

7 *Myths*

About Liquid Alternative
Mutual Funds



The Arbitrage Funds

ADVISED BY WATER ISLAND CAPITAL

1. *Liquid alternative mutual funds are just the latest Wall Street gimmick foisted on investors.*

For decades, institutional and accredited investors have been allocating capital to alternative investment strategies in an effort to diversify returns and reduce volatility. This allocation was mainly implemented through limited partnerships and private funds (a.k.a. hedge funds). Managers employed long/short, market neutral, multi-strategy, catalyst-driven and managed futures strategies, in an attempt to deliver returns independent of the market's performance.

After the 'lost decade' ending in 2009 when the S&P 500 index recorded a loss, many advisors recognized their clients needed alternate sources of investment return that go beyond stocks and bonds. Some increased exposure to mutual funds or exchange traded funds (ETFs) focused on gold, real estate and commodities, to name a few alternative investment categories that have gained popularity over the past five years.

Others recognized the potential of those hedged strategies in a mutual fund format as specified by the Investment Company Act of 1940, 'the 40 Act.' The appeal of a portfolio of liquid alternatives is, if properly constructed and managed, it can mitigate some of the systematic market risk that is inherent in portfolios solely composed of long-only equity and fixed income holdings.

The absolute return focus of most alternative investment strategies has historically provided ballast during times of tumult. On the flipside, during boom times these strategies may lag the broader indices. As the mutual fund rating agency Lipper notes, these funds are not benchmarked against a traditional long-only market index, such as the S&P 500 index, but rather have the aim of outperforming a cash or risk-free benchmark.

Beyond the diversification-enhancing attributes of liquid alternatives, these funds are available at a lower fee structure than the typical hedge fund, are available with lower investment minimums and provide investors with the ability to withdraw funds at will.

2. *These strategies and investments are inscrutable and hard to value.*

An alternative investment by simple definition is any security and asset that isn't cash, bonds or stocks, which is a pretty broad universe. While some alternative investments such as real estate, private equity holdings, distressed debt, derivatives and other vehicles may be harder to value, most liquid alternative funds invest in marketable securities that trade and are priced during market hours, much the same as a traditional long-only fund.

Indeed, in deploying alternative investment strategies, such as event-driven, long/short, merger arbitrage and relative value credit, portfolio managers are usually investing in -- and in some cases shorting -- stocks and bonds that can be easily bought and sold and priced daily.

There may be certain alternative strategies that don't translate well to the mutual fund format because they rely too much on leverage or they invest in securities or instruments that are not easily valued, especially during times of stress. As with any investment, you should make sure it is suitable for your needs and meets your expectations.

3. *These funds are pale imitations of hedge funds.*

One of the biggest criticisms of alternative mutual funds is that on average, returns suffer from what's known as the liquidity premium, that is, the drag on returns from providing investors with the ability to withdraw funds at will. Unlike hedge funds, which generally require that investors agree to a 'lock-up' or agreement to forgo access to funds for a prerequisite period of time, alternative mutual funds give investors daily access to their funds as dictated under 'the 40 Act.' To facilitate the ability to redeem at will withdrawals, alternative mutual funds generally invest in highly liquid securities and rarely tie up funds in securities or assets that do not have a ready and active market.

Additionally, because most liquid alternatives do not employ leverage to the same extent as the average hedge fund may, the returns profile should show relatively lower volatility, particularly in falling markets. The tradeoff for this ready access to funds, lower fees, and limited use of leverage is a more moderate returns and risk profile vis-à-vis traditional limited partnership structures.

Some alternative strategies may work better in the liquid alternative format. Long/short equity, event driven and global macro may be best translated into a liquid fund structure. Distressed assets and private equity holdings can be the least effective due to the illiquid nature of the securities and holdings in which these strategies may invest.

4. *These funds lack oversight and regulation.*

The Investment Company Act of 1940, 'the 40 Act,' resulted from the stock market crash of 1929 as an attempt to stabilize financial markets. It is enforced and regulated by the Securities and Exchange Commission. This statute clearly lays out the rules regarding filings, service charges, financial disclosure, the use of leverage, daily liquidity requirements, and the fiduciary duties of pooled investment vehicles, among other things. They are also required to have an independent board of directors and auditor. In short, liquid alternatives, by nature of mutual fund regulations, have to meet the highest standard for transparency and independent oversight in terms of investment strategy, holdings and reporting.

As a result of the quintupling of assets and the number of alternative mutual funds (respectively to \$150 billion and 450) since 2008 through the end of June 2014, the SEC is currently conducting a regulatory examination related to leverage, liquidity, transparency, and other concerns, according to press accounts. We believe that a thorough examination and account of the purveyors and advisors of liquid alternative mutual funds will only further legitimize the liquid alternative space.

