Inflection Commentary

INFLECTION
Alternative Assets

Inflection Performance: May 2018

Think the Collapse of 2007 is Behind Us? Think Again

- **The world's debt problems have only gotten worse since 2007**
- **As the cycle comes to an inevitable end there will be an impact on traditional assets**
- **Uncorrelated strategies will likely outperform long-only portfolios in the transition**

Much ink has been spilled (and pixels lit) on analyzing the causes and aftermath of 2008, and many would have investors believe that those problems are now behind us. Indeed, the stock market very much seems to validate that view by rising ever higher.

The truth however is more complex, more of a risk for investors' portfolios, and more of an opportunity for those who choose to delve deeper than headline news.

Among other things, 2007 was a collapse of credit. Too much debt could not be repaid, risking economic stability worldwide. The developed economies, all in the same very leaky boat, worked together and printed the equivalent of 12 *trillion* dollars to keep their economies afloat and financial markets from drowning. In the US various programs of fiscal stimulus allowed the banking system to deleverage and recapitalize and allowed households to increase savings.

Not so in the rest of the world. Debt overall has in fact risen from 358% of global GDP in 2007 to 382% of GDP in 2017. Debt in emerging markets, led by China, has risen even more in percentage terms, from 145% of GDP in 2007 to 210% in 2017. All that debt may have seemed tolerable when interest rates were near 0%. Not so now that interest rates are on the rise.

In previous commentaries we've focused on the downside of how this potential looming crisis would impact traditional assets like North American stocks and bonds. But there is also an upside, and it is on the upside that ISOF and ULTRA are focused:

-As the world's developed economies have started to decouple we've seen increasing divergence of growth between the US, China, and Europe. Our portfolio is positioned to benefit via long-short and market-neutral specialists as well as the ensuing volatility by, for example, going long the companies, regions, and sectors that are performing well, and going short the companies, regions, and sectors that are not.

-As the US dollar appreciates, it will pressure US-denominated foreign debt and other assets that are sensitive to global rates. Our portfolio is positioned to benefit from what we believe could be another crisis in European sovereign debt and a long-expected reckoning in Asia.

-Over the 9 years that interest rates were kept artificially low, what would in more normal times have been considered high-risk assets came to be seen as safe. As interest rates rise, those assets will be recognized as near toxic. Our portfolio is positioned to benefit from the reversal of that trend, and we have a long track record proving our ability to act profitably on the kinds of opportunities that appear as investors rush for the exits.

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Finance is often spoken of as a 'zero-sum game.' One investor's gain is another's loss, and vice versa. The continuing excess of indebtedness will inevitably collapse and create serious losses for investors who have invested in the wrong assets. But it will also create opportunity for savvy investors prescient enough to switch tracks at the right time and get out of the way of trouble.

Seen through that lens, the Collapse of 2007, looks a lot like the gift that keeps on giving.

Contribution

In May ISOF was up 1.13% and Ultra 1.44% for Series A USD investors, bringing ISOF to +0.04% and Ultra to -0.75% YTD.

Gains in May were broad-based, with 7 of our 21 managers contributing more than 0.10% (for ISOF Series A USD investors). HUN, an arbitrage specialist that was mentioned in previous commentaries as a source of temporary idiosyncratic underperformance, led the way, up 5.35% and contributed 0.47% to monthly performance. CBH, our market-neutral regional banking specialist, put in a solid performance as well, up 1.88% on the month and provided 0.22% to performance. President Volatility in the US caused a backup in merger activity with his ceaseless bombast. Now that the courts have overruled the Department of Justice on the AT&T/Time Warner deal, mergers in all sectors have picked up again and are expected to remain strong through the remainder of the year.

VEC, our tech-focused credit manager, had another solid month up 2.18% and provided 0.20% to performance. AND, our energy specialist, who was recently featured in the Wall Street Journal for his non-consensus views and outstanding performance, was up 5.29% on the month and contributed 0.22% to performance.

Last, but not least, GAR, a merger arbitrage specialist, was up 2.32% on the month and contributed 0.20%. As mentioned above with the recent positive ruling on the AT&T/Time Warner merger, we expect much of the backlog in this sector to clear, resulting in a robust opportunity set for our M&A specialists.

The only meaningful detractor this month was PIN, a quantitative arbitrage and event-driven manager, down -1.48% on the month and detracted -0.19% from performance. As with all managers who underperform our expectations, their performance has been examined to determine whether they should remain in the portfolio. It's possible that this manager's trading edge has lessened. As such we are watching closely and will likely recycle the capital into better opportunities.

Sincerely,

The Inflection Team

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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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Disclosure

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