LEE CAPITAL MANAGEMENT

Lee Adaptive Strategies Update

Monthly Commentary

June 2018

The Market is Not Expensive

To most investors, it is still not clear if the great rally that began in 2009 is continuing or not. Perhaps all is forgiven. Maybe the frightening moments of late winter and spring were just another false alarm, similar to the events of early 2016 and any number of now forgotten declines from the past nine years. Or maybe this is it. The party has to end sometime.

This bull market is like a misbehaving pet dog that keeps escaping from the backyard and disappearing for a few days. He has left a dozen times and returned a dozen times. And yet every time he runs off you worry that this time is different, that this time he will not come back. Wherever it is that he goes, it is probably more interesting than being kept in the yard.

It is often said that bull markets climb a wall of worry. For the past few years that worry has been tinged with guilt, a feeling that the generous rewards of the market have been undeserved and will, inevitably, have to be returned. It is not an especially logical belief, but it has an intuitive appeal. If we did not think that the market was particularly cheap five years ago, and we did not, then how can we justify it having roughly doubled since then? Surely it is just too expensive now.

We disagree. If there is a ceiling to the market, and we are not conceding that there is, it is still far above our heads. As cynical as we are, in our hearts we believe that the long run outlook for equity is very positive. Our expectation is that the average returns over the next thirty or forty years will be much like the average returns over the past thirty or forty years.

That does not mean we think that every year or even every decade to come will be good for stocks. On the contrary, much of the work we do centers on the idea that there are identifiable periods in which the potential for loss outweighs the potential for gain. But we also believe that an investor should hold equity much more often than not, that the good years will outnumber the bad ones for the foreseeable future.

We do not think it is particularly difficult to make the argument that today's market is not overvalued.

Start with a simple question. What would you pay for an investment that returned a fixed sum every year, guaranteed, forever? Perpetuities, as these forever bonds are called, are rare beasts, but it does not take much imagination to calculate a reasonable price. Thirty-year Treasuries are currently priced to yield about 3%. So perhaps a perpetual Treasury might be priced at 3.5%? Let us say 4% to be generous. Thus a perpetuity that pays $100 a year should be worth about $2500.

Now imagine that instead of being fixed, the payments from the perpetuity grew over time. Mathematically, the adjustment is simple. You deduct the growth rate from the yield. That means you should be indifferent between a perpetuity that pays 4% fixed and one the pays 1% at the start but will grow at 3% a year. Hence, if $2500 for a $100 a year fixed is a good price, then $10,000 for $100 in the first year, $103 in the second, $106.09 in the third, etc. is also a good price.

And now consider a special "earnings perpetuity" that pays a yield that starts at $100, but will grow (or shrink) every year in line with the percentage change in profits of the members of the S&P 500. Of course, on average, we expect those earnings to grow. Over the five years ending 2017, they grew an average of 3.55% annually, significantly below the long-run rate. Over the 50 years ending in 2017, they grew an average of 6.11% a year.

As an expected growth rate to plug into our perpetuity pricing equation, 4% does not seem crazy. But it does not take into account the unpredictability of S&P earnings. The fact that the growth rate is not actually a known thing, and over shorter periods can be negative, is clearly a drawback. So, to compensate for the risk, and to be very conservative, let us assume a fairly dismal 2% growth rate in earnings.

The 4% yield of the simple perpetuity less the 2% conservative growth rate of S&P earnings, gives a 2% yield for the earnings perpetuity. That means if it paid $100 a year initially, we should be willing to buy it for $5000.

You have probably noticed that a perpetuity that pays a coupon proportionate to S&P earnings is a close analog to a passive equity investment in the S&P 500. And yet our conservative 2% yield price corresponds to a price earnings ratio of 50. As of the end of June, FactSet estimated that the S&P 500 was trading at a trailing PE of just under 19.

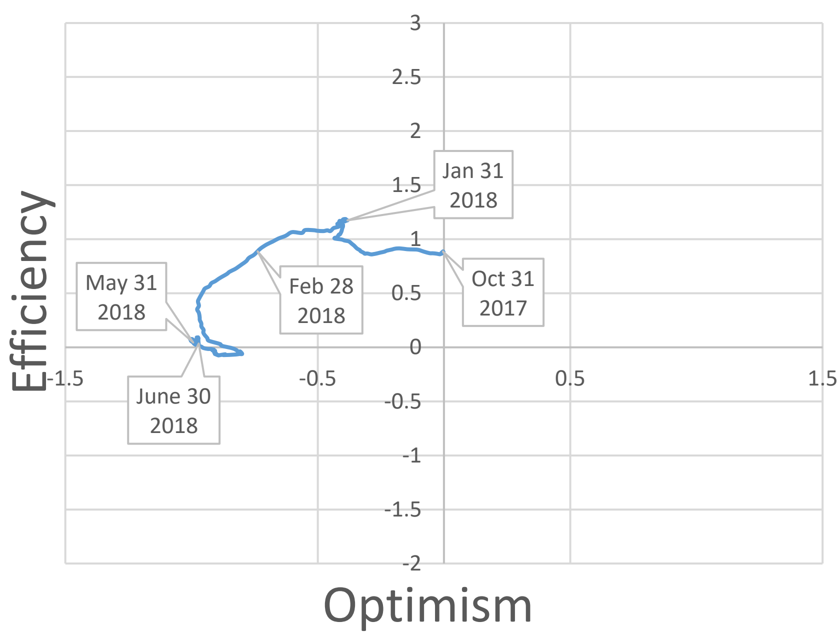
Does this mean the market will soon go up 263% to reach the PE of 50 that it deserves? Not likely. Because as long as there has been an equity market it has suffered under the burden of what academics call the "equity risk premium," a very sizable discount on equity prices to compensate for the inherent scariness of owning stocks. That discount may not be entirely rational, and it has been in a secular decline for decades, but it is still there and it is still large.

