# Inflection Performance: August 2016

**Why Take The Risk When You Don't Have To?**

Investors have been very fortunate with the run up in equities this year. But it's crucial to understand why the rally was inevitable, why it is unlikely to persist much longer, and what investors can do to reduce their risk of losing those gains going forward.

In our view, the inflation of equity prices has been a direct result of central bank policies designed to push investors away from less risky assets, like bank deposits, and towards more risky assets like stocks, real estate, and private equity. Although that policy has succeeded brilliantly in skewing both private and professional investors' portfolios toward the higher end of the risk spectrum, it doesn't appear to have been successful in boosting the economy enough to put the collapse of 2008 fully behind us, nor enough to normalize the economy with higher interest rates.

Moreover, there is a hidden risk to investors that has barely been mentioned in the popular press: By pumping unprecedented amounts of cash into markets, the central banks have effectively pulled forward the returns you would have expected from stocks over the next 5 years. From a stock investor's point of view that has been great news, but it bodes very poorly for the future.

With the S&P 500 price-earnings ratio at 25x GAAP trailing earnings, the central banks would have to keep the interest rate at its current ultra-low level to keep the gains coming. But that is directly contrary to the Federal Reserve's stated objective of raising interest rates as soon as possible. Over the last several years the Fed has repeatedly mooted the idea of raising rates only to retreat in the face of negative reactions from markets and/or weak economic indicators.

But this situation obviously cannot continue indefinitely. As soon as the Fed sees enough growth in the economy it will strike, and even an interest rate increase of 1%, still well below average historical rates, could translate to a significant decline in stocks and bonds. Worse, if there is insufficient growth for the Fed to raise rates, stocks, already priced for perfection, will only be able to go sideways.

Either way, the outlook for equities isn't pretty. How much should investors risk on this game of hot potato? Whether it's a little or a lot, if they don't want to give up their gains they should balance the risk with a more stable, uncorrelated allocation.

At the Inflection Strategic Opportunities Fund ('ISOF'), we serve our clients best by avoiding the risk of changes in interest rates entirely and structuring our portfolio to benefit from what we call 'double positive asymmetry.' The first asymmetry is to choose an exposure where the positive outcome is a multiple of likelihood of the negative outcome. The second asymmetry is that the positive outcome can produce a gain that is a multiple of any possible loss. By controlling the downside, ISOF's managers limit their risks and increase their likelihood of success.

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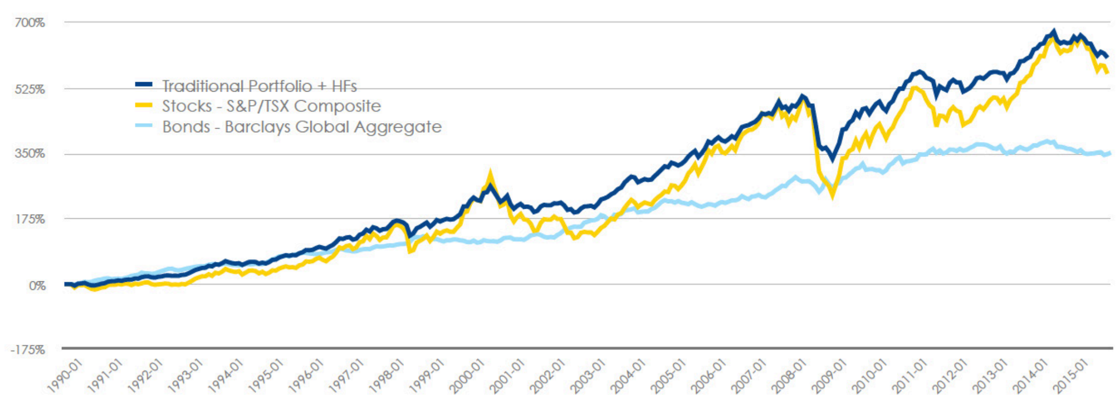
All-weather niche strategies of the sort that compose ISOF's portfolio (merger arbitrage, volatility trading, structured credit, statistical arbitrage, etc.) are hard to find, require work to analyze and monitor, and are limited in capacity.  But adding alternatives to portfolios has been proven over multiple business cycles to improve returns, reduce volatility, and reduce drawdowns. There is peace of mind to be gained by adding this third leg to your portfolio, an asset class that is not interest rate sensitive, not exposed to the Canadian market, and takes as little risk as possible.

The following graph nicely illustrates the point.  Rather than limit the graph to the post 2008 world in which ISOF has existed, the graph uses our HFRI benchmark (which ISOF outperforms) going back to 1990, covering several different economic cycles.

