Inflection Commentary

INFLECTION
Alternative Assets

Inflection Performance: December 2015

The Free Option (and the Gold Lining)

2015 will go down in history as having been a tough year to preserve wealth let alone produce a profit. A major inflection point in August introduced a new environment of incessant volatility that has followed us into 2016, and almost all asset classes were negatively impacted in the second half of 2015. Americans lost $1.2 trillion in stock market wealth in the 3rd quarter alone.

Thankfully, the Inflection Strategic Opportunities Fund ('ISOF') stayed true to its name and prepared for both the inflection point and the heightened volatility, and, unusually frequently for us, twice pivoted the portfolio during the year to both preserve wealth and position ourselves to profit in various future scenarios.

ISOF is happy to once again have graduated at the top of its class in 2015, without taking on what we consider to be the kind of outright risk associated with equities at the moment. By remaining nimble we managed to adapt to several different investing climates over the course of the year and stay poised to gain from either of two diametrically opposed potential scenarios: economic recovery or economic deterioration. We believe that we've created what is, in effect, a free option…with a valuable gold lining.

2015 in Brief

December was essentially flat. ISOF's net monthly US dollar return was -0.53% (3.10% in Canadian dollar terms) bringing our year to date net return to 0.05% (19.36% in Canadian dollar terms). By comparison, the HFN Fund of Funds-Multi-Strategy Index, our closest US dollar benchmark, returned -0.69% for December (-1.25% for the year). On the Canadian dollar benchmark side, the S&P TSX Index returned -4.26% for the month (-8.32% for 2015) and the Scotiabank Canadian Hedge Fund (Equal Weighted) Index lost -0.24% in December (0.60%% for the year).

During 2015, we crossed our 5-year anniversary of being entrusted with our investors' capital. Since inception in October 2010 ISOF has produced a net US dollar return of 33.65% (79.76% in Canadian dollar terms), outperforming the Scotiabank Canadian Hedge Fund Index by 73.12% and the TSX Index by 57.12% (on a Canadian Dollar returns basis), and the HFN Fund of Funds-Multi-Strategy Index by 20.31% (on a US Dollar returns basis). Over that period ISOF's Sharpe ratio was 0.92 (1.28 in Canadian dollar terms), and its correlation to the S&P TSX Index was -0.05 in Canadian dollar terms.

In 2015, 15 of our managers contributed positively and 10 detracted from ISOF's annual performance. There were two major pivots in the portfolio, the second anticipated by the first. We exited 7 managers and added 3 in 2015, and 3 more in January 2016 alone.

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As regular readers of our commentaries may recall, we noted the clouds gathering on the economic horizon in the first half of 2015 and much of the movement in the portfolio was designed to first insulate the portfolio from the anticipated inflection point (which materialized dramatically on an otherwise quiet summer day when the world was on holiday), and then to benefit from what we believed would be heightened volatility for the remainder of the year. Key indicators that the time to act had come included credit market illiquidity, unusual return dynamics across asset classes and currencies, banking regulatory changes and most importantly, what we then believed was the imminent end of economic stimulus in the US.

Our biggest contributor for the year was our European Equity long/short strategy which finished the year up 17.6%, handily beating its benchmark, the EURO STOXX 50, which was up only 3.8%. Although it was a winner, this exposure was reduced drastically during the year in response to changing macro-economic conditions. If those clouds clear we may ramp up the strategy again.

By contrast, Merger Arbitrage strategies remained strong throughout the year despite the market volatility and markets clocked a new record of $4.59 trillion in transactions by year end. Our strongest manager in the strategy contributed 11.80% with only one down month of -0.34% in June. Typically, CEOs prefer not to take the risks inherent in the merger process when markets get choppy, but we believe that the inherent length of the M&A process once it gets moving plus the strength of the US dollar when American companies go shopping in the rest of the world (not to mention Chinese companies flexing their economic muscles) will continue to produce opportunities at least partway into 2016.

At the beginning of the second quarter of 2015, we made a conscious decision to spend some of our profits on a combination of downside protection and strategies that benefit from volatility. Both can be expensive but we worked hard to find managers who can preserve wealth in difficult markets at reasonable cost. A good example is a Commodity Trading Advisor ('CTA') that we added in the third quarter that allows us to toggle our exposure in any given month to either a more neutral or shorter orientation. Though only in the portfolio for 5 months, this manager produced a 9.90% return on capital and is one of the top performing hedge funds in the world so far in 2016.

For 2015, our technology equity long/short manager also earned honorable mention by contributing 10.1% by skillfully making money on both the long and short side. This is in contrast to 2014 when the short side was all but shut down by the stock market's unbridled enthusiasm for all things technological, and proves the worth of managers who have the skills and resources to adjust their market bias from fully long to fully short and thus avoid fighting the market. Finally, kudos also goes to our European Credit manager who returned 8.48% on invested capital in 2015 net with only one down month of -0.15% in June.

