BARRON'S
THE DOW JONES BUSINESS AND FINANCIAL WEEKLY www.barrons.com JANUARY 4, 2010

Talking With John Orrico
President, The Arbitrage Fund

Deal or No Deal

By Michael Shari

(The following has been excerpted.)

BACK IN JANUARY 1989, WHEN STOCK trades were still executed by hand, a misunderstanding between a floor broker and a young options trader named John Orrico resulted in a sell order getting executed twice and then a buy order being mistaken for a sell order. The result was a $3,396,000 loss, which cost Orrico his job, and an NYSE order barring him from trading for five years, according to the exchange's records.

It was an inauspicious start for a star investor, but it taught Orrico a brutal lesson in risk management that helped make him one of America's best-performing portfolio managers during the recent stock-market crash. His Arbitrage Fund (ticker: ARBFX), a $647 million retail-mutual fund that invests in mergers and acquisitions, nearly broke even with a hairline-thin loss of 0.63% from Jan. 1 to Dec. 31, 2008, the year the S&P 500 plunged 37%.

"My trading loss experience 21 years ago, as humbling as it was, is an example of the unintended consequences of poor risk discipline," says the 49-year-old Orrico, who worked as a merger-arbitrage analyst at Gruss & Co., a family office, in the 1990s before founding Water Island Capital in New York and launching the Arbitrage Fund in September 2000.

"Employing a strict discipline around avoiding capital loss was imprinted on my DNA, a discipline that our firm adheres to today. We were better prepared than most managers in 2008 because we prepare for the worst," adds Orrico, who is president of Water Island and has a bachelor's degree in finance and international management from Georgetown University.

Orrico and co-portfolio managers Roger Foltynowicz and Todd Munn aim to keep any losses from a particular deal to less than 1% of total assets by assigning an implied-risk rating to all of the more than 40 transactions they may be tracking at any one time. They use options to short an acquirer's shares, particularly if it's making a purchase in stock. And they don't hesitate to sell if a deal seems to be unraveling.

Since inception, the Arbitrage Fund has returned 6.0% on an annualized basis, while the S&P 500 has lost 0.95%. That has attracted investors, who deposited about $430 million from Jan. 1 to Dec. 21, 2009. "It's as close to a sure thing as you can find," says Arthur Cohen, a registered investment advisor in Northbrook, Ill., who has invested about $8 million of client money in the fund.

For the three years through Nov. 30, the Arbitrage Fund earned four stars from Morningstar. It was up 5.34% while the S&P 500 lost 5.79% on an annualized basis in that time. In 2009, again through Nov. 30, the fund delivered a total return of 9.14%, as the M&A market emerged from the recession with a vengeance, driven in part by the broader market index's breathless 25.39% return.

The fund's singular strategy is merger arbitrage. After a company announces that it has signed an agreement to buy another company, Orrico pounces on the target's stock. Then he waits to see if the deal closes as promised or if other would-be acquirers swoop in with higher bids, which ratchets up the share price before the merger formally closes.

Orrico also evaluates the individual deals on the basis of implied risk, which includes measures of regulatory scrutiny, shareholder approval, pro forma financial strength of the combined entity and likelihood of a competing bid threatening the existing one. He then decides whether the potential return is worth the risk. At times he'll shun an otherwise solid deal if there are other risks, such as a management group with a bad acquisition track record.

This is an absolute-return strategy that is generally regarded as the domain of private hedge funds run by star investors like John Paulson, another Gruss veteran. These hedge funds require a steep minimum deposit of $100,000-$250,000 and charge high performance fees.

But Orrico offers the same strategy in a plain-vanilla mutual fund with a minimum investment of just $2,000 and an expense ratio of 1.69%. The fee is higher than average but still worth the performance, says Cohen. And this fund is less risky than many hedge funds because it doesn't use leverage.

An advantage of the fund's small size is that it can invest in small-cap companies and still benefit from the impact of price appreciation. That's a big advantage in the post-recession M&A market, which is dominated by small-cap deals. Blue-

(over please)

chip corporations that slashed costs and stockpiled cash during the crisis are buying their smaller competitors to take advantage of the economic recovery. At the same time, private-equity firms that were frozen into a holding pattern by the credit crunch in 2008 are selling equity stakes to raise cash.

Orrico prefers small deals because they often pit competing bidders against each other. They have more upside potential than the predictable large-cap deals that account for the bulk of the fund's assets, such as Berkshire Hathaway's (BRK.A) planned $26 billion, or $100 a share, acquisition of Burlington Northern Santa Fe (BNI). About 5% of the Arbitrage Fund's assets are in Burlington shares at a cost of $96.70-$97.25 a share.

Orrico's most lucrative investments in 2009 were small cash-only deals that ranged in size from $80 million to $2.1 billion each. They each made up less than 4% of the fund's assets.

One was AltaGas Utility Group, a small gas-distribution company that was bought by its largest shareholder, AltaGas Income Trust (ALA.UN.T), in October. Orrico had started buying the utility group's stock last summer, when the merger agreement was announced, for 8.90-9.00 Canadian dollars (US$5.25- $5.31) a share. He only expected to make about 10 Canadian cents a share. But then another bidder came in, bumping up the price to C$10.50 and stretching Orrico's return to about C$1.50 a share, or 17%.

