Inflection Commentary

INFLECTION
Alternative Assets

Inflection Performance: January 2019

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- **The time to de-risk your portfolio is *ahead* of a recession**
- **Markets can fall faster than investors can react**
- **Uncorrelated assets can protect portfolios in a downturn**

After a harrowing end to 2018, equity markets have rallied impressively in 2019. Citing a slowdown in growth the US Federal Reserve effectively cried uncle, paused their rate hike cycle, and indicated that it will end the 'roll-off' of its balance sheet (Quantitative Tightening) later this year. In other words, equity markets have gone up because the outlook for growth *has gotten worse*!

While the data isn't yet foretelling a recession, it is important to understand that new trends in the way equity markets react have made them far more volatile, especially in the face of bad news which is considered good (like the FED isn't raising rates) and bad news which is truly bad (like a recession).

For years now investors have been abandoning actively managed equity accounts for passive index-tracking funds, and for good performance-related reasons. The total amount invested in passive funds is forecast to possibly surpass active investing by as soon as 2021*, but we are already seeing the effect of their popularity in increased market volatility and price distortion. Because so many of these funds react similarly to the same data, their combined selling or buying can have a huge impact on a particular stock and the market as a whole.

The rise of passive investing has also created a potentially catastrophic liquidity problem for markets when the selling really gets going, as previewed in equity markets at the end of 2018: When everyone is trying to reduce their holdings at the same time because all the passive funds hold similar securities, there are significantly fewer participants left to slow the fall in price by buying the other side. The ensuing downward price spiral can be further exacerbated by quantitative funds that use market volatility data as an input to determine their level of market exposures: When large scale selling builds, volatility rises and therefore the machine-driven models start selling as well.

What could have been an even worse scenario was prevented in December by the FED's change in tone and subsequent reduction in rate hike forecasts. But that felicitous announcement was predicated on an economic outlook that was slowing but still stable. What will happen next time the outlook is less rosy - a very real possibility given today's macroeconomic conditions and geopolitical landscape?

* Moody's Investors Service, quoted: https://www.forbes.com/sites/greatspeculations/2018/09/19/are-we-headed-for-a-passive-index-meltdown/#cf345413e402

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It's also important to note that the catalyst for the next serious drawdown might not be anything terribly dramatic. Indeed, the biggest threat we currently see to markets is profit margins. Corporations are currently enjoying record levels of profitability, but due to slowing growth and tight labour markets these margins are likely to come under pressure. In addition, rising wages often create inflationary pressures in the economy which result in higher interest rates. Higher interest rates and lower margins equals lower earnings and lower earnings multiples. The combination of falling profit margins and falling earnings multiples can translate into lower stock prices in a low growth environment, even without triggering a recession.

How to react to all this?

Despite the risks, equities can still be a valuable long-term contributor to investors' portfolios. But if an investor is the least bit sensitive to timing issues, or simply wants to live with less volatility in his or her life, a prudent mix of uncorrelated alternative assets such as ISOF and ULTRA can both reduce the volatility and improve returns over time. That is true both in good times and bad, so diversification isn't dependent on timing so much as good planning.

Although the world keeps on changing, diversification is still the only free lunch in the investing world. Enjoy the banquet!

Contribution (ISOF Series A USD)

ISOF Series A USD returned +0.69% and Ultra Series A USD returned +0.88% in January. 14 of our 19 strategies performed positively for the month.

Our top contributor was CBH, a regional banking specialist, who produced 0.78% for the portfolio. Our second largest contributor was VER, a multi-strategy arbitrage specialist, who produced 0.25% for the portfolio, and our third was MAL, a relative value volatility specialist, who produced 0.24% for the portfolio.

Our largest detractor was TSA, a structured credit specialist, who detracted -0.82% from the portfolio. Our second largest detractor was ART, a volatility specialist, who detracted -0.23% from the portfolio, and our third was ALP, a short-term CTA, who detracted -0.19% from the portfolio.

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.

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

Tel: 604.730.9147
www.inflectionmanagement.com

Disclosure

ISOF/Ultra 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 ISOF/Ultra and may not be useful for comparison purposes. The Scotiabank Canadian Hedge Fund Equal Weighted Index (SCHF | Equal Weighted) is an equal weighted index intended to represent a comprehensive overview of the Canadian Hedge Fund universe. The index includes both open and closed funds with a minimum AUM of C$15 million and at least a 12-month track record of returns, managed by Canadian-domiciled hedge fund managers. Index returns are quotedin CAD. 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/Ultra are exempt market funds available to Canadian resident accredited investors in British Columbia, Alberta, 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.