On the other hand, it should be clear that the equity market does not have a valuation problem. We have not reached a logical maximum, nor are we likely to reach one any time soon.

We do not know if the dog is coming back. Based on past experience, he is much more likely to return than not. But who knows? This could be it. But we do know that there is no reason to think that this time is special. And if he is gone for good, there will be other dogs. They will probably get out of the yard too.

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.



After meaningful movements since last fall, our scores on both axes of our framework remained nearly unchanged during the month of June.

Optimism holds at -0.97. 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.

Efficiency remains at essentially zero. Having crossed over into negative territory in mid-April for the first time since September 2012, this measure remains at a relatively 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 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 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 June 2018, the Lee Adaptive Large Cap Sector Strategy composite, on a net of fee basis, was up an estimated 1.73%, ahead of the the S&P 500, which was up +0.62% on a total return basis. For first half of 2018, LALCS is up +2.17% on a net of fee basis, trailing the S&P 500, which is up +2.65%.

The strategy began the month invested in all sectors except for Energy. It then exited Tech and Telecom on June 6th, sold Healthcare on the 18th, and bought back Energy on the 21st.

All of these trades were beneficial to the portfolio during the month. From May 31 to June 21 the Energy ETF (XLE) lost -2.41% while the S&P 500 gained 1.75%. And then from June 21 to the end of the month XLE rose 3.07% while the S&P retreated -1.12%. The Tech ETF (XLK) lost -3.68% after the 6th, trailing the S&P, which gave up -1.83%. And Healthcare (XLV) lost -1.40% since being sold on the 18th, as against a loss of -1.96% for the S&P.

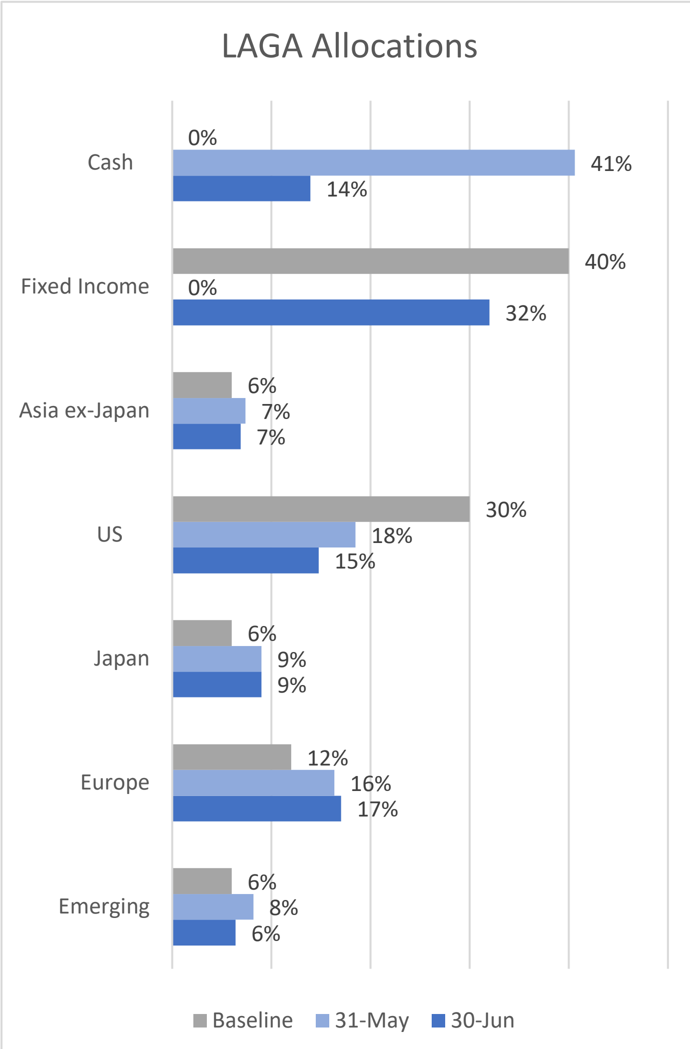
Lee Adaptive Global Equity (LAGE)

For the month of June 2018, the Lee Adaptive Global Equity Strategy composite, on a net of fee basis, was down -1.70%, behind the MSCI All Country World Index, which was down -0.50% on a total return basis. For the year to June, LAGE was down -2.85% net of fees, trailing the MSCI ACWI, which is down -0.13%.

During June, the strategy modestly increased its cash allocation to 6%, while reducing exposure to the US and Asia ex-Japan equity markets.

Lee Adaptive Global Allocation (LAGA)

For the month of June 2018, the Lee Adaptive Global Allocation Strategy composite, on a net of fee basis, was down -1.02%, behind our blended benchmark, which was down -0.35% on a total return basis. For the year to date to June, LAGA was down -1.88% net of fees, as compared to the blended benchmark which ended down -0.65% year to date.



The strategy began June holding no fixed income and ended it with a 32% allocation, still below the product's baseline, but a considerable increase in absolute terms. Much of the fixed income purchase was funded with cash, which went from a 41% allocation to 14%, but US and Emerging equity were both also reduced.

As at the start of the month, the overall equity allocation is near baseline (54% vs. 60%) while cash largely explains the less than baseline fixed income position.

Although more positive on fixed income than the portfolio has been for much of 2018, with 14% cash this is still a comparatively defensive positioning appropriate for what is still an unsettled market.

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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