The Arbitrage Funds
ADVISED BY WATER ISLAND CAPITAL

ARBITRAGE FUND
Q3 2018 COMMENTARY

PORTFOLIO REVIEW

The Arbitrage Fund (ARBNX) returned 0.54% for the third quarter of 2018 and 0.54% for the year-to-date period. The S&P 500 index returned 7.71% and 10.56%, while the Bloomberg Barclays US Aggregate Bond index returned 0.02% and -1.60%, for the same periods, respectively. HFRI Merger Arbitrage – an index of hedge funds focused on the merger arbitrage strategy – returned 0.57% for the quarter and 3.29% year-to-date.

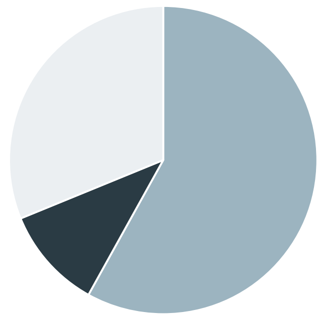
At quarter-end, the portfolio was invested in 60 active merger transactions, with 84% of the portfolio in Americas-based deals, 9% in Europe/Middle East/Africa (EMEA), and 0% Asia-Pacific (APAC) transactions.

TRAILING RETURNS (ARBNX) AS OF 9/30/18

1-Year	0.67%
5-Year	2.02%
10-Year	2.66%

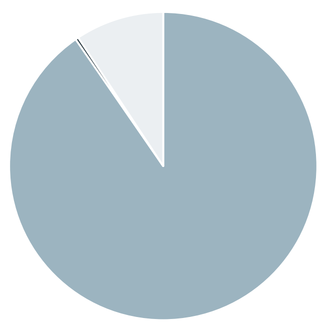
Performance greater than one year is annualized.

DEAL CONSIDERATION AS OF 9/30/18



Subject to change. Reflects long alpha exposure as percent of net assets.

GEOGRAPHIC EXPOSURE AS OF 9/30/18



Subject to change. Reflects long exposure as percent of net assets.

MARKET PERSPECTIVE

The Federal Reserve, seeking to normalize interest rates in response to strong economic growth and an extremely tight labor market, raised rates once again in Q3. Consensus suggests an additional hike before year-end, with three to four more next year, and we don't disagree. Nonetheless, investors were largely undeterred by rising rates and trade-related headlines, as strong consumer confidence and economic stability moved markets higher over the quarter. While investors may eventually begin to factor in elevated interest rates and the potential for increasing costs associated with tariffs, we welcome the rising rate environment with open arms. Rising rates typically act as a tailwind for merger arbitrage spreads, and this is a development for which we have been patiently waiting for over a decade.

Looking ahead, our outlook for merger arbitrage remains constructive. Global M&A will likely continue at record levels, fueled by corporate tax cuts coupled with the repatriation of offshore cash by US companies. We're witnessing particularly aggressive activity within the internet infrastructure, biotech/pharmaceuticals, industrials, chemicals, and consumer sectors.

That said, the ongoing trade dispute between the US and China keeps us cautious regarding exposure to high profile transactions requiring approval from China's regulators. Holding the regulatory approval process hostage in retaliation for tariffs or sanctions would not be out of character, as China has already demonstrated a willingness to reject or delay mergers – especially in industries China deems vital to the achievement of its economic development plans (e.g. semiconductors, artificial intelligence, 5G) – based on political motives. We are similarly cautious toward consolidation activity in sectors that are highly concentrated or dominated by one or two large entities. Healthcare (HMOs) and mobile communications come to mind (e.g. T-Mobile/Sprint), as do the dominant internet/social media companies that face increasing scrutiny from global anti-trust regulators in both the US and Europe.

We do not anticipate the rising rate environment will disrupt deal flow, though we are cognizant of the risks associated with rising rates for those transactions involving high levels of leverage. More broadly, today's environment reminds us of the excesses of 2006-2007, with disproportionate risk-taking on the part of financial buyers, and we are focused on the potential risks that such excesses can bring.

Entering the final quarter of the year, we see a multitude of potential risks for global markets, stemming from areas such as the ongoing US/China trade dispute, Italian government budget negotiations, Q3 earnings, and mid-term elections in the US. We cannot stress enough the importance of understanding the downside associated with each transaction under review, and of constructing well-diversified portfolios (by industry, jurisdiction, risk factors, etc.) that can deliver both capital preservation and low volatility. Nonetheless, we remain enthusiastic about our strategy. We're currently experiencing favorable conditions for all three of the primary driving factors of merger arbitrage returns: interest rates are on the rise, deal flow is healthy, and the third – market volatility – returned in earnest starting in Q1. Ultimately, this leads us to believe the months ahead will be a supportive and profitable period for the strategy.

The performance quoted represents past performance and does not guarantee future results. Investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than the original cost. Current performance may be lower or higher than the performance quoted. For performance data current to the most recent month end, please call (800) 295-4485. The Total Annual Fund Operating Expense for ARBNX is 1.69%. Total Annual Fund Operating Expense Excluding the Effect of Dividend and Interest Expense on Short Positions and Acquired Fund Fees for ARBNX is 1.23%.

