Inflection Commentary

INFLECTION
Alternative Assets

Inflection Performance: December 2014

Compare Your Apples and Oranges for Fun & Profit

The beginning of a new year is traditionally a time when investors compare the performance of the various parts of their portfolio over the past year and make changes accordingly. Often the comparison starts with raw returns: investment A returned 10%, investment B returned 5%, and therefore additional cash gets allocated to investment A.

Unfortunately, that kind of thinking can be a trap that may lead investors deeper into very risky investments and possibly into losing not just their profit but a large chunk of their principal as well. That is not the investment goal of most investors. Most investors are looking for the best possible return for the least amount of risk, and therefore only comparing raw returns would be a mistake.

Fortunately, a clever Nobel Laureate named William Sharpe created a mathematical formula that allows investors to tell whether an investment's returns are due to smart investment or excessive risk. Even better, the Sharpe ratio allows different kinds of investments, apples and oranges, to be compared. That can be very helpful when deciding to allocate between stocks, bonds, and alternatives, each of which has very different return characteristics, and each of which has its own Sharpe ratio.

Simply put, a higher Sharpe ratio indicates that an investment has historically produced a better return per unit of risk taken. Thus an investment with a Sharpe of 1.44 (like the Inflection Strategic Opportunity Fund since inception) produced a higher return with less risk than an investment with a Sharpe of 0.41 (like the TSX Index for the same period).

And while a well-diversified portfolio should contain a variety of investments, investors would do well to pay more attention to the Sharpe ratio of each when making relative decisions about how much to allocate to each investment. If you don't know the Sharpe ratio of one of your investments, you can ask your advisor to provide it for the period you've been invested.

In response to our investors' requests, we have redesigned our Fact Sheet to make metrics like our Sharpe ratio more visible in the chart at the top of the page. Aside from a column comparing the Sharpe ratios of our benchmark indexes, we've also added columns that highlight how little correlation ISOF has with the TSX. We believe that most of our clients already have significant exposure to Canadian stocks in their portfolio, and therefore likely need ISOF to provide efficient diversification, particularly during periods when Canadian stocks may perform poorly, like now, in the wake of the collapse in the price of oil.

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Sharp-eyed readers (pun only partially intended) will also notice that we've begun to report our Canadian and US dollar returns separately. ISOF was created as an un-hedged US dollar investment for Canadian investors and the second half of 2014 exemplifies the beneficial effect this can have. The US dollar often moves counter-cyclically to Canadian asset prices; As the TSX fell 13.07%, peak to trough, the US dollar rallied 7.26% against the Loonie. Of course as Canadians, we all harbor the fervent hope that our dollar will once again achieve parity with the US dollar, and so the gain may reverse, but the US exposure has added 15.07% to ISOF's returns since inception when returns are measured in Canadian dollars.

The relationship between the US dollar and Canadian asset prices also tends to reduce drawdowns to the fund and damp oscillation. That too can be a significant benefit to investors seeking to improve the performance and reduce the volatility of their portfolio and create the potential for steady wealth accumulation.

2014 In Brief

December was essentially flat, an appropriate end to a challenging year. ISOF's net monthly US dollar return was 0.10% (1.51% in Canadian dollar terms), bringing our net annual US dollar return to 3.82% (13.24% in Canadian dollar terms). By comparison, the HFN Fund of Funds-Multi-Strategy Index, our closest US dollar benchmark, returned 0.24% for the month and 2.84% for the year, and the TSX Index lost -0.76% for December and gained 7.41% for 2014. The Scotiabank Canadian Hedge Fund (Equal Weighted) Index gained 0.32% for the month to end the year at 5.44%.

Since inception in October 2010 ISOF has produced a net US dollar return of 33.57% (50.60% in Canadian dollar terms), outperforming the Scotiabank Canadian Hedge Fund Index by 44.60%, the TSX Index by 32.21% on a Canadian Dollar returns basis, and the HFN Fund of Funds-Multi-Strategy Index by 18.81% on a US Dollar returns basis.

ISOF ended the year with twenty-one managers in our stable. Interestingly, our greatest contributor for the year at 38.57% of returns was our Quantitative Behavioural Traders, a strategy that benefits from the movement of capital between assets. In some ways the success of the strategy in 2014 is an indication of how little satisfaction was to be had in more conventional strategies, and we were glad to have had these managers in place as a quasi-portfolio hedge. Going forward in 2015, this strategy will remain in place as an important way for ISOF to benefit from volatility.

Close behind in contribution to our 2014 return, our Equity Long Short managers contributed 32.56% of our returns and profited from opportunities in Europe and from currency gyrations. While our managers remain hedged to the Euro (to avoid exposing the ISOF portfolio to unwanted currency fluctuation), the falling Euro was correctly seen as positive for worldwide exporters based in Europe.

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Similarly, some of our managers benefited from the dislocations in the energy industry while avoiding direct exposure to energy prices (which we cannot reliably predict). Instead our managers focused on warehousing and distribution, infrastructure plays that benefited from the glut in oil and gas. We expect both these opportunities to continue well into 2015.

