# Lee Adaptive Strategies Update

## Monthly Commentary

March 2018

**The markets had a second down month in a row in March,** with the S&P losing -2.54%[1] on a total return basis. That brought the first quarter return for the S&P in at -0.76%[1], its first quarterly loss since Q3 2015. February and March were the first consecutive down months since September-October 2016.

We have seen that clichéd phrase, that this is the first occurrence of X since Y, a lot lately. The point of the formula, generally, is to illustrate how extreme or unlikely X is. But in current use it often winds up saying that things have not been this bad since way back during the second Obama Administration.

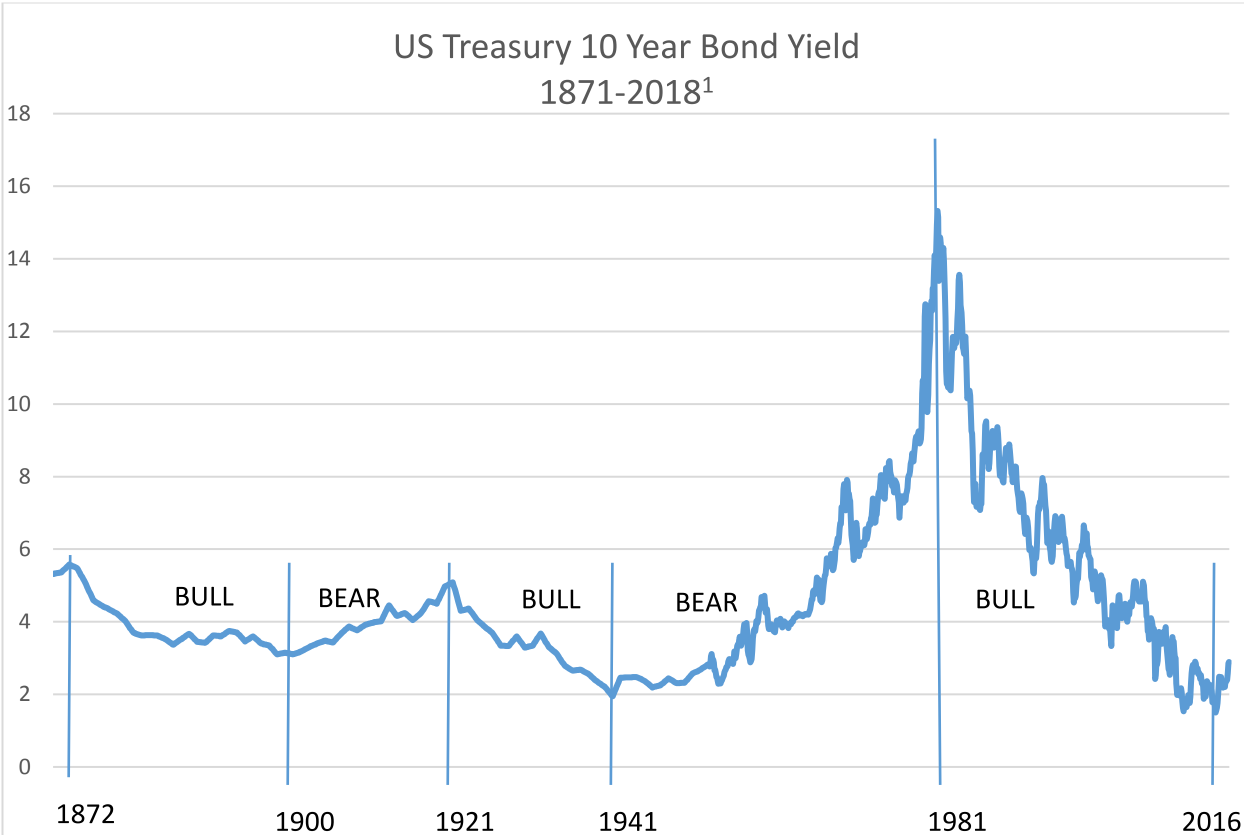
But somehow, **many investors are spooked, and no amount of reassurance from calmer and grayer heads that recent events are actually fairly ordinary seems to help.** In truth, those who are most concerned about the market today were only somewhat less worried a few months ago when the S&P seemed to make a new all-time high every week. For them, an ultra-low volatility rally eight years into a bull market was inexplicable and an accident waiting to happen.

What we have now is a market searching for a narrative. We are not yet sure how the story will unfold. It is entirely possible that the bull market that began in March of 2009 ended in January of 2018. On the other hand, it may turn out that the two down months of February and March 2018 will have no more significance in the long run than the three down months of August-September 2016 did. After all, the last time the S&P lost money in a quarter it proceeded to gain for each of the next nine.

**So where does this leave us?** With regard to US equities, saying we are cautiously optimistic would overstate the case. Perhaps cautiously cautious? On European equities we are more fully pessimistic. All that worries American investors plagues Europeans as well, but they also have a less stable political situation, not to mention Brexit on the horizon. In theory, we are now less than a year from the Great Divorce. Details are still to be worked out, but it should be clear to all by now that net economic effects on both sides of the Channel will be negative, perhaps significantly so.

And then there is fixed income. **It is our belief that we are most likely in a fixed income bear market right now.** And we do not mean merely that fixed income is likely to have a challenging second quarter. We believe that fixed income is subject to very long, multi-decade, trends and that we have almost certainly left the up trend that began in 1981 and entered into a new down trend that could last quite a while. The chart below ought to be familiar to all serious investors, but, sadly, is not.

