The Arbitrage Funds
ADVISED BY WATER ISLAND CAPITAL

WATER ISLAND CREDIT OPPORTUNITIES FUND

Q3 2018 COMMENTARY

PORTFOLIO REVIEW

The Water Island Credit Opportunities Fund (ACFIX) returned 0.50% for the third quarter of 2018 and 2.68% for the year-to-date period. The Bloomberg Barclays US Aggregate Bond index returned 0.02% and -1.60%, while the ICE Bank of America Merrill Lynch US High Yield index returned 2.44% and 2.52%, for the same periods, respectively.

At quarter-end, the effective duration of the portfolio was 1.4 years, with a duration to event (our internal measure of the duration of the portfolio based on expected timing to completion of a catalyst) of 0.3 years.

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. An obvious question comes to mind: When will the market begin to factor in higher rates along with the specter of higher costs associated with potential tariffs? With such an uncertain backdrop, we believe our investments in shorter duration catalysts can continue to benefit from a higher risk-free rate. This year, we have seen increased demand for short-duration fixed income assets, and a flatter yield curve continues to offer investors the ability to capture yields without the duration risk commonly associated with longer-dated bonds.

For our own portfolio, higher risk-free rates have increased the total return potential for many of our shorter-dated investments. During the quarter, we spent time actively analyzing companies following their announced pursuits of strategic actions including company sales, assets dispositions, and spin-offs. These companies included Arconic, a manufacturer of aerospace and industrial parts, and, Nielsen Holdings, the data and analytics provider which was reported to be in talks with private equity (PE) firms to evaluate a sale or breakup among other strategic options. Among the larger definitive deals that we saw during Q3, Engility Holdings agreed to be acquired by government contractor Science Applications International Corp, and both Dun & Bradstreet and LifePoint Health agreed to be acquired by private equity firms.

Q4 should prove to be an interesting time for investors. Aside from rising interest rates, investors will need to grapple with the US/China trade dispute, focus on Italian government budget negotiations, and look toward Q3 earnings and any guidance regarding higher input costs. Mid-term elections could also impact volatility and market direction. Regardless of these risks, we will continue to focus on delivering returns independent of market moves. While increased interest rates may dampen refinancing activity, we continue to see PE funds raising significant capital. These firms are not only focused on taking public companies private, but they are also looking at peer PE firms seeking to monetize their own investments. In situations involving the sale of a private company, the issuer bonds are often subject to redemption provisions that are triggered by the company sale. These are situations that we follow very closely to find the most attractive merger-related opportunities.

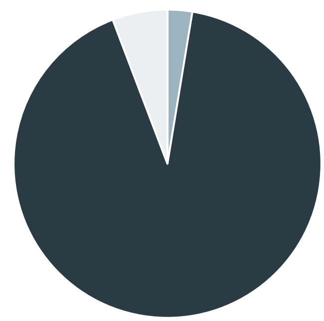
Another evolving trend is consolidation in the energy sector which has been spurred by higher oil prices and higher stock prices (which can be used as acquisition currency). During the quarter, off-shore drillers Ensco and Rowan Companies agreed to merge while Trinidad Drilling agreed to be acquired by Precision Drilling. Although we expect this trend to continue in the near-term, we remain aware of the impact that gyrating commodity prices can have on any capital structure.

As we near the end of the first decade following the financial crisis, we recognize that the recovery has been a long one by historic standards. We are also aware that the cycle could turn at any point and bring about a completely new set of investments and opportunities. While it is difficult to predict when such a change will occur, we are fortunate to have the team and process in place to take advantage of long and short investments amid higher rates, market dislocations, and an ever-changing investment landscape.

TRAILING RETURNS (ACFIX) AS OF 9/30/18	
1-Year	3.01%
5-Year	2.12%
Since Inception (10/1/12)	2.47%

Performance greater than one year is annualized.

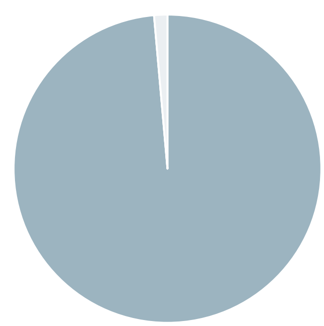
CREDIT QUALITY AS OF 9/30/18



- Investment Grade (3%)
- High Yield (92%)
- Not Rated (6%)

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

GEOGRAPHIC EXPOSURE AS OF 9/30/18



- Americas (99%)
- Asia Pacific (0%)
- Europe/Middle East/Africa (1%)

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

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 higher or lower 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 ACFIX is 1.99%. The Fund has entered into an Expense Waiver and Reimbursement Agreement and has contractually agreed to limit the total annual operating expenses of the Fund, not including taxes, interest, dividends on short positions, brokerage commissions, acquired fund fees and expenses and other costs incurred in connection with the purchase or sale of portfolio securities, so that they do not exceed 0.98% for Class I shares. The agreement remains in effect until September 30, 2020. Without such fee waivers, performance numbers would have been reduced.

TOP CONTRIBUTORS

Aleris International Inc — Aleris is a producer of aluminum parts for various industries. In 2016, Apollo announced the sale of the privately-held company to China-based Zhongwang USA. Due to issues with national-security related regulatory review in the US, the deal was ultimately terminated. In July 2018, Hindalco Industries of India announced its intent to acquire Aleris for $2.6 billion. Hindalco bonds traded down significantly after investors became concerned that the company's leverage would increase if it succeeded in acquiring Aleris. We assessed the bonds and recognized that prices reflected a worst-case scenario for leveraging. In reality, a planned equity issuance and stated leverage targets gave us comfort in purchasing these bonds at 52-week lows. These bonds also served as a hedge on the deal, as they would trade up in the event of a deal break.

