Inflection Commentary

INFLECTION
Alternative Assets

## Inflection Performance: August 2017

**Burning Down The House**

This has been quite the summer for biblical plagues: Wildfires in BC; Floods in Houston; Hurricanes in Florida. Aside from the tragic devastation and displacement, what they all have in common is that those who unfortunately did not have house insurance just saw a substantial drop in their net worth. One that, in many cases, will take years, if ever, to replace.

To many it would seem absurd not to insure a substantial asset like a house because homeowners don't know exactly when a fire or flood might come. Yet many investors haven't taken the similarly prudent step of insuring, or at least protecting, what is possibly an even bigger asset: their equity portfolio. This despite a crucial distinction between the asset types: with a house, a fire or flood is a remote possibility that may never happen. By contrast, a stock market drop is not just a possibility; it is an historical certainty.

All markets are cyclical, and in the case of the stock market the big drops come, on average, every 7 years. We are now 9 years into the latest expansion. Similarly, real estate also goes through dramatic, though slightly longer, swings. We are now more than 20 years into the latest residential real estate expansion in Toronto and Vancouver. In other words, two of the biggest asset classes most of us tend to hold are overdue for a correction. That doesn't mean the correction in either asset class will come tomorrow or next month, but it will eventually come. The question isn't if; it's how and when to prepare.

There is not yet a way of insuring the value of your home or other real estate investments against a decline in value (though there was some movement in this direction after the Global Financial Crisis). For stocks, there is indeed such a thing as equity insurance that works like home insurance, but the most efficient ways to insure stock portfolios (such as tail risk funds) consistently lose money until the drop actually comes. Not many investors have the willpower nor the net worth to keep that kind of insurance in place.

Fortunately, there is a much cheaper and equally effective alternative for investors, and it can be put in place right now so that no supernatural predictive powers are required: diversifying your portfolio with assets that perform solidly and don't correlate with the stock market. This strategy is often referred to as 'the only free lunch in investing.' (You can google it).

Nine years ago, on September 28, 2008, the Dow Jones Industrial Average famously took the biggest point dive in its history. To many this came as a total surprise, and they were unprepared for it. By the end of the year, many stock portfolios were down 60% and investors discovered that no matter how good their long-only equity managers were, they still were down substantially. It was too late to take any corrective action.

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By including alternative assets as a portion of your portfolio, disastrous scenarios such as a 60% drawdown could have been substantially reduced. Adding an allocation to alternatives now can reduce the volatility that comes with stock investing while actually *improving* returns over time. And of course, diversifying now, after an historic run up in stock valuations, makes it easy and not just prudent to take some 'risk chips' off the table.

That's like having home insurance that *pays you* to own it! How's that for peace of mind?

### Adding Alternative Assets to a Traditional Portfolio

**Traditional Portfolio** **Traditional Portfolio + Alternatives** *


**Performance Statistics Jan 01, 2000 to Dec 31, 2016**

| | Traditional Portfolio | | Traditional Portfolio + Alternatives | Difference | | |
|---|---|---|---|---|---|---|
| Cumulative Return,% | 121.78 | → | 180.43 | +58.65 | +48% | Improves Cumulative Return |
| Annualized Return,% | 4.77 | → | 6.22 | +1.45 | +30% | Improves Annualized Return |
| Annualized Volatility,% | 9.54 | → | 7.82 | -1.72 | -18% | Reduces Volatility |
| Max Drawdown,% | -33.97 | → | -27.69 | +6.28 | -18% | Reduces Drawdown |
| Sharpe Ratio | 0.5 | → | 0.79 | +0.29 | +58% | Improves Sharpe Ratio |

### Contribution

ISOF was down -0.18% in August for Series A investors. AHL was our biggest contributor, up 1.47% on the month and providing 0.19% net to the portfolio. FJ, part of our regional banking theme, was our largest detractor down -1.54% on the month and detracting -0.27% from total performance. We believe FJ's performance relative to its index, which was down -4.52%, is an excellent example of how careful manager selection and active oversight can outperform a sector, both when markets are up and down.

* The Traditional portfolio above has been constructed using the S&P TSX TS Index to represent a typical equity investment allocation, the Barclays Global Aggregate Bond Index to represent a typical bond investment allocation, and the HFRI Fund Weighted Composite Index to represent a typical alternative asset investment allocation

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| Strategy | # of Managers | Ending Weight | August | YTD |
|---|---|---|---|---|
| Arbitrage | 5 | 27.09% | -0.19% | 1.03% |
| Relative Value | 7 | 39.82% | 0.34% | 2.38% |
| Macro | 3 | 21.24% | -0.09% | -0.76% |
| Volatility | 2 | 8.44% | -0.23% | -2.29% |
| CASH | NA | 3.40% | -0.02% | -0.19% |

**Portfolio Changes**

In August we added another regional banking specialist to the portfolio. CBH captures the secular trend of consolidation within the US community and regional banking sector by employing a relative value approach that maintains a low net exposure while taking advantage of a trend uncorrelated to the broader markets. Switching tracks within a theme as the business cycle progresses is a technique we've employed profitably many times over the last two decades. In this case it will allow us to transition to the next phase of the regional banking opportunity that has been so rewarding for ISOF for the last two years.

Sincerely,

The Inflection Team

The Inflection Strategic Opportunities Fund (ISOF) invests in a broad array of carefully selected hedge fund strategies in order to capitalize on dislocations and market opportunities. The Fund has a global mandate and focuses primarily on the Americas, Europe and Asia, providing access to the expertise of hedge fund managers in identifying what we believe are exceptional investment opportunities throughout the world. Some taxable investors may find that the Fund's option structure has significant tax benefits. Please refer to the attached Factsheet for additional information.

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Disclosure

ISOF performance presented are USD net returns after investment management and performance fees and is not an estimate of any specific investor's actual performance, which may be materially different from such performance depending on numerous factors. ISOF returns represent historical returns adjusted for the June 2015 performance fee structure change to the current fee structure. Information presented is believed to be correct and accurate at the time of production but may change due to circumstances beyond our control. Returns may be amended after these numbers have been reported due to repricing adjustments or receipt of more recent data, among other things, and will be reflected in the most recent document. Comparative returns selected are for informational purposes only and may or may not accurately represent the composition or potential performance of Inflection Strategic Opportunities Fund and may not be useful for comparison purposes. The HFRI Fund Weighted Composite Index is a global, equal-weighted index of over 2,000 single-manager hedge funds that report to HFR Database. Constituent funds report monthly net of all fees performance in US Dollars and have a minimum of $50 Million under management or a twelve (12) month track record of active performance. The HFRI Fund Weighted Composite Index does not include Funds of Hedge Funds. The S&P/TSX Composite Index (Net TR) is the Net Total Return version of the S&P/TSX Composite Index and is presented in Canadian Dollars. The Net Total Return Index Value is based on the aggregate, float quoted market value of the index constituents (Stock Price Index Value) plus their paid net dividends/distributions after applying a withholding tax at the national level. The Barclays Global Aggregate Bond Index is a market capitalization-weighted index denominated in US Dollars representing the universe of investment grade bonds available for purchase in the United States, securities underlying the index include Treasuries, Agencies, Mortgages, and Corporate Bonds. ISOF is an exempt market fund available to Canadian resident accredited investors in British Columbia, Alberta, Ontario, and Quebec and to a limited investor base in certain provinces under the Minimum Amount exemption. Investing involves risk. Please seek professional advice before making any investment. This is not an offer to purchase or sell securities. It is for information only. Please refer to the Confidential Information Memorandum for more detailed information