Inflection Commentary

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## Inflection Performance: November 2014

**Oil Oil Oil**
***Or***
**How to Benefit From a Truly New Paradigm**

Every once in a while the trading universe produces exactly the kind of disruptive macro-economic event on which the Inflection Strategic Opportunities Fund ('ISOF') tends to thrive. While we would love to claim all-seeing oracular powers, sometimes an unforeseen event makes a good thesis even better. In November OPEC gave an assist to our Oil/Canadian dollar thesis and ISOF netted 2.49% (3.87% in Canadian dollar terms).

ISOF regularly scours the world for overlooked silver linings in headline economic events. We began working on our oil thesis over a year ago when crude oil was more than double its current price of around $48. It was clear to us even then that simultaneous technological developments in fracking and shale oil and gas extraction were going to completely change the energy landscape in North America.

As a fund developed to provide diversification to Canadian investors, ISOF tries to avoid direct exposure to energy and minerals in the belief that most of our investors already have plenty of exposure to the sector through the TSX as well as the Canadian dollar. By some estimates 20% of the Canadian economy and as much as 60% of the TSX is somehow connected to natural resources. One pundit recently described the Canadian dollar as a virtual 'prisoner' to the price of oil.

The challenge for ISOF was to add exposure to assets and a market facing historic value dislocation while avoiding direct exposure to energy prices, the timing of which we could not accurately predict. Seeking to provide diversification, we searched for a strategy that would benefit from the new paradigm. We found it in the nuts and bolts, pumps and pipelines that will have to be adapted to meet the new geography of oil transportation in the US.

For the last hundred years or so oil and gas has predominantly been transported from the coasts of the US, where it is drilled or imported, inland, and an entire network of infrastructure has been developed to connect suppliers with consumers. Confoundingly, many of the biggest shale oil and gas deposits that are being developed are located deep inland. As a result nearly all the infrastructure to transport oil and gas to the coasts, either for refining, consumption or, potentially, export, needs to be reversed in direction.

The oil and gas transportation network took decades to construct the first time around; It will take years to reverse this time around. We expect to have more to report on this interesting strategy in the years to come.

While we can lay claim to foreseeing and profiting from the disruptive technology, and even for forecasting an eventual drop in demand from emerging markets which would pressure pricing, we did not foresee the huge assist we got from the Organization of Petroleum Exporting Countries (OPEC).

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The new dynamic of shale oil, fracking, and energy independence for the US threatens the advantage OPEC has had for over four decades to dictate pricing and supply. For months the twelve fractious members of OPEC debated how best to respond to this new challenge to their hegemony. In November the group, led by Saudi Arabia, decided to reach into their collective deep pockets and announced its intention to keep supply high and prices low to force new technologies and marginal producers out of business. And they made a particular point of saying that they are willing and able to keep up the pressure for years if necessary.

That is good news for oil consumers, but very bad news for oil producers. Like Canada. Predictably the price of oil plummeted and, as it tends to do, took the Canadian dollar with it. ISOF however benefitted in four ways:

> First, the steep sudden drop in the price of oil was highly disruptive to the energy infrastructure industry. As we've seen many times before, markets tend to overreact to sudden events, taking whole industry sectors up or down without distinguishing between very different companies. Our managers in this strategy, with veteran traders and a very long institutional memory, had no trouble distinguishing babies from bathwater and executed multiple trades both long and short.
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> Second, we are a US dollar denominated fund. This is by design, to provide currency diversification to our Canadian investors. Predictably, the collapse in the price of oil in November was very bad for the Canadian dollar, and therefore very good for ISOF. In 2014 (as in our entire history) that diversification has worked out very well, boosting our Canadian dollar return by 7.25% so far this year.
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> Third, the US which, unlike Canada, benefits from the decrease in the price of oil is emerging from the Great Recession of 2008 as the relatively strongest economy. Our managers have been using strong US dollars to purchase assets in countries with weaker currencies, like Europe.
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> And fourth, some of our managers had the foresight to short oil-exposed currencies, like the Russian ruble.

Even the most sanguine of Canadian cheerleaders are not forecasting a significant recovery for the price of oil or the Canadian dollar any time soon. Indeed many believe the carnage in the energy sector of the TSX will likely spread to the larger economy over time (Sample headline from the December 6th, 2014 Globe and Mail: 'Stock rout tests Canada's image as a safe haven').

By contrast, we believe the events unfolding in the energy sector are creating a truly new paradigm from which we hope to benefit for years to come not just in themes like energy infrastructure, but also in core strategies like merger arbitrage and distressed investing.

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If that forecast comes true, investors might be well-advised to seek sources of return outside of the Canadian economy, particularly if they can find a vehicle tailored to the needs of Canadian investors…like ISOF.

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The fund netted 2.49% in November and is up 3.71% year to date (10.96% in Canadian dollar terms).  By comparison our benchmark, the HFN Fund of Funds-Multi Strategy Index, gained 1.20% for the month and is at 2.65% YTD.  The TSX Index gained 0.90% for November and is now at 8.24% YTD, and the Scotiabank Canadian Hedge Fund Index was up 0.19% for the month and is at 4.29% YTD.

Since inception in October 2010 ISOF has produced a cumulative net return of 33.43% (44.40% in Canadian dollars), outperforming the Scotiabank Canadian Hedge Fund Index by 27.78%, the HFN Fund of Funds Multi-Strategy Index by 18.88%, and the TSX Index by 14.14%.

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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