[1] Source: FactSet Research Systems Inc.




This is the yield on ten year US Treasury bonds, going back as far as data is available[2]. Rates last bottomed out just before the US entered the Second World War, and rose unsteadily but inexorably until 1981. From then they fell, again not consistently, for the following 35 years until the summer of 2016. Of course, rates could now move sideways for a while, rather than going up. That is not unprecedented. But a return to the 1981-2016 trend seems unlikely.

To be clear, we are not predicting that bonds will lose value every year for the next few decades. That is not what happened from 1941 to 1981. But the tailwind we all enjoyed in fixed income for so long is likely now a headwind.

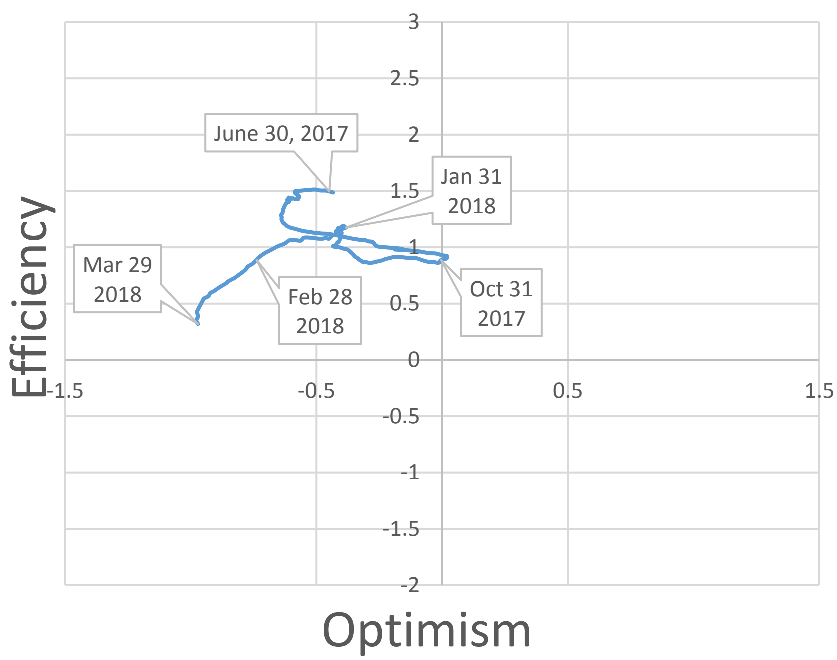
In a fundamental sense, **the value proposition for fixed income is now challenged** in a way that it has not been in quite a while. The argument in favor of bonds has always been reduced risk relative to equity in exchange for reduced return. But lately, the reduction in risk has been less obvious. Certainly, equity has been more volatile over the past few weeks, but that was not true over the past year or two. Further, the potential gains from fixed income are even more limited now than they have been in the past. Add the credible prospect of years of Fed tightening to the usual double-edged sword of low rates, low income yields and slim prospects of capital gains from rates going even lower, and return expectations for fixed income become quite modest indeed.

[2] Source: Prof. Robert Shiller, Yale University (http://www.econ.yale.edu/~shiller/data.htm)

**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 continued to fall, a trend that began at the end of October 2017 and has lately accelerated. At only slightly above -1.00, it left what might have been called neutral territory and is now bone fide evidence of market pessimism. Although not an extreme reading, it was -2.00 as recently as Q1 2016, both the absolute level and the trend are now clearly negative.




Efficiency, which had been comparatively stable at modestly positive levels for much of 2017 and the first weeks of 2018, has also declined. This sort of fall is typical of a market coming under stress.

The current positioning of the Sentiment Framework implies a market that is neither particularly efficient nor 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 March 2018, the LALCS composite, on a net of fee basis, was down -1.94%, ahead of the S&P 500, which was down -2.54%[1] on a total return basis. For the first quarter, the LALCS composite, on a net of fee basis, was down -1.77% against down -0.76%[1] for the S&P 500 on a total returns basis.

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

*Lee Adaptive Global Equity ("LAGE")*

For the month of March 2018, the LAGE composite, on a net of fee basis, was down -0.97%, ahead of the MSCI All Country World Index, which was down -2.15%[1] on a total return basis. For the first quarter, the LAGE composite, on a net of fee basis, was down -0.29% against down -0.91%[1] for the MSCI All Country World Index on a total returns basis.

During March, the LAGE strategy reduced exposure to European equity and increased exposure to the other equity regions proportionately. It ended the month 60% US, 4% Europe, and 12% in each of Japan, Asia ex-Japan, and Emerging Markets.

*Lee Adaptive Global Allocation ("LAGA")*

For the month of March 2018, the LAGA composite, on a net of fee basis, was down -0.46%, ahead of our blended benchmark, which was down -1.03%[1] on a total return basis. For the first quarter, the LAGA composite, on a net of fee basis, was down d -0.22% against down -1.06[1] for the Blended Benchmark.

The LAGA strategy eliminated what was already a greatly reduced weighting in fixed income in March. It also significantly reduced European equity exposure and built a meaningful position in cash. At month end, the portfolio was allocated 38% to US equity, 3% to European equity, 9% to each of Japan, Asia ex-Japan, and Emerging Markets equity, and 32% in cash.

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**<u>Definitions:</u>**

**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.

**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-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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