LCM
LEE CAPITAL MANAGEMENT

Lee Adaptive Strategies Update

Monthly Commentary

July 2018

Letting It All FAANG Out

The tail end of July brought something new to worry about. "FAANG divergence" is a classic example of one of our favorite types of manufactured news, the disturbing reversal of a trend you were unaware of. Apparently, the FAANG stocks were supposed to converge, or at a minimum proceed upwards into the heavens in lockstep. The fact that, at least for a few days, they actually went in different directions is, we infer, an unsettling omen. That the divergence was inspired by something as banal as quarterly earnings reports only added to the unease.

For the uninitiated, FAANG refers to five specific companies: Facebook, Apple, Amazon, Netflix, and Google. (Google is, strictly speaking, called Alphabet now, but it still gets to be the G.) Together the five make up the cool kids table of global capitalism, changing our lives for the better and bestowing riches upon those investors hip enough to share the vision.

In truth, it is hard to define membership in FAANG beyond cultural criteria. All five are very successful, headquartered on the West Coast, and have strong consumer brands. We think of them as internet companies, but here in 2018 just about all businesses depend on the internet to some degree. We also think of them as new, but Apple was founded in 1976, eight years before Facebook founder Mark Zuckerberg was born.

And one of the five does not seem to belong. Netflix is much smaller than the other four, has a non-celebrity CEO/founder, and has a business that is not nearly as ubiquitous or all conquering as the others. So why is Netflix in the club? Is it possible that it provided a useful consonant for the acronym? Two A's, an F, and a G are hard to work with.

On the other hand, one name prominently missing is that of Microsoft. It is large, deeply involved in our digital lives, and has a well known name. It even has a West Coast HQ and a famous nerd-turned-gazillionaire founder. But somehow, and it is hard to explain this in other than the most subjective terms, it is not cool enough. Despite being of essentially the same vintage as Apple, Microsoft is passé. At best, it is one of the cooler teachers, not one of the cool kids.

The other day we saw an amusing pie chart that purported to show constituent weights for the S&P 500. The right half was taken up by the FAANG stocks, each at about 10%. The left side had the other 495 names in the index as tiny paper-thin wedges with tiny hard to read labels. Of course, it was a joke. As of July 31, the FAANG stocks are merely 12.75% of the S&P. (15.94% if Microsoft is included.) But in the minds of many investors, it often feels as if these five names are half the market, if not more.

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To be sure, as a proportion of overall market returns this year, FAANG has been significant. Through the first seven months of 2018, the five are collectively up 21.23%, against 6.47% for the S&P 500. Based on our algebra, that means that without FAANG the S&P would have been up just 4.59% this year.

Of course, over any period of modest market gains a few large stocks with high returns will make an outsized contribution to the net result of the index. Nor can it be said that the current concentration of S&P index weight in a few names at the top is particularly unique or, in and of itself, troubling. As the Wall Street Journal helpfully pointed out on July 29, the total weight of the S&P top 5 is now lower than it was before either the dot-com bust or the 2008 financial crisis.

But it is not the degree of concentration in the largest names that is worrisome, but the nature of those names and how they got to the top. The five largest weights in the S&P at the end of 2007 were Exxon Mobil, GE, Microsoft, AT&T, and Proctor and Gamble, a reasonably diversified list dominated by 100-year-old stalwarts. Today the five largest are Apple, Amazon, Microsoft, Google, and Facebook.

One interpretation of the market's enthusiasm for FAANG is investor optimism, an abiding faith in our digital future. These are the iconic hero companies that have changed the way we live and will continue to do so, profitably.

A darker, less optimistic view is that investors buy these names not out of greed but out of fear. They have nowhere else to go. Scared of fixed income and wary of an expensive equity market, but too worried about missing out to go to cash, a person might naturally gravitate to FAANG. The open ended growth that everybody expects for these special few sets aside valuation concerns. And the FAANG names are reassuringly familiar businesses. Investors can tell themselves that they understand what makes the companies tick in a way that would be impossible with a bank or a drug stock, or even with names like Intel and Cisco.

There is at least one measure on which the FAANG members do seem to have converged, and it is the most obvious one: size. Apple, Amazon, Microsoft, and Google occupy a narrow, if exalted, market capitalization range of $814 to $935 billion. (Facebook was closer to the same level before it kicked off the divergence scare with disappointing earnings.) This strikes us as more than coincidental. Investors are buying FAANG as an equal-weighted set, rather than picking among them.

And thus the danger of divergence. Examining FAANG stocks one at a time is a slippery slope. Once you realize that Facebook's well publicized privacy issues might actually hurt its business and downgrade your view of it, next you will be asking if Amazon's three digit PE ratio is compatible with Apple's mid-teens one. Or if Netflix should really be as valuable as Comcast or Disney. And then the spell will be broken.

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.