Momentive Performance Materials Inc — In April 2014, Momentive Performance Materials filed for Chapter 11 bankruptcy and outlined a plan back to solvency. As part of the plan, senior creditors opted to receive new debt with interest rates set by a district judge. However, the rates set by the judge were deemed to be below market value and the bonds immediately traded below par upon emergence from bankruptcy. For the past four years, Momentive creditors have been in litigation with the company seeking payment of certain issues as well as filing an appeal to be compensated for the below-market interest rate on the bonds. We initiated a position earlier this year with the thesis that bondholders would prevail in their appeal, securing both a higher interest rate on first lien bonds as well as a catch-up payment. During Q3, court arguments concluded and evidence was presented that gave bond holders more confidence that the initial interest rate would be adjusted higher. In addition, Apollo – Momentive's sponsor – agreed to sell the company to KCC/Wonik, giving creditors a more defined timeline on redemption of the notes and pushing Momentive bond prices higher.

BMC Software Finance Inc — In May 2018, BMC Software – owned by private equity (PE) firms Bain Capital and Golden Gate Capital – entered into an agreement to be acquired by KKR. Because this is a PE-to-PE sale, we expected no regulatory issues. We purchased the bonds as it was highly likely that the acquisition would violate a limitation on restricted payments in the bond indenture, given that the transaction is effectively a new leveraged buyout. Furthermore, the bonds mature in about three years, so KKR would likely want to clear the debt runway as part of this transaction. During Q3 the acquisition financing was placed and the company received requisite approvals for the deal to close. The bonds have since been called for redemption early in Q4.

TOP DETRACTORS

NXP Semiconductors NV / Qualcomm Inc — During Q2 2018, NXP's merger with Qualcomm became caught directly in the ongoing trade dispute between the US and China, which has led to a delay in the regulatory approvals necessary for the deal to complete. While the politics made it difficult to accurately assess the deal's probability of success, we remained invested in these bonds for several reasons: 1) the convertible bonds had roughly half to one-third less volatility than the underlying equity due to their inherent structure; 2) we were at levels where the upside/downside of the transaction is better than 2:1; and 3) we were able to use the equity as a hedge against the convertible bond thereby creating optionality for the fund while simultaneously decreasing our downside. Chinese regulators effectively terminated the transaction when they had yet to approve the deal by the merger deadline and Qualcomm and NXP declined to extend. With no near-term catalyst in sight, we exited the position.

Obrascon Huarte Lain SA — Obrascon Huarte Lain is a global construction and engineering company based in Madrid. During April, the company completed the sale of its concession business (highway tolls and airports) to IFM Investors for €2.2 billion. At that time the company had gross recourse debt of €1.5 billion and indicated plans to repay this debt to realign the capital structure and to reduce financing costs. Bondholders did not tender into a 101 mandatory asset sale offer as bonds were trading higher and closer to their call prices. We believed the 2023 bonds were an attractive short-term refinancing opportunity. After initiating our investment in April, the bonds traded from approximately 102 to below par in August and September. Weakness began after the Villar Mir family sold a stake in the company which left them holding less than 50% of the shares for the first time. Also, following a company investor call early in September, we became more convinced that the company would not de-lever their balance sheet to the extent we desired. We have since exited the position.

Market Hedges — As part of our long/short strategy, we deploy various issuer-specific hedges in the portfolio as well as broader macro hedges. The intent of these hedges is to reduce market risk while providing the portfolio with lower volatility and smaller drawdowns. During the quarter, our short position in certain high yield ETFs led to losses for the portfolio, but this loss was offset by positive gains in other long positions.

GLOSSARY: *Duration* is the approximate percentage change in a bond's price that will result from a 1% change in its yield. A *spin-off* is the creation of an independent company through the sale or distribution of new shares of an existing unit of a parent company. A *yield curve* plots the interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates. *Recourse debt* is a debt that is backed by collateral from the borrower. *Par* is the face value of a bond. *High yield* bonds have a credit rating lower than investment grade.

IMPORTANT INFORMATION

Top 10 holdings as of 9/30/18: Aleris International Inc 10.75% 7/15/23; BMC Software Finance Inc 8.125% 7/15/21; DJO Finance LLC 8.125% 6/15/21; Envision Healthcare Corp 6.25% 12/1/24; KLX Inc 5.875% 12/1/22; LifePoint Health Inc 5.375% 5/1/24; Rent-A-Center Inc/TX 6.625% 11/15/20; Scientific Games Corp 10% 12/1/22; SUPERVALU Inc 7.75% 11/15/22; TIBCO Software Inc 11.375% 12/1/21. Top 10 holdings represent 39.5% of the portfolio. Holdings are subject to change. Current and future holdings are subject to risk.

The Bloomberg Barclays U.S. Aggregate Bond Index covers the U.S. investment grade fixed rate bond market. The ICE Bank of America Merrill Lynch U.S. High Yield Index is a measure of the broad high yield market, commonly used as a benchmark for high yield corporate bonds. Indexes are unmanaged and one cannot invest directly in an index.