

Inflection Performance: August 2015

“Luck Favours the Prepared”*

August was an exceptionally volatile month as a number of markets experienced declines of a severity not seen since the 2008 global financial crisis. On August 24th the Chicago Board Options Exchange Volatility Index, (‘VIX’), a measure of the expected volatility of US large cap stocks and a proxy gauge of fear in the stock market generally, spiked to 53 from the more typical teens and low twenty levels seen all year. For Canadians with a strong home bias, the month was particularly ugly.

To some this came as a very unwelcome surprise. But for the Inflection Strategic Opportunities Fund (‘ISOF’) it was an opportunity to take some of our portfolio overlay hedges out for a spin, and they spun even better than expected.

In August ISOF produced a net monthly US dollar return of -1.99% (-1.41% in Canadian dollar terms), bringing our year to date total to 3.35% (17.21% in Canadian dollar terms). By comparison, the HFN Fund of Funds-Multi-Strategy Index, our closest US dollar benchmark, returned -2.14% for August (0.38% YTD) and the S&P TSX Index lost -6.65% (-6.11% YTD). The Scotiabank Canadian Hedge Fund (Equal Weighted) Index was down -1.89% for the month and is up 1.41% for the year.

Since inception in October 2010 ISOF has produced a net US dollar return of 38.06% (76.52% in Canadian dollar terms), outperforming the Scotiabank Canadian Hedge Fund Index by 69.02%, the TSX Index by 50.91% (on a Canadian Dollar returns basis), and the HFN Fund of Funds-Multi-Strategy Index by 22.86% (on a US Dollar returns basis). Over that period ISOF maintained a Sharpe ratio of 1.13 (1.34 in Canadian dollar terms), and a correlation to the S&P TSX Index of .67 (-.03 in Canadian dollar terms).

The ostensible cause of all this volatility (which continued into September) was China. Since 2008 most of the world’s developed economies have been looking to Chinese demand and the modernization of Chinese markets to pull their own economies back into the black. But in August China made several unexpected market interventions in an effort to stimulate economic growth and stem a cascading sell-off in its local equity markets. The willingness of Chinese authorities to rewrite their definition of market reform at will not only served as a wakeup call to those who chose to believe Chinese propaganda but worse, in its ineffectiveness, warned of the potential inability of those authorities to effectively guide the world’s second largest economy.

*Fans of the animated classic “The Incredibles” will recognize this quote from the diminutive Edna Mode, who mashed together the old Latin proverb “Fortune favours the bold” with the Boy Scouts’ motto “Always Be Prepared.”

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ISOF has been skeptical of the China story since 2010 and therefore has maintained various types of overlay hedges in varying degrees as protection against the day the emperor may be exposed as wearing no clothes. There are many kinds of hedges, and we have been dynamically adjusting them according to the risks we see each month. Currently, we see some of those hedges not just as a means of safely keeping our more growth-oriented themes in place, but as a potential source of profit, in and of themselves.

In August a small tail hedge position on the S&P Index that uses less than 2% of our capital returned 43% on the month, enough to erase a considerable share of the mark-to-market draw-downs of our other managers, and to give us more dry powder with which to buy assets at lower prices.

The bulk of those mark-to-market losses came from just four of our fourteen portfolio managers, a good confirmation of the degree of non-correlation within the portfolio even when subjected to the unusual stress of several global markets suffering simultaneously. Historically, even very profitable months for ISOF have incorporated the returns of several individual managers who are temporarily negative due to transitory market forces within their respective arena. That August was no worse than an average month is important validation of our theories of diversification and portfolio construction.

Two of the negative performing managers in August, one a European Equity Long/Short manager and the other an Event-Driven/soft-activist manager have been among our largest contributors over the past two years. August's losses were small relative to their previous performance, and both saw the August pullback as a buying opportunity.

A third manager that contributed negatively in August is a market neutral Asia-Pacific specialist that was down -2.44% for the month vs -8.25% for the benchmark Asia-Pacific index. We consider this a very good relative performance number, and the manager remains up 9.14% YTD.

Finally, the last position to contribute negatively to our August return is an Equity Long/Short manager in the energy infrastructure space. This manager managed to contain downside risk in a treacherous market very well but the manager is currently under review as we believe the theme may not be able to overcome near-term headwinds in the sector.

Our remaining managers of Asset-Backed Securities ('ABS'), Convertible Arbitrage, Algorithmic, European Credit, and Merger Arbitrage, all performed extremely well given the large drawdowns in their respective markets.

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Outlook

At it's worst, the TSX and S&P were down -12.19% and -11.26%, respectively, in August and therefore ending the month at -6.65% and -6.26% was something of a reprieve for equity-exposed investors. The big question going forward is will Canadian investors be so lucky next time when so few economists are forecasting significant hunger for our natural resources?

Even with the pullback, still-high equity valuations and still-low bond yields may continue to retard traditional asset price growth for some time, and make the uncorrelated returns offered by managers of non-Canadian assets all the more attractive.

Though it may have been difficult to stomach for some, the upheaval of August was a good stress test of our managers and a gift for those who actively seek volatility. We believe the month will ultimately be remembered as fortuitous for our well-prepared managers.

Inflection In the News

Ari Shiff, Founder and Chief Strategist at Inflection Management Inc., appeared on BNN's Business Day PM on Tuesday, September 22nd, to explain how Inflection Management uses market volatility to produce returns for investors.

In case you missed it, please click on the following link to view the segment:

<http://www.bnn.ca/Video/player.aspx?vid=710771>

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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Disclaimers

ISOF performance numbers presented are blended net returns after investment management and performance fees which vary by class of unit. 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 we have reported these numbers. These amendments may be due to repricing adjustments or receipt of more accurate data, among other things, and are reflected in the next document. Benchmarks selected are for informational purposes only and may or may not accurately represent the composition or potential performance of Inflection Strategic Opportunities Fund. All comparative returns are provided for informational purposes only and may or may not be useful for performance comparison purposes. USD returns source: The HedgefundNet Fund of Fund Multi-Strategy (HFN FOF Multi Strategy) index, a USD denominated index comprised of funds of hedge funds. CAD returns source: ISOF USD returns converted into CAD returns based on the last monthly closing USD/CAD exchange rate as posted on the Bank of Canada website. The S&P TSX Total Return index measures the total return of a basket of stocks traded on the TSX index in Canada. The ScotiaMcLeod Equal Weighted Hedge Fund Index is comprised of Canadian-based hedge funds whose returns are equally weighted within the index. Inflection Strategic Opportunities Fund is an exempt market fund available to Canadian resident accredited investors in British Columbia, Alberta, Saskatchewan, 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 detailed information.