Inflection Commentary

INFLECTION
Alternative Assets

Inflection Performance: February 2018

Battle Tested

February's markets started out difficult, continued difficult throughout the month, and ended difficult. Though both ISOF and ULTRA were down for the month, we were pleased that our portfolio construction proved how well it can withstand very difficult market conditions (9 of our 21 managers were positive, and 5 were down less than 0.15%). We were even more pleased that the big changes we've been expecting in macroeconomic conditions have finally arrived. With a bang!

This inflection point has been a long time coming. After years of suppressed interest rates and volatility, the real economy was finally able to successfully escape the threat of secular stagnation and deflation as it recovered from the collapse of 2008. However, when rates started to rise in the middle of 2016, asset prices started to shift in reaction. We were fortunate to enjoy a 'goldilocks period' (as in economic conditions being 'just right') right up until late January of this year, at which point the market started to worry about inflation getting too hot and the effect future rate increases could have on the stock market. The result was a wave of volatility in equities, and the fastest 10% drop in the S&P 500 on record, and a liquidity spillover effect on virtually every traditional market. Even traditional safe havens, like long-term treasuries, sold off.

Most investors were caught flat-footed, some disastrously so. After years of complacency, many were crowded into the same narrow set of themes: low volatility, secular stagnation, deflation, central bank stimulus, long duration bonds, growth, technology, and passive investing.

Some of those themes appeared to come to a decisive end in February, and indications are that we are now in a cyclical recovery when rising rates and inflation are likely to provoke a big rotation in capital flows. The strategies, asset classes, and sectors that benefit in a rising rate and inflation environment are very different from those which benefitted over the past few years: think commodities instead of bonds; value instead of growth; banks instead of technology; active instead of passive; volatility instead of repression; fiscal stimulus instead of central bank stimulus; economic nationalism instead of globalization; deregulation instead of regulation; and on it goes.

If February was an example of how the market behaves when investors are looking to sell during a technical correction in a *bull* market, how might they react when we have a darkening economic outlook or an actual *bear* market?

Concentration can make investors rich or poor. It is a high stakes game. But prudent diversification and non-correlated alternative exposure has proven its ability to help keep investors rich and protect wealth during periods of turmoil.

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Contribution

While we expect all of our strategies to benefit from the higher rate and higher volatility environment that we believe February heralded, inflection points often produce temporary drawdowns in our portfolio as the constituent strategies adapt to the new regime. February was no exception to this pattern though the specifics, as usual, are interesting for their idiosyncrasy.

ISOF returned -1.99% in February and ULTRA -2.77% (for Series A investors). While 18 of our 21 managers performed admirably, getting through a month like February scot-free may have been too much to ask. Modest drawdowns are expected and tolerated in order for the portfolio to remain in a position where it can benefit from the larger opportunity sets we see unfolding. Our drawdown this month was primarily attributable to 3 of our managers:

- A merger arbitrage manager who saw a deal effectively break (in terms of price action) in the last two days of the month detracted -1.01% from performance (for ISOF Series A investors). The deal could still close in the near term as the widening of the deal spread was attributable to the suspicious timing of an anonymous tip to the acquiring company that instigated an internal investigation. That investigation has failed to produce any evidence three weeks in and, due to the 'hell or high water' nature of the deal agreement, would require proof of systemic fraud to actually break the original agreement. Most importantly for the dynamics of our portfolio, this detractor which accounted for nearly half of the month's drawdown, was completely unrelated to the broader market turbulence in February.

- Our energy specialist, who has a structural bullish view on oil and hence had a long-biased exposure at the beginning of February, detracted -0.54% (for ISOF Series A investors). There was no fundamental news to change our manager's view regarding oil in February, but as leveraged trend followers like CTAs felt pressure in their equity positions, they also liquidated their oil positions and the price declined. Our manager follows a strict risk management framework to protect capital, and de-risked as the market moved lower. This manager posted healthy positive performance for the two months prior (+10.6% in December and +5.3% in January), and is well positioned to benefit from future upward moves in oil.

- A CTA who had a decent amount of equity exposure after the long run up in equities, and suffered -0.47% accordingly (for ISOF Series A investors). CTAs position with the trend and trade equity indices, rates, currencies and commodities. They are often long in bull markets and short in bear markets, and therefore suffer temporarily at inflection points.

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Finally, it is important to note that our long volatility manager, who we maintain as a hedge on the overall portfolio and to profit from certain crisis scenarios, was up 30% during the month but finished the month up 2.76%. That is as it should be. If markets had closed the month near the lows, the manager would have ended the month with eye popping numbers and nicely benefited our portfolio. Our manager did not take those mid-month gains, because his job is to maintain his long volatility positions for when they're most needed. In the event, volatility lessened somewhat toward the end of February, and therefore his particular type of insurance (against volatility regime shifts, which can be permanently damaging, as opposed to volatility spikes, which are transitory events that often reverse) was not needed to the same extent.

Sincerely,

The Inflection Team

The Inflection Strategic Opportunities Fund (ISOF) and the Inflection Strategic Opportunities Fund Ultra (Ultra) invest in a broad array of carefully selected hedge fund strategies in order to capitalize on dislocations and market opportunities. The funds have global mandates and focus 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 funds' option structure has significant tax benefits. Please refer to the attached Factsheet for additional information.

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