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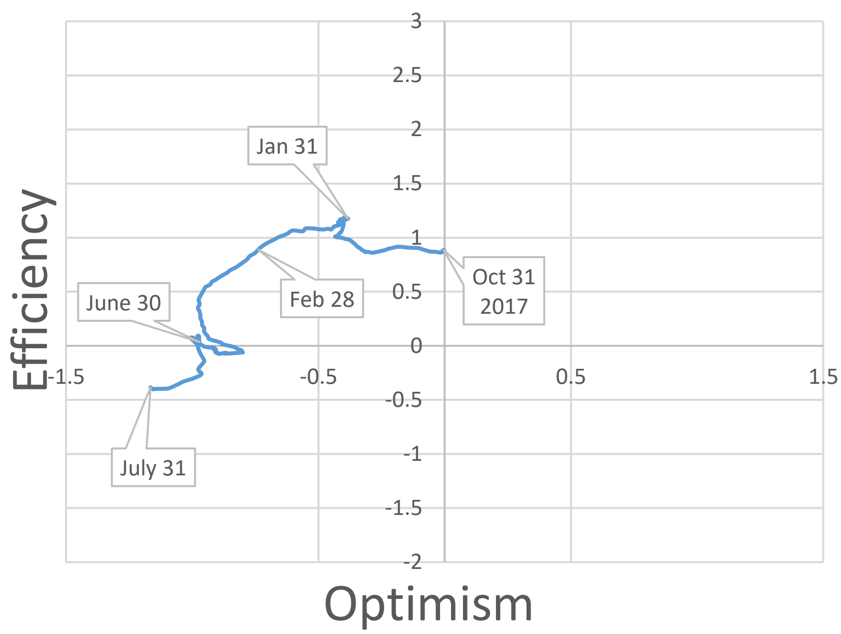
July saw a return to the trend of the spring, with both Optimism and Efficiency falling. Optimism now reads at -1.16. Although not an extreme reading, it was -2.00 as recently as Q1 2016, both the absolute level and the multi-month trend are clearly negative.

After staying close to zero for most of the second quarter, Efficiency made a more decisive movement downwards to end July at -0.38. 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 Strategy (LALCS)

For the month of July 2018, the LALCS composite, on a net of fee basis, was up an estimated +2.77%, trailing the S&P 500, which was up 3.72% on a total return basis. For the year to date through July LALCS is up +5.03% on a net of fee basis, trailing the S&P 500, which is up 6.47%.

The strategy began July invested in all sectors other than Healthcare and Technology. Four days into the month, on July 9th, it returned to Tech, leaving only Healthcare absent. It ended the month with this positioning.

The Healthcare ETF (XLV) outperformed the S&P 500 during July, 6.56% vs. 3.72%.

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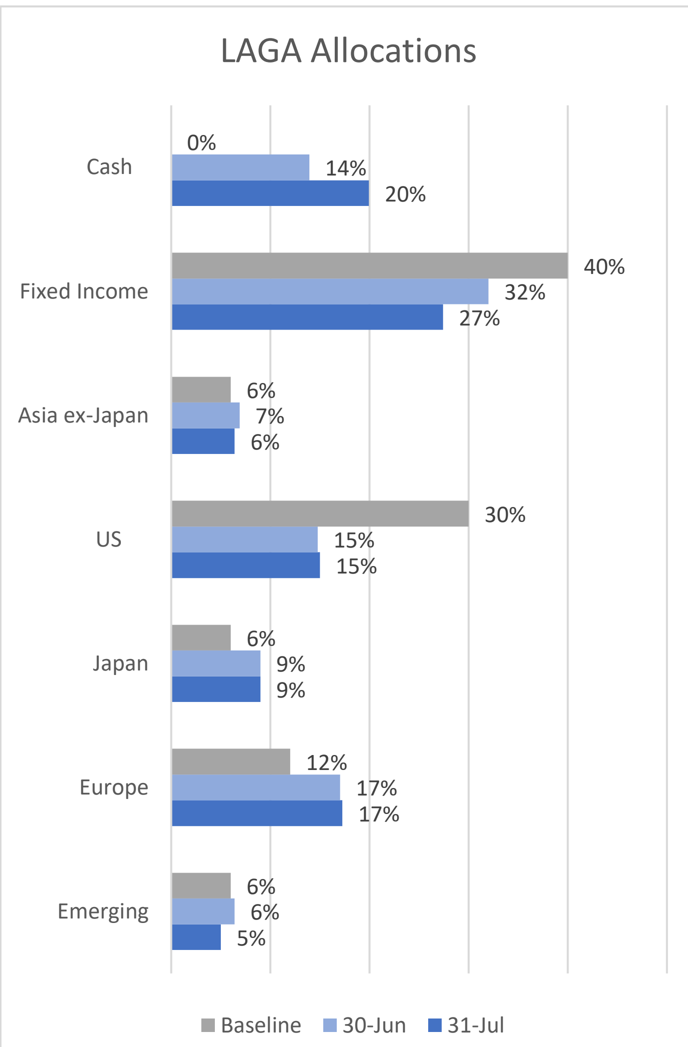
Lee Adaptive Global Equity Strategy (LAGE)

For the month of July 2018, the LAGE composite, on a net of fee basis, was up an estimated +1.85%, trailing the MSCI All Country World Index, which was up +3.05% on a total return basis. For the year to date through July, LAGES is down -0.91% on a net of fee basis, trailing of the MSCI All Country World Index, which is up +2.91%.

During July, the strategy increased its cash allocation to 16%, while reducing exposure to US equity and Emerging Markets.

Lee Adaptive Global Allocation (LAGA)

For the month of July 2018, the LAGA composite, on a net of fee basis, was up an estimated +1.15%, trailing our blended benchmark, which was up +1.84% on a total return basis. For the year to date through July, it is down -0.69% on a net of fee basis, as compared to the blended benchmark which ended July up +1.18% year to date.



July was a relatively quiet month with regard to changes in asset allocation. Fixed income was reduced from 32% to 27% of the portfolio, while cash rose from 14% to 20%. All other allocations remained essentially unchanged.

As has been the case for a few months, the overall equity allocation is just under baseline (53% vs. 60%) while cash largely accounts for the less than baseline fixed income position.

Although with more than half the portfolio invested in equities the strategy is not entirely defensive, the 20% cash weighting does imply caution. The underweights in both fixed income and US equity, the asset classes with the largest baseline weights, are a conservative approach to what is an increasingly unsettled market.

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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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