

Don't Fall for TINA

As proponents of a tactically-diversified investment portfolio we believe our investors should maintain an exposure to equities alongside other strategies that complement their valued allocation to alternatives like the Inflection Strategic Opportunities Fund ('ISOF'). However, we beg to differ when it comes to TINA, as in the current mantra of promoters: "There Is No Alternative" to stocks. We believe that stocks are particularly high risk right now and that rather than deepen their exposure, prudent investors might wish to re-evaluate how well their current stock allocation matches their risk tolerance, and if it doesn't perhaps seek greater safety in assets that don't correlate to the stock market.

Incredibly, we are now almost eight years into the greatest experiment in global monetary policy *ever*. After the Great Recession of 2008 interest rates were set at virtually zero and the US Federal Reserve expanded its balance sheet by \$3.6T to support asset prices until such time as an economic recovery would allow the withdrawal of stimulus and a return to normal. While the various forms of financial stimulus did a good job of inflating asset prices on assets like stocks and bonds, the economic recovery has still not yet materialized as hoped and the Fed and its central bank brethren have run out of ammunition to keep asset prices at their current inflated levels. It also doesn't help that major foreign asset holders in the Middle East are struggling with their own economies and repatriating capital to meet domestic needs. In our view the global fatigue combined with country specific concerns in virtually every developed nation is creating a dangerous situation for a stock market trading at an average PE of 18x projected earnings (or 23x when using GAAP earnings).

Experts worth paying attention to like Stanley Druckenmiller, who presciently predicted back in 2005 that the Fed's liberal policies then were setting the stage for what became the collapse of 2008, are now saying that the "[pre-2008] policy excesses pale in comparison to the duration and extent of today's monetary experiment."¹ According to Druckenmiller and others, The Fed not only has no end game, but through its maintenance of monetary leniency long after it has stopped being effective, it is *increasing*, not decreasing, "the odds of the economic tail risk they are trying to avoid".

If one cares to look, the signs of this, both big and small, are all around us. Negative interest rates are no longer a theoretical thought experiment. They now exist in Europe and Japan even though no-one fully understands the implications of a banking system that reverses centuries of financial doctrine and instead pays borrowers to take out a loan and charges money for saving.

¹ The Endgame, Sohn Investment Conference, 4th May, 2016.

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Closer to home the data is equally dismaying. Back in 2008, the guiding idea behind accommodative economic policy was that by making money more freely available, the Fed would stimulate additive economic investment. But that's not what happened. Instead of stimulating more lending to the small businesses and individual entrepreneurs who tend to drive real economic recovery, the banks and bondholders provided capital to larger companies that were considered better credit risks. Unfortunately, rather than use that windfall to build new factories or start new business lines, those companies mostly spent the Fed's largesse on share buybacks and other forms of financial engineering that tend to inflate current share prices, and that has grown since 2012 to three times the amount of productive investment in areas that might contribute to future growth such as research and development.

Indeed, the unusual performance of the markets in the first quarter of 2016- a sharp selloff followed by an even steeper recovery- far from being a positive indicator of future growth, may have been a signal that the day of fiscal reckoning is near and that the reassertion of reality that ISOF has been patiently preparing to potentially benefit from may not be that far off.

March continued the 'relief rally' of the second half of February, as investor appetite for credit risk appeared to be almost insatiable. Nearly every asset class across the risk spectrum rallied and some sectors experienced the highest monthly returns in years, despite the economy barely growing at only 0.6% annualized during the first quarter (vs. the 2.1% forecast), and despite a corporate sector that remains challenged by the combination of stagnant leverage and falling profits, with an 8.5% decline in earnings predicted for the coming year.

The rally not only reversed the beginning of the year selloff, it virtually wiped away legitimate worries about China, tighter financial conditions, weak economic growth and collapsing commodity prices. Yet, as the Wall Street Journal pointed out, it was full of contradictions that signal all is not normal. "How often do stocks, government bonds and gold rally together? Why did the yen rise even as the Japanese economy weakened? How come oil rose 67% while producers struggled to find places to store excess supply?"²

According to the WSJ and others, these anomalous and nonsensical markets are due to years of weak economic growth and the distortions caused by eight years of central-bank stimulus. "The normal rules of investing have been upended, causing bond markets to predict slowdowns while stocks expect recoveries and currencies move on their own, increasingly untethered from economic fundamentals or central-bank direction." The risk of course is that "To the extent the market's rally was based on... fundamentals, a shift in government policy, such as the expected slowdown in China's credit boom, also could hit markets."

² Today's Markets Are Turned Upside Down, The Wall Street Journal, Ken Brown, 5th May, 2016.

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As mentioned in previous commentaries, we're fortunate that the nature of our managers' long/short, hedged investing does not require us to predict exactly when economic distortions will roil markets. We only have to be prepared, and then wait. Accordingly, we've structured ISOF with the deliberate intention of protecting and profiting from anticipated events when they eventually occur. With the shift in macro-economic factors, the return drivers of the past eight years will likely not be the ones driving returns for the next period. We believe investors should plan and allocate accordingly for increased market gyrations, volatility, corporate disappointments and national political dislocations. Those types of events will likely be toxic for TINA, but will also be exactly the kinds of opportunities that our managers work hard to identify and profitably exploit.

In March ISOF's net return was -0.86% bringing our year to date net return to -4.49%. By comparison, the HFRI Fund Weighted Composite Index returned 2.06% for the month (-0.57% for the quarter), the S&P TSX Index returned 3.92%, (4.17% for the quarter) and the Barclays Global Aggregate Bond Index Index gained 2.70% in March (5.90% for the quarter).

Since inception in October 2010 ISOF has produced a return of 27.65% outperforming the HFRI Hedge Fund Index by 10.30%, and the Barclays Global Aggregate Bond Index by 18.38%. With only 60% of the volatility, ISOF has been essentially even with the S&P TSX Index during the period, with a Sharpe ratio of 0.72 and a correlation to the S&P TSX Index of 0.60.

US Community banking consolidation, our largest economically sensitive position, was also our largest contributor in March, up 4.5% gross and adding 0.41% to our return for the month. Smaller gains between 0.11% and 0.20% were also seen in our Convertible Arbitrage, CTA, Energy Trading, Equity Market Neutral, European Credit, Event Driven, and Merger Arbitrage Strategies.

Detractors for the month included ABS Trading, Short Credit, and our Volatility managers which gave back some of the gains they earned in the highly volatile first 6 weeks of the year. Our Multi-Strategy and Tail Hedge managers also detracted slightly at -0.22% and -0.27% respectively.

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Business Update

During the first quarter of 2016 we welcomed a new member to the Inflection team. Amanda Singh, CPA, CMA joins us as our new CFO and CCO, and assumes the compliance and finance responsibilities previously handled by Trevor Giles. As part of her duties, Amanda will be assisting investors with capital transactions and looks forward to serving the Inflection community.

We would like to take this opportunity to thank Trevor, our Senior VP Investments, who will be leaving Inflection at the end of June. Jamison McAuley, CFA will assume responsibility for investment management functions previously handled by Mr. Giles. Trevor has been a valued part of our company over the last five years and we wish him well in his new endeavors.

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.