At 20.80% of contribution to ISOF's 2014 returns, Distressed and Corporate Bonds continue to perform well, though not as strongly as these mostly legacy assets did coming out of the 2008 Recession. Our managers made money in the gaming, energy, banking, and shipping industries, and of course in 'The Gift That Keeps On Giving', the continuing cleanup of Lehman Brothers' dual bankruptcies.

Looking ahead, we expect that sooner or later interest rates will rise, and some of the walking dead, companies that have been artificially kept alive by low borrowing costs, will be forced into bankruptcy, creating a whole new wave of opportunity for this strategy. In the meantime, the recent collapse in energy prices as well as the implementation of Volcker and Basel III regulations in the US and Europe, respectively, are creating lucrative pockets of distressed opportunity for 2015.

While we are generally pleased with our 2014 performance, we also learned some important lessons. We expect to make a few mistakes every year, and consider ourselves blessed if we don't repeat any old errors again. From that perhaps skewed point of view, 2014 was quite successful, with only three notable missteps, each of them new!

Global Macro Traders were responsible for 57.09% of our losses in 2014.
Much to our chagrin, we wrote about a year ago how we were waiving our long-standing bias against global macro funds, funds that invest on a large scale around the world based on economic theory, because we believed that this time the heavens had aligned perfectly (in the sense that we were seeing significant dispersion in some of the world's leading economies) and the strategy was going to be wildly profitable.

Wrong. The heavens did align, there was indeed significant dispersion in 2014, and macro managers continue to be some of the smartest people in the industry. But the difficulty of consistently making money off of enormously complex trades with multiple moving pieces around the world remains. We hope never to be tempted by global macro again, and the lesson we learned is that sometimes it's OK to be biased.

We learned our second lesson from a small holding in one of the larger funds (formerly) in our portfolio. Primarily engaged in mergers & acquisitions, the manager has already earned his place in history as one of the most brilliant and profitable investors of his generation. Unfortunately 2014 was not his year.

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The discipline to sell losing investments can be one of the most difficult skills to execute. Although we determine the limit on losses we're willing to tolerate in any investment before we invest, we also invest based on a carefully thought out thesis. Often the most profitable part of a trade is the beginning, and therefore we attempt to time our entrances very carefully: not too early, but not too late either. It is not unusual for markets to oscillate even as they develop a favourable trend, and a manager can sometimes lose money before his thesis proves itself.

But sometimes, though both we and the manager believe the thesis will eventually prove itself correct and very profitable, the mark-to-market losses on the investment become too disruptive of our stable's returns. This manager was a smaller holding for ISOF, in line with our risk management parameters, so we gave him more rope than is normally our practice and the loss was not large. Still, we should have cut the rope months earlier.

The third lesson we learned was more subtle and in an area of due diligence where we take tremendous care. As an opportunistic manager we search for highly profitable niche strategies that are too small for larger investors to access. Our sweetest spot is often veteran managers managing between USD 300-600million, large enough to develop a robust firm, but not too big to overwhelm a market with trades.

We made an exception and invested in a fund with a proprietary history slightly shorter than the length we like to see. The investment was profitable for ISOF, but we believe the fund made mistakes that a more mature firm would have avoided. The lesson we learned here was that sometimes there is no substitute for experience.

Outlook for 2015

The cracks we've long been expecting to develop in the aftermath of the Great Recession of 2008 finally started to show in 2014. Global currency wars and the surging US dollar are the latest reminders that, seven years later, much of the plumbing of global financial markets remains broken. We search for managers who know how to profit from the broken plumbing.

ISOF often thrives off the irrational panic that periodically grips markets. The nature of modern markets tends to create over-reactions where some very attractive babies are thrown out with the bathwater, and ISOF's history is full of examples of the benefits of taking a more thoughtful look at investments other investors hastily cast off. Going forward, we will continue to sift through the bathwater and make the most out of rescuing the potentially profitable babies that we find.

We will also continue to remember that the goal of ISOF is to provide profitable diversification to our Canadian clients' portfolios, and will therefore work to keep our Sharpe ratio high, and our correlation to the TSX low.

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According to Preqin, an industry data and intelligence service, alternative investments grew by almost 14% in 2014 to 3.02 trillion dollars under management, an encouraging indicator that many investors have learned to value the benefits to their portfolio that can only be gained through alternatives.

With investments, as with apples and oranges, it is possible to produce a sweet mixture by combining unlike things.

Inflection In the News

Ari Shiff, Inflection Management's Founder and Head of Fund Research, was the subject of a recent article in the Financial Post titled "Vancouver's Inflection Management looks to M&A, distressed Europe in fund-of-funds approach." To view the article please click on the link

Vancouver's Inflection Management looks to M&A, distressed Europe in fund-of-funds approach

or visit our website to view all of our past articles and commentaries.

On a final note, we wish to express our sincere appreciation to all of our investors, some of whom have been invested in our fund since inception. We look forward to 2015 and would be delighted to discuss our views further should you have any questions.

Sincerely,

The Inflection Team

The Inflection Strategic Opportunities Fund (ISOF) invests in a broad array of carefully selected and analyzed hedge funds 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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