Inflection Commentary

INFLECTION
Alternative Assets

Inflection Performance: September 2016

Size Matters: Hitting the Sweetest Spot

Size can be an advantage or a disadvantage for a fund. The challenge is to choose a fund of a size best suited to its strategy. For example: Smaller if you need to be nimble, larger if you need to influence the outcome.

For the past year, many large hedge funds have produced uncharacteristically disappointing results that appear to have been the result of growing too large to maintain their investing advantage and overcrowding in their markets. As alternatives have grown in popularity and become a standard component of private and institutional portfolios, a handful of monster funds have emerged. Ironically, in many cases they became too big for their opportunity set, and their size handicapped their ability to perform.

Not all hedge funds are created equal. In fact, of the more than 10,000 in the world we only consider about 200 of a quality to warrant our interest. While there are indeed some alternative strategies where size can convey a real advantage (like distressed and activist funds that need heft to push their agenda, or some CTAs that require constant expensive technology upgrades), most of the biggest funds are engaged in strategies like long-short equity trading where size can actually hinder returns because it limits the range of the opportunity set.

Simply put, no matter how smart the manager, funds can only come up with so many good ideas at a time. Dividing a $100 million fund by 10 good ideas means any opportunity in which you can deploy $10 million is theoretically fair game, and therefore there are thousands of possible opportunities. But dividing a $10 billion fund by 10 ideas mean that only a $1 billion idea is going to 'move the needle' of your returns. You can go one of two ways to deploy $1 billion on a single investment: throw your weight around and go activist; or invest passively in only the biggest companies where a $3 billion positon is not going to draw you unwanted interest from other investors. Either way, you're limiting yourself to only the biggest companies, a small subset of the investing universe.

In a strategy like Merger Arbitrage ('M&A'), even during a year like 2016 that is setting historical records for the pace and size of mega deals, there are only a small number of deals that get announced each month, and most of them won't have the characteristics that investors, whether passive or active, are looking for. The result: crowded trades with the same well-known investors investing in marquee deals. When these deals 'break' (i.e. fail to complete, as happened in 2016 with Pfizer's acquisition of Allergan, Halliburton's merger with Baker Hughes, and many more), there isn't enough liquidity in the stock to allow all of the big players out at the same time, and pricing consequently suffers. In these cases crowding creates an outsized downside risk relative to upside potential, an unattractive asymmetry that is the opposite of what we look for.

The Inflection Strategic Opportunities Fund ('ISOF') has long preferred smaller, more nimble managers in niche strategies with defined growth limits and high barriers to entry who respect the capacity constraints of their strategy and are more concerned with generating strong returns than growing their assets under management. Even in strategies like M&A, we distinguish ourselves by searching out managers who have found an un-crowded, defensible, corner where uncommon skill, diligence, and a limited market size, is very likely to produce reliable returns in the future, such as trading the more obscure convertible bond components of M&A deals.

These managers are harder to find because they are often publicity averse and don't want PR that will encourage competitors. Often they incubate under the cover of another fund, and are closed to new capital by the time they land on the cover of a trade magazine or are featured in the Wall Street Journal. Inflection Management regularly visits the major hedge fund centres of New York and London and maintains an extensive network of contacts to uncover these stars before they fully begin to shine. It takes hustle to do all the research and due diligence necessary on a new fund during the short period when the window of opportunity is open, but the reward is a unique portfolio international funds in uncorrelated strategies that can provide one-stop diversification of a kind otherwise unavailable to Canadian investors.

Market Review

Rates started to move meaningfully higher in September and became the driving force behind market moves. Some of the catalysts were firming growth in Q3, higher commodity prices, and what appears to be the beginning of central banks' recognition of the trade-offs associated with unconventional monetary policy.

After a soft patch earlier this year, growth rebounded with consumption once again the principal driver in developed markets, and the recovery in commodity prices reducing pressure on commodity producing countries. While it does not appear the economy will perform above trend growth any time soon, overcoming these negatives has reduced some of the tail risks for the time being.

In our post-2008 world, one eye must always be on central bank policies which continue to dominate the macro-economic landscape. Speeches from Federal Reserve chair Janet Yellen and vice-chair Stanley Fischer boosted the already up-trending probability of a December rate hike. In Europe, the ECB disappointed by not discussing the possibility of extending its QE program and instead vaguely discussed the possibility of tapering at some point in the future. The Bank of Japan introduced a new unconventional policy tool by committing to buying an unlimited number of JGBs to keep the ten-year rate at zero.

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Portfolio Review

For the month of September, eight of our twelve strategies were profitable. The leader again this month was Multi-Strategy up 0.35%, followed by Energy Trading up 0.26%, European Credit up 0.17%, Equity Market Neutral up 0.13%, ABS Trading up 0.11%, Merger Arbitrage up 0.05%, Convertible Arbitrage up 0.05%, and Community Banking up 0.01%. Detractors from performance for the month were Volatility -0.40%, Short Credit -0.16%, CTA -0.08%, and Muni Trading -0.05%.

In September, ISOF's Series A net return was 0.41% bringing our year to date net return to –4.15%. By comparison, the HFRI Fund Weighted Composite Index returned 0.57% for the month (4.16% YTD), the S&P TSX Index returned 1.22%, (15.82% YTD) and the Barclays Global Aggregate Bond Index Index rose 0.55% in September (9.85% YTD). The Scotiabank Canadian Hedge Fund (Equal Weighted) Index gained 1.02% in September (8.38% YTD).

Since inception in October 2010, ISOF Series A has produced a cumulative return of 23.05% outperforming the Scotiabank Canadian Hedge Fund Index by 7.47%, the HFRI Hedge Fund Index by 0.11%, and the Barclays Global Aggregate Bond Index by 9.71%. With only 59% of the volatility, ISOF trailed the S&P TSX Index by 19% during the period, with a Sharpe ratio of 0.56 and a correlation to the S&P TSX Index of 0.57.

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.