In the U.S. tech sector, Orrico began buying Data Domain, which provides data storage for computer networks, for about $24 a share after NetApp (NTAP) announced in late May that it was acquiring its smaller peer for about $25 in cash and stock. Then, in early June, industry leader EMC (EMC) launched a hostile cash-only bid of $30 per share, then raised its bid, and ultimately closed the deal for $33.50. Orrico had already bailed out at $31.50 with a handsome 31% return.

The Arbitrage Fund invested back in January in another Australian energy company, Pure Energy, for about five Australian dollars per share (US$4.39) a month after Arrow Energy of Australia (AOE.AU) bid A$5.40 in a cash-and-stock deal. Then, in February, BG Group (BG.LN) of the U.K. bid A$6.40 in cash. When the deal finally closed at A$8.25, Orrico chalked up a superlative return of 65%. (He posted a respectable 11% return on a later batch of Pure shares he bought at A$7.45.)

In January 2008, Orrico began accumulating stock in CV Therapeutics, for about $15.50 a share when Astellas Pharma (4503.TO), Japan's second-largest drug maker, offered to buy CV for $16 a share to expand its U.S. drug pipeline. Then CV put itself up for auction, selling out to Gilead Sciences (GILD) for $20 in March 2009. Orrico walked away with a 29% return.

Orrico hasn't been badly burned since Dec. 11, 2008, when the $50 billion buyout of Bell Canada (BCE.T) by a consortium of investors unexpectedly collapsed. The fund lost nearly 0.5% of its assets on the deal, preventing it from posting a positive result in 2008's horrid markets.

"The year 2010 will look a lot like the last 12 months," says Orrico. "We are not going to see a return to the go-go buyout days of 2006-2007. But the economic stabilization and growth that we are seeing in some parts of the world are helping deal flow."

Whatever the volume of deals, Orrico will try to limit his firm's risks. Each morning, Foltynowicz and Munn sift through press releases to see what new deals have been hatched. Because they enter and exit on such short notice, the fund's annual turnover rate is 709%. That increases the chances of a trading error, so Orrico personally checks every trade. He takes them to task for minute errors like a one-penny discrepancy in a share price.

Says Munn: "John says, 'I don't want what happened to me to happen to you.'" ■

MICHAEL SHARI, a free-lance writer, covers finance and politics from New York City.

Annualized performance through 9/30/2015 for ARBFX: 0.16% (one year); 1.39% (five years); 3.12% (ten years). Arbitrage Fund assets under management as of 9/30/2015: $1,981 million.

*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. Performance data current to the most recent month-end may be obtained by calling (800) 295-4485. The fund assesses a 2% redemption fee on shares that are redeemed or exchanged between funds within 30 days of purchase. Returns shown above include the reinvestment of all dividends and capital gains. The Total Annual Operating expense for ARBFX is **2.31%**. Total Annual Fund Operating Expenses Excluding the Effect of Dividend and Interest Expense on Short Positions for ARBFX is 1.45%.*

An investor should consider the investment objectives, risks, charges and expenses of the Fund carefully before investing. The current prospectus contains this and other information about the Fund. 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: In addition to the normal risks associated with investing, the Fund may realize losses if the proposed reorganizations in which the Fund invests are renegotiated or terminated. The Fund uses investment techniques that are different from the risks ordinarily associated with equity investments. Such techniques and strategies include merger arbitrage risks, high portfolio turnover risks, options risks, borrowing risks, short sale risks, and foreign investment risks, which may increase volatility and may increase costs and lower performance.

Overall, rated 3 stars for the period ending 9/30/2015 out of 99 US OE Market Neutral funds. For each fund with at least a three-year history, Morningstar calculates a Morningstar Rating based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a fund's monthly performance (including the effects of sales charges, loads and redemption fees), placing more emphasis on downward variations and rewarding consistent performance. The top 10% of funds in each category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars and the bottom 10% receive 1 star. The Overall Morningstar Rating for a fund is derived from a weighted average of the performance figures associated with its three-, five- and ten-year Morningstar Ratings metric. ARBFX was rated against 99 US OE Market Neutral funds over a three-year period, 74 over a five-year period, and 31 over a ten-year period. With respect to these periods, ARBFX received ratings of 3 stars, 3 stars, and 3 stars, respectively.

The S&P 500 is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy. One cannot invest directly in an index. Annualized performance through 9/30/2015 for the S&P 500 is: -0.61% (one year); 13.34% (five years); and 6.80% (ten years).

Top 10 holdings as of 9/30/15: PartnerRe Ltd, Precision Castparts Corp, Sigma-Aldrich Corp, Chubb Corp, Cytec Industries Inc, Thoratec Corporation, Ansaldo STS SpA, Symetra Financial Corp, HCC Insurance Holdings, World Duty Free SpA. Top 10 holdings represent 37.7% of the portfolio. Holdings are subject to change. Current and future holdings are subject to risk.

Distributed by ALPS Distributors Inc., which is not affiliated with the Advisor or any other affiliate.
[ARB000803 2015-12-31]