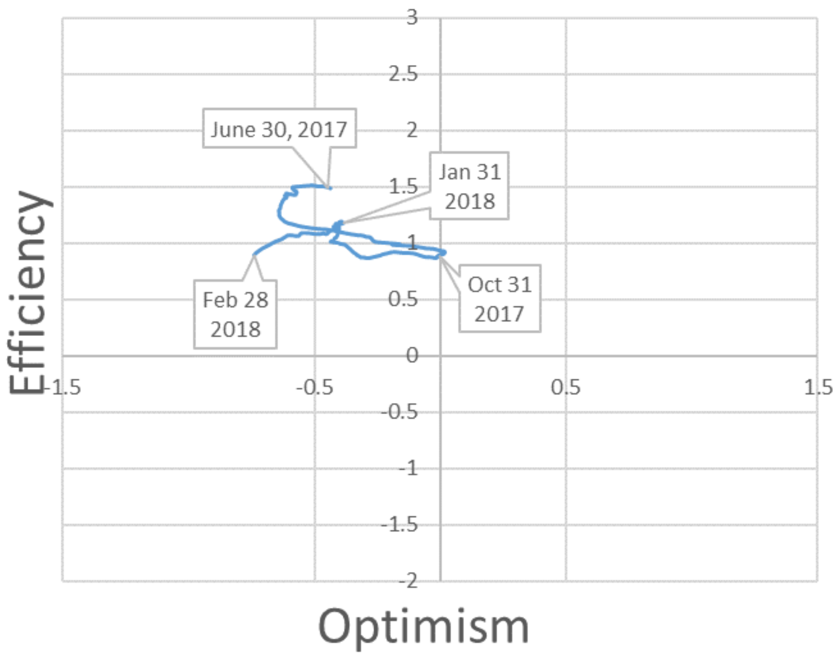
One popular after-the-fact explanation for the fall in equity markets is the fall in fixed income markets. January, after all, was very strong for stocks and weak for bonds. Perhaps a contagion spread from fixed income over to equity. This explanation seems strained to us. Just because A happened before B does not prove cause and effect. Moreover, other than the fact that bonds went down, something that has happened many times in the past, there was precious little news from the fixed income markets. Yes, interest rates appear to be on a long term trend upwards. Surely this has been clear for some time now?

As normal as it may have been, February was not a pleasant experience. That it could easily have been much worse is, for most, little consolation. On the other hand, it may prove to be a worthwhile reminder of the true nature of the markets.

[1]Source: FactSet Research Systems Inc.

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 has been in retreat since briefly crossing into positive territory at the end of October 2017. Perhaps not surprisingly, its fall accelerated during February of this year. Although its current level, at -0.75, is not extreme, this is the lowest level it has been for more than a year.

In contrast, Efficiency has been relatively stable. After falling modestly last summer it has remained within a very narrow band near 1.0.

The current positioning of the Sentiment Framework implies a market that is modestly efficient, with fewer opportunities for easy 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 market returns.

Performance

Lee Adaptive Large Cap Sector (”LALCS”)

For the month of February 2018, the LALCS composite, on a net of fee basis, was down an estimated (4.37%), versus the S&P 500, which was down (3.69%)[1] on a total return basis. For the year, the LALCS composite gained +0.17% against +1.83%[1] for the S&P 500 on a total returns basis.

The LALCS strategy spent the entire month of February invested in all ten sectors.

[1]Source: FactSet Research Systems Inc.

Lee Adaptive Global Equity ("LAGE")

For the month of February 2018, the LAGE composite, on a net of fee basis, was down an estimated (3.64%), versus the MSCI All Country World Index, which was down (4.16%)[1] on a total return basis. For the year, the LAGE composite has gained an estimated +0.69% against +1.27%[1] for the MSCI All Country World Index on a total returns basis.

The LAGE strategy spent the entire month of February fully invested in all regions.

Lee Adaptive Global Allocation ("LAGA")

For the month of February 2018, the LAGA composite, on a net of fee basis, was down an estimated (2.62%), versus our Blended Benchmark, which was down (2.88%)[1] on a total return basis. For the year, the LAGA composite has gained an estimated +0.28% against (0.02%)[1] for the Blended Benchmark.

The LAGA strategy continued to reduce its exposure to fixed income during the month of February, ending with an approximate weight of 3.4%, as against the fully invested level of 40%. Funds taken from fixed income were reallocated proportionately to the other equity sectors and to cash, which ended the month at 8.15% of the portfolio. This represents a strong positioning against fixed income, in reaction to its very poor scoring from our quantitative model.

PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS OR PROFITABILITY. Please read the important definitions and disclaimers on the following pages.

[1]Source: FactSet Research Systems Inc.

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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certain accounts managed by LCM on a discretionary basis ("LAGA Managed Accounts"). The LAGA Managed Accounts use the same investment program as the LAGA Strategy. The LAGA Composite performance is based on actual trading profits/losses/expenses net of a management fee of 0.50%. Actual expenses of operating the LAGA Strategy may vary, depending on the investment structure in which the LAGA Strategy is used, which could result in lower returns than those stated for the LAGA Composite. Such expenses may detract materially from the performance of the LAGA Strategy and, consequently, the results shown above may not be fully indicative of the actual performance results of the LAGA 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.

Bloomberg Barclays US Aggregate Bond Index. The returns for the Bloomberg Barclays US Aggregate Bond Index ("US Agg") 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 US Agg is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The US Agg index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and non-

[1]Source: FactSet Research Systems Inc.

agency). The index is one of the most widely used benchmarks for fixed income 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.

Blended Benchmark. Is a hypothetical index comprised of 60% ACWI and 40% the US Agg. You cannot invest directly in this index.

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[1]Source: FactSet Research Systems Inc.