Inflection Commentary

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Inflection Performance: January 2017

Winners and Losers

What a difference a new President makes! While we have no intention of wading into the political quagmire, the new guy in the White House has been quite beneficial to what was already a rapidly improving environment for the type of strategies the Inflection Strategic Opportunities Fund ('ISOF') employs. As we wrote about in last month's commentary, the mid-2016 pivot in macroeconomic conditions supercharged our managers in Arbitrage, Relative Value, Macro, and Volatility. But since the election, President Volatility, with his strong agenda and unusual style, has had even more favourable repercussions for ISOF's managers.

Our managers often take long and short positions in order to reduce risk and increase the likelihood of a positive outcome. Long/short trading techniques work better when there is dispersion (the gap between the best and worst performers in a market) and, whether in companies or countries, President Volatility seems to anoint winners and losers every time he tweets. But more importantly, Trump has helped change the whole macroeconomic environment we live in.

From 2009-2016 we had an environment of rising equity prices and bond prices as the recovery from the Great Financial Crisis was helped along by the large scale asset purchases of central banks, especially the Federal Reserve in the United States. At the same time, near-zero interest rates kept the whole economy on life support and allowed even very weak companies to continue operating. Those factors made it more difficult for hedged managers to make money from shorting and also reduced dispersion, as the valuation of weak companies and strong companies alike benefited from the fall in interest rates.

But all that changed, and changed quickly, in the middle of last year. After many false starts, the Fed finally saw enough health in the US labour market to signal that it would break away from its fellow central bank brethren and start to raise interest rates. This created a resurgence in dispersion as the US economy began to exhibit expansion quite different from every other developed economy. The rise in interest rates removed the safety net underlying valuations of the losers, and a meaningful (and tradable) gap began to appear between the winners and losers.

Of course the Trump administration is not the only factor contributing to the atmosphere of simmering volatility that is favourable for our trading strategies. In our view, growing tensions in the European Union, the pressure on China to devalue its currency, the prospect of trade pact renegotiation, and the effects of repatriating offshore cash by US corporations could all cause widespread disruption in the near future.

Market Review

Markets were in a holding pattern in January as participants mostly waited for news from the Trump administration regarding deregulation, tax reform, and infrastructure spending. The starkly visible trends of rising equities and rising interest rates in Q4 of 2016 paused, but appear now to have reasserted themselves in February.

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Economic data continues to confirm global growth coming in above trend in the most synchronized upswing since 2011. This appears to be creating a self-reinforcing cycle with the consumption-led growth we have been seeing for the last year being met by growing business investment. Higher rates of growth are also creating higher rates of inflation and the likelihood of higher interest rates. While some of this is due to the increase of commodity prices from a low base, the tightening between aggregate supply and demand is also contributing to inflation.

With each passing week, the policy environment in the US is growing increasingly complex (or, if you believe 'fake news', chaotic). The Trump Administration has yet to provide viable plans that will move forward stated policy objectives in economically relevant areas like taxation, trade and infrastructure spending. The US Federal Reserve is projecting several assertive rate hikes this year, in contrast to both the European Central Bank and the Bank of Japan. That further global divergence should create opportunities for our macro strategies.

Contribution

While the vast majority of our portfolio (10 of 13 managers) was positive on the month on a gross basis, two of our highest volatility managers (i.e. they have a lumpy return profile), Energy Trading and a downside protection CTA, were down, coming in at the lower end of the range of their expected return for any one-month period. An occasional negative month is within the range of expected outcomes for ISOF, and it is the price we willingly pay for the potential to produce more robust annual returns. Our target remains net returns of 8-10% per year with 5% volatility (a third of the TSX) over a ten-year period.

Portfolio Activity

In January we deployed capital to two new managers. One is a high-yield bond specialist with a very long track record of producing better than 9% annualized returns. Even in 2008 the manager was mildly negative at -3.91% which, in the crisis environment that existed then is extraordinarily good and a testament to their deep credit analysis and active trading strategy.

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The high-yield bond market has many of the characteristics we look for. Trading is done 'over-the-counter' (as opposed to a centralized exchange) via personal relationships with broker-dealers, and therefore pricing and depth are not nearly as transparent as for exchange-traded securities like equities. This inevitably leads to inefficiencies upon which traders with superior advantages, like better trading relationships, can capitalize and profit.

We also like that high-yield bonds are typically held by 'long-only' institutions- like pensions funds and insurance companies- that mostly rely on credit rating and yield to select the securities they buy, and that they typically hold the bonds to maturity. These buyers typically do not have the time or resources to do a deep credit analysis of the bonds they buy and thus are often caught wrong-footed around credit rating events and other changes in fundamentals that create mis-matches in supply and demand. Active traders can benefit from the ensuing volatility.

Further disruption, and trading opportunity, may come from the fact that since its rise in the late 1970s the high yield market has never experienced a secularly rising interest rate environment, like we have now. For nimble active traders, volatility can create short term tactical trading opportunities as well as good entry and exit points for medium to longer term investments.

The second manager we added in January is a short-term commodity trading advisor (CTA) that benefits from volatility expansion in the futures markets for equities, bonds, commodities and currencies. As technology evolves we continue to find better ways of meeting defined goals. In this case, the manager provides the same necessary downside protection we were getting from a previous manager, but with much better asymmetry. This manager falls into our much-loved "getting paid to own insurance" category and fits nicely within our favourable outlook for volatility.

Inflection in the News

Ari Shiff, President and Chief Strategist of Inflection Management Inc., and Jamison McAuley, Vice President of Investments, were featured in the Financial Post's Buy & Sell Column on February 17th. In case you missed it, please click on the following link to view the article:

Buy & Sell: These fund managers are taking U.S. regional lenders to the bank

Sincerely,

The Inflection Team

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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.

Inflection Management Inc.
Suite 2300 - 1066 West Hastings Street
Vancouver, British Columbia
Canada V6E 3X2

Tel: 604.730.9147
www.inflectionmanagement.com