The Arbitrage Funds
ADVISED BY WATER ISLAND CAPITAL

ARBITRAGE EVENT-DRIVEN FUND

Q2 2018 COMMENTARY

PORTFOLIO REVIEW