### Performance Statistics February 1, 1990 to December 31, 2015




| | Traditional Portfolio<br>60% Stocks, 40% Bonds | Traditional Portfolio + HFs<br>48% Stocks, 32% Bonds, 20% Hedge Funds | | |
|---|---|---|---|---|
| Annualized Return | 7.20% | 7.83% | (+0.63%) | Improves Return |
| Annualized Volatility | 9.23% | 8.49% | (-0.74%) | Lowers Volatility |
| Largest Drawdown | -29.60% | -27.74% | (+1.85%) | Reduces Drawdown |
| Sharpe Ratio | 0.78 | 0.92 | (+0.14) | Increases Sharpe Ratio |

*Returns selected are for informational purposes only and may or may not accurately represent the composition or potential performance. Past performance should not be taken as an indicator of future performance. The proxy for hedge funds, the HFRI Fund Weighted Composite Index, is a global, equal-weighted index of over 2,000 single-manager funds that report to HFR Database. The HFRI Fund Weighted Composite Index does not include Funds of Hedge Funds. The S&P/TSX Composite Index is presented in Canadian Dollars. 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. Returns shown are gross of fees. Please seek professional advice before making any investment. This data is for information only and is not an offer to purchase or sell securities.*

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**Market Review**

The low volatility environment we saw in July continued in August. Like much of 2016, the principal theme was outperformance of emerging markets. Currencies moved higher, bond yields declined, and equities and credit in those markets performed well. In developed markets, foreign exchange and rates continued to be range-bound. The principal driver continued to be the Federal Reserve which in its drive toward greater transparency may have inadvertently sowed confusion in markets by publicly debating policy.

Globally the economic picture also remained fundamentally unchanged. Growth remained around trend with emerging economies narrowing their multi-year underperformance. Labour markets appeared to improve in most Western economies, supporting consumption but insufficient to encourage companies that remain hesitant to invest. One August surprise came from post-Brexit UK data, which came in stronger than expectations, leading to lessening expectations of a technical recession in that market.

Despite much debate, monetary and fiscal policies also remained unchanged. Financial conditions remain very accommodative with interest rate increases still forecast just beyond the horizon (ie. no-one is setting any firm dates). That said, central bank omnipotence is widely being questioned as the risk/benefits of new, unconventional monetary policies are increasingly running into real world opposition in the US, Europe and Japan. When the questioning turns into open revolt, the effects will likely be quite negative for traditional markets like equities and bonds, but quite positive for most of the volatility strategies in ISOF’s portfolio.

In August, ISOF’s (Series A) net return was 0.86%, bringing our year to date net return to –4.53%. By comparison, the HFRI Fund Weighted Composite Index returned 0.39 for the month (3.39% YTD), the S&P TSX Index returned 0.27%, (14.12% YTD), and the Barclays Global Aggregate Bond Index Index fell -0.49% in August (9.25% YTD). The Scotiabank Canadian Hedge Fund (Equal Weighted) Index gained 0.53% in August (7.29% YTD).

Since inception in October 2010, ISOF (Series A) has produced a cumulative return of 22.55%, outperforming the Scotiabank Canadian Hedge Fund Index by 8.14%, the HFRI Hedge Fund Index by 0.53%, and the Barclays Global Aggregate Bond Index by 9.83%. With only 58% of the volatility, ISOF trailed the S&P TSX Index by 17.41% during the period, with a Sharpe ratio of 0.55 and a correlation to the S&P TSX Index of 0.57.

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**Portfolio Review**

For the month of August, 11 of our 17 managers were profitable, with Multi-Strategy up 0.45%, Energy Trading up 0.43%, Community Banking up 0.38%, European Credit up 0.30%, Convertible Arbitrage up 0.19%, Merger Arbitrage up 0.14%, ABS trading up 0.13%, and Muni-Trading up 0.11%. Detractors from performance for the month were Volatility -0.50%, Short Credit -0.32%, CTA -0.26%, and Equity Market Neutral -0.17%. Interestingly, our worst performing strategy bucket this month, Volatility, was split between both our best (0.46%) and worst (-1.07%) performing managers.

**Inflection In the News**

Ari Shiff, President and Chief Strategist at Inflection Management Inc., appeared on BNN's Business Day to talk about the appeal of consistent returns that are independent of equity markets and agnostic to the direction of interest rates.

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

Ari Shiff's Latest Interview on BNN - Making the Case for Hedge Funds

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, 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 more detailed information.