5. *The fees and expenses for these funds are so high.*

Compared to the fees and expenses of a typical ETF or passive index mutual fund, fees and expenses may look high. According to Morningstar, the typical alternative mutual fund charges 1.62% versus 1.30% for the average actively managed long only mutual fund and 0.4% for passive index funds and ETF vehicles (as of April 30, 2014). However, liquid alternative mutual funds usually employ investment strategies that require highly specialized skill sets, active management and use of hedges to deliver an absolute return strategy. These strategies may also be capacity constrained, meaning that there is only so much capital that can be effectively deployed.

When compared to the cost of investing in the limited partnership version of these strategies, alternative mutual funds' fee structure is quite attractive. In a hedge fund format, accredited investors typically are charged upwards of 2% annual management fee and a 20% performance fee after surpassing a prior high water mark.

6. *These funds and strategies use too much leverage.*

Under the 40 Act law, mutual funds and other open-ended investment vehicles are limited in their use of leverage up to 30% of assets under management. They are also required to have enough liquidity to be able to redeem shares within seven business days though most can meet redemptions on a daily basis. For these reasons, many alternative mutual funds use little or no leverage. Their hedge fund counterparts tend to rely on leverage to enhance returns. While the prudent and judicious use of leverage is appropriate for some strategies and funds, leverage can exaggerate losses during periods of market tumult.

7. *These funds are untested. Most have short track records and are subject to 'run on the bank' risk.*

While the number of alternative mutual funds has proliferated since 2008 to around 450 from 80, there are dozens of alternative mutual funds that have performance records going back through multiple market cycles.

Many of the funds introduced during the last couple of years are liquid alternative versions of successful and legitimate hedge funds/limited partnerships strategies. While they may be untested as '40 Act' funds, the advisor is likely to have years of experience executing the underlying strategy in an unconstrained manner.

Alternative mutual funds that invest in liquid securities carry no more additional redemption risk than a bond fund in a period of rising interest rates or an equity fund during significant market corrections. Moreover, many alternative mutual fund strategies are considered portfolio shock absorbers and volatility reducers that may offer ballast during times of market turbulence.

GLOSSARY

A **Long/Short** strategy takes long positions in stocks that are expected to appreciate and short positions in stocks that are expected to decline. A long/short equity strategy seeks to minimize market exposure, while profiting from stock gains in the long positions and price declines in the short positions.

A **Market Neutral** strategy seeks to profit from both increasing and decreasing prices in a single or numerous markets. Market-neutral strategies are often attained by taking matching long and short positions in different stocks to increase the return from making good stock selections and decreasing the return from broad market movements. Market neutral strategists may also use other tools such as merger arbitrage, shorting sectors, and so on. There is no single accepted method of employing a market-neutral strategy.

A **Multi-Strategy** strategy generally maintains positions in companies currently or prospectively involved in corporate transactions of a wide variety including but not limited to mergers, restructurings, financial distress, tender offers, shareholder buybacks, debt exchanges, security issuance or other capital structure adjustments. Security types can range from most senior in the capital structure to most junior or subordinated, and frequently involve additional derivative securities. Exposure typically includes a combination of sensitivities to equity markets, credit markets and idiosyncratic, company specific developments.

A **Catalyst-Driven** strategy involves investments, long or short, in the securities of corporations undergoing significant change (e.g., spin-offs, mergers, liquidations, bankruptcies). Such change often provides managers with a tangible catalyst by which the manager may be able to realize the expected change in value in the underlying security.

A **Managed Futures** strategy uses futures contracts as part of its overall investment strategy. Managed futures provide portfolio diversification among various types of investment styles and asset classes to help mitigate portfolio risk in a way that is not possible in direct equity investments.

IMPORTANT INFORMATION

An investor should consider the investment objectives, risks, charges and expenses of the Funds carefully before investing. The current prospectus contains this and other information about the Funds. To obtain a prospectus, please call (800) 295-4485 or visit our website at <http://arbitragefunds.com>. Please read the prospectus carefully before investing. There is no guarantee the Funds will meet their stated objectives.

We are making this presentation available to you for your information and education.

RISKS: Investing involves risk, including possible loss of principal. Liquid alternatives are subject to market risk. Investment risk may be magnified with the use of alternative strategies. When using hedging strategies investors should not expect significant outperformance during market rallies. It is possible to lose money when investing in mutual funds. The use of leverage and short selling techniques may increase the risk of investment loss. Asset allocation/diversification does not guarantee a profit or protect against a loss.

Index returns are for illustrative purposes only and do not represent actual fund performance. Index performance returns do not reflect any management fees, transaction costs, or expenses. Indexes are unmanaged and one cannot invest directly in an index.

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