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At the end of each year we take a clear-eyed view of our performance to identify the mistakes we made in the hope that we won't repeat them. Sometimes these errors don't necessarily lose money, but nevertheless provide important lessons. And sometimes, unanticipated market forces simply overwhelm an otherwise good idea and force us to beat a retreat. An example of the latter in 2015 was our Energy Infrastructure manager who started out strong at the beginning of the year and then sank 15.62% as retail investors indiscriminately sold the sector irrespective of fundamentals. They will eventually be proven wrong, but prudence required us to exit the position and redeploy the capital for nearer term opportunities.

Another position that detracted from ISOF's 2015 performance but benefited the portfolio by considerably dampening our volatility was a Tail Hedge manager. In August, the manager produced a gain of 34% on invested capital and provided the cushion that allowed us to keep our more equity-exposed strategies in place. The hedge remains in place as of writing to protect the portfolio from extreme downside moves in the stock market. We believe that if the stock market were to come anywhere close to a meltdown, this strategy would not just serve as a hedge but would produce meaningful profits for the portfolio.

A third detractor in 2015 was a new strategy that uses a quantitative framework to synthesize fundamental data and create a market neutral portfolio of equities in Asia Pacific economies. These markets tend to be highly inefficient as the bulk of the trading is from retail investors and the infrastructure is new and developing rapidly. We've been very patient to wait for the exact entry point, but suffered slightly from our caution: Though the manager was positive for the year, our mid-year deployment produced a small loss for ISOF. That said, we tend to take a much longer view of manager performance and look forward to this strategy producing meaningful returns in 2016.

Outlook for 2016

As a source of meaningful diversification for our Canadian investors, we avoid taking exposure to assets that are positively correlated to the health of Canadian asset markets. But as with our inherent short position on the Canadian dollar (for our USD investors), some opportunities are just too good to pass up and therefore we search for a way to benefit without taking positions directly contrary to our clients.

In 2016, we added an energy volatility trader who by the nature of his trading exhibits no meaningful correlation to oil over the long term. Using a proprietary supply and demand model, as well as a very independent cast of mind, he has been able to profit from most of the major price moves over the past ten years. The dramatic moves we've been seeing in energy markets should provide excellent opportunities for this volatility focused strategy.

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One of the cracks we anticipated would develop in our Outlook for 2015 opened wide in December, and we were ready with a niche short credit strategy that we found tucked away inside a very large private equity manager. The double whammy of the end of Quantitative Easing and the new restrictions on bank lending will force many more companies to be taken off life support and be downgraded to junk.
Selectively shorting companies with deteriorating credit is one of our highest conviction ideas and has already produced meaningful returns in 2016

Although we reduced our equity exposure in 2015 (to near zero beta on a portfolio basis) as part of our second pivot, we remain prepared to turn even more bearish and add more short positioning if we sense a strong opportunity. Of course sentiment could recover and/or some of the macroeconomic risks washing over the planet could weaken, in which case we might pivot again as needed. In general though the portfolio is becoming more and more independent of market moves.

While we were happy to preserve our investors' capital in 2015, for our USD series investors we did better than that, producing a Canadian equivalent of 19.69% for investors who rely on ISOF, as a US dollar denominated asset, as an important diversification from the Canadian economy. While that was definitely a nice gold lining, going forward we're not certain there is going to be deterioration in the Canadian dollar on the scale of what we've seen over the last five years. Accordingly, we've introduced a Canadian dollar series, providing the option of a currency overlay hedge on our US dollar-based portfolio of strategies.

We believe that much of the volatility experienced over the last few months has been overly attributed to the slowing China economy. The Federal Reserve's initiation of credit tightening last fall after seven years of the most accommodative monetary policy ever is likely the more salient event. Even though the Fed may eventually be forced to capitulate and re-initiate monetary easing, the cycle has broken and we won't likely return to the status quo ante. With a new credit regime comes a whole new set of opportunities. We look forward to exploring them in 2016.

Inflection In the News

Ari Shiff, President and Chief Strategist at Inflection Management Inc., appeared on Bloomberg TV's Daily Brief Wednesday, February 3rd to discuss how Inflection Management has allocated to managers that capture volatility to produce returns for investors. To view the segment click on the following link:

http://bloombergtv.ca/2016-02-03/news/industries/retail/global-ma-activity-to-decline-shiff/

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Both Ari Shiff and Jamison McAuley, our VP Investments, were quoted extensively in Dean DiSpalatro's article on Global Macro hedge funds in the January 22nd, 2016 edition of Advisor's Edge magazine. To view the article please click on the link:

http://www.advisor.ca/investments/market-insights/the-ins-and-outs-of-global-macro-199063

Additionally, in February, Ari Shiff contributed an article on how to potentially improve RRSP returns while reducing risk to the Advisors.ca website. To view the article please click on the link:

http://www.advisor.ca/investments/alternative-investments/better-ways-to-invest-rrsps-200886

Business Update

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. ISOF quintupled its investor base in 2015 and we are pleased to accept further referrals.

To better serve our clients, we are moving to new offices in Vancouver and opening an office in Toronto. We look forward to a 2016 already rife with fresh opportunities, 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 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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