Inflection Commentary

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Inflection Performance: September 2015

Behold the Inflection Point?

Bond, corporate event and equity market gyrations took a toll on portfolios in September, effectively ravaging many non-market neutral portfolios which survived August's extreme volatility. Was the third quarter ('Q3') the inflection point we've been anticipating? Such points typically take investors by surprise but often correct excesses and differences in perceived versus actual value and therefore tend to be good for deep value investors like the Inflection Strategic Opportunity Fund ('ISOF').

While the answer won't be clear for months, what is already apparent is that markets are increasingly taking notice of the issue we've been contemplating since the collapse of 2008: In a world of slowing demand, what drives asset prices? The Federal Reserve in the US and its brethren worldwide obscured that fundamental question by pumping cash into their respective economies, artificially creating demand, driving up higher risk assets like stocks, and thereby buying time until the economy could rebuild or a new source of demand appear.

Seven years later central bank illusions are wearing thin and it's brutally obvious that the countries generally expected to drive economic growth (China, India, Brazil…) were actually engaged in some creative economic window dressing of their own. Now it's official: global trade volumes are shrinking. While pundits might debate how much or how little the US stock market will fall victim, Q3 certainly looks like an example of the kind of negative feedback loop that reverses some of the perhaps excessive stock market gains of the last few years.

But all that is not to say that there will not be significant opportunities for investors even if some of the world's most important economies are indeed slowing. "Market dislocations", "Illiquidity", "forced sellers"… these have all been opportunities for our managers since the inception of ISOF five years ago. Inflection points are catalysts that create deep opportunities for nimble investors, and down markets can be as conducive to healthy profits as up markets for long-short traders. Given our fondness for distressed and arbitrage-focused themes, not to mention hedging and volatility, and that we tend to avoid the traditional equity holdings found in Canadian investors' portfolios, we believe we are once again in a period where our differentiating diversification can provide needed performance to investors.

It won't all be smooth sailing though. Some quarters will be more about avoiding losses than making profits. The third quarter of 2015 was definitely one of those periods, and thankfully we anticipated the volatility much earlier in the year and protected the portfolio by spending some of our profits to augment our hedging. We are pleased that our strategy worked, and that our positive year to date return, though modest, is in stark contrast to all of our benchmarks which are deep into negative territory. Perhaps more significantly, our hedges allowed us to moderate mark-to-market losses while remaining fully invested in the themes around which our portfolio is constructed.

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In September ISOF had a net return of -3.12% (-1.74% in Canadian dollar terms) bringing our year to date return to 0.12% (15.17% in Canadian dollar terms). By comparison, the HFN Fund of Funds-Multi-Strategy Index, our closest US dollar benchmark, returned -1.78% for September (-1.45% YTD) and the S&P TSX Index returned -1.46% for the month (-7.48% YTD). The Scotiabank Canadian Hedge Fund (Equal Weighted) Index lost -1.77% in September (-0.38% YTD). Since inception in October 2010 ISOF has produced a net US dollar return of 33.74% (73.45% in Canadian dollar terms), outperforming the Scotiabank Canadian Hedge Fund Index by 67.85%, the TSX Index by 49.68% (on a Canadian Dollar returns basis), and the HFN Fund of Funds-Multi-Strategy Index by 20.63% (on a US Dollar returns basis). Over that period ISOF's Sharpe ratio is 0.98 (1.27 in Canadian dollar terms), and its correlation to the S&P TSX Index is -0.02 in Canadian dollar terms.

Q3 2015 In Brief

Regular readers of our commentary may recall that we have been closely watching the economic clouds gather all year and therefore were not surprised by the third quarter storm. From a strategy perspective we adjusted the portfolio both to reduce market or systematic risk and to turn some of our hedges into potential profit centres. ISOF was successful on both fronts, with tail hedges moderating mark-to-market losses on our long exposures while opportunistic hedges contributed 70.6% of our gains during the quarter.

Any listing of opportunistic shorts is necessarily going to skew toward technical language, but a partial listing of our more successful positions for the quarter includes: short North American energy and materials; long Canadian swaps (rates); short European energy; short Korean Won/US Dollar; short Brazilian bonds; short electricity; short European materials; and short S&P futures.

Another positive contributor for Q3, delivering 15.9% of the quarter's positive contribution was Asset Backed Securities which continue to exhibit much valued non-correlation with both equity markets and our other strategies. Merger Arbitrage (M&A), which has been a star performer all year was muted in Q3 (13.5%) as merger spreads widened out. Wider spreads are a temporary phenomenon and usually close as the deal date approaches. They are also often an opportunity to deploy capital with a higher expected return, so we look forward to reaping those rewards later in the year. Among the contributing deals for the quarter were Vivint Solar's acquisition by SunEdison, Celgene's acquisition of Receptos, and OmniVision Technologies' acquisition by a consortium of three Chinese firms.

Not surprisingly, our more equity-exposed strategies contributed the lion's share of the losses (81.1%) in Q3, while Fixed Income also detracted (12.6%). Detractors were concentrated in energy and healthcare related names, as well as some of our European holdings. Excepting energy (where we believe our infrastructure theme has played out and have since exited), almost all of our managers saw Q3 as an opportunity to purchase additional exposure and to deepen their highest conviction positions. Both Currencies & Commodities and Quantitative Strategies demonstrated their beneficial non-correlation, and were relatively flat for the quarter.

While we expect our positions to ultimately make money regardless of economic direction, we believe that the volatility we experienced in Q3 is likely to continue and are therefore opportunistically increasing our allocations to strategies that tend to benefit from volatility while pivoting the larger portfolio to take advantage of the changes that have taken hold in markets since the summer.

As we move past the fifth anniversary of ISOF, we believe that the advantages of staying nimble and dynamically shifting the portfolio in response to changing market conditions is apparent in our differentiated performance. We are pleased to report that our 5-year results are strong, outperforming stocks and with no meaningful correlation to equities or bonds. Perhaps more importantly, our results were accomplished while keeping our risk relatively low. While higher-risk investments might succeed or fail over the next five years, we aim to remain the stars of our clients' lower risk portfolio.

Inflection News

Inflection Management was pleased to sponsor the Prime Quadrant Conference in Toronto in November. Among the speakers were investment legends Sam Zell, Jack Bogle, and Leon Black as well as up-and-coming managers of the younger generation.

We are also pleased to announce that, in response to requests, we are now accepting commitments for RRSPs, and TFSAs for a minimum of $25,000. Both are available in either a US dollar series or a Canadian dollar series that is hedged to the Canadian dollar (so as to produce the same return as the US dollar series). Interested investors should contact our Director of Business Development, Paul Mayer, at pmayer@inflectionmanagement.com (647.923.4161) or any member of the Inflection Team.

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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