TOP CONTRIBUTORS

Sky PLC / Twenty-First Century Fox Inc — In December 2016, Twenty-First Century Fox – a US television and film company – entered into a definitive agreement to acquire Sky – a UK pay-television service operator – for $23 billion. During Q1 2018, the fund benefited from a topping bid for Sky on the part of Comcast (a $42 billion offer) which led to shares trading through the terms of Fox's original offer. In addition (to make matters more complicated), Fox itself became the subject of a bidding war between Disney and Comcast. While Comcast ultimately abandoned its pursuit of Fox, it remained focused on Sky. In September, the failure to resolve the competing bids forced a rather uncommon mandatory auction process under UK takeover code. Comcast emerged victorious, with a winning bid that was 60% greater than Fox's original offer in December 2016, leading to a profit for the fund.

Starz Inc / Lions Gate Entertainment Corp — On June 30, 2016, Lions Gate Entertainment – a US-based producer and distributor of film and television entertainment – announced a definitive agreement to acquire Starz – a US-based distributor of subscription-based entertainment programs – for $3.6 billion in cash and stock. The deal closed successfully on December 8, 2016. We are currently pursuing event-driven litigation following the completion of this transaction and during Q3 2018, the mark-to-market valuation of this position contributed to returns.

Tribune Co / Sinclair Broadcast Group Inc — In May 2017, Sinclair – a US diversified television broadcasting company – entered into a definitive agreement to acquire Tribune – a US media company with operations in publishing, television and radio stations – for $6.6 billion. During Q2 2018, the deal spread widened following reports the FCC would solicit additional comments and may wait to render its decision until after a federal appeals court ruled on whether the agency can continue to allow companies to only partially count certain stations against ownership cap restrictions. In Q3, the transaction was officially called off, after the companies and the FCC were unable to come to an agreement. Despite the deal termination, Tribune's stock traded up based on speculation that an unnamed third party – which had been mentioned as an interested suitor in the merger background – may launch its own bid for the company. In addition, Tribune shares were further supported by news of a lawsuit it launched against Sinclair, whereby the company alleged Sinclair mishandled the FCC negotiations and is seeking $1 billion in damages.

TOP DETRACTORS

NXP Semiconductors NV / Qualcomm Inc — In October 2016, Qualcomm – a US telecommunications equipment provider – entered into a definitive agreement to acquire NXP Semiconductors – a Dutch provider of mixed-signal semiconductor solutions – for $53 billion. As of Q1 2018, the deal had received regulatory approvals from all required jurisdictions with the exception of one: China. Approval from Chinese authorities appeared imminent when, in Q2, the transaction was caught in the crossfire of the ongoing trade dispute between the US and China, with China initially refusing to approve any transactions involving the US. Investors subsequently fled for the exits, leading to a sharp decline in NXP's share price and driving the deal spread wider. The deal was ultimately withdrawn when, after Chinese regulators had yet to approve the deal, the parties declined to extend the merger deadline, leading to a loss for the fund.

Market Hedges — From time to time, in addition to various issuer-specific hedges, we may choose to implement broader market hedges in the portfolio. The intent of these hedges is to reduce directional exposure and market risk while providing the portfolio with lower volatility and drawdowns. As equity markets rallied over the quarter, these hedges detracted from returns.

Twenty-First Century Fox Inc / Walt Disney Co — In December 2016, Disney – a US media and entertainment company – entered into a definitive agreement to acquire the entertainment business of Fox – a US television and film company – for $85 billion. During Q2 2018, Comcast also launched a bid for Fox's assets which led to shares trading through terms in expectation of a protracted bidding war with Disney. However, in July, Comcast abandoned its pursuit of the company which led to a share price decline and mark-to-market losses for the fund. Nonetheless, we expect the deal to successfully complete during Q1 2019.

GLOSSARY: *Deal flow* refers to the volume of announced mergers and acquisitions activity.

IMPORTANT INFORMATION

An investor should consider the Fund's investment objectives, risks, charges and expenses carefully before investing. The Fund's prospectus contains this and other important information. You may obtain a copy of the Fund's prospectus at http://arbitragefunds.com or by calling (800) 295-4485. Please read the prospectus carefully before investing.

RISKS: The Fund uses investment techniques with risks that are different from the risks ordinarily associated with equity investments. Such techniques and strategies include merger arbitrage risks (in that the proposed reorganizations in which the Fund invests may be renegotiated or terminated, in which case the Fund may realize losses), high portfolio turnover risks (which may increase the Fund's brokerage costs, which would reduce performance), options risks, borrowing risks, short sale risks (the Fund will suffer a loss if it sells a security short and the value of the security rises rather than falls), and foreign investment risks (the securities of foreign issuers may be less liquid and more volatile than securities of comparable US issuers), which may increase volatility and may increase costs and lower performance. Foreign investing involves special risks such as currency fluctuations and political uncertainty.

Top 10 holdings as of 9/30/18: Bob Evans Farms Inc/DE; Forest City Realty Trust Inc; Gramercy Property Trust; KLX Inc; LifePoint Health Inc; MB Financial Inc; Pinnacle Entertainment Inc; Pinnacle Foods Inc; Rockwell Collins Inc; Twenty-First Century Fox Inc. Top 10 holdings represent 39.2% of the portfolio. Holdings are subject to change. Current and future holdings are subject to risk.

The S&P 500 Index is an index of US equities meant to reflect the risk/return characteristics of the large cap universe, and is one of the most commonly used benchmarks for the overall US stock market. The Bloomberg Barclays US Aggregate Bond Index covers the US investment grade fixed rate bond market. The HFRI Merger Arbitrage Index includes funds which employ an investment process primarily focused on opportunities in equity and equity-related instruments of companies which are currently engaged in a corporate merger or acquisition transaction. Indexes are unmanaged and one cannot invest directly in an index.

Material represents the manager's opinion and should not be regarded as investment advice or a recommendation of any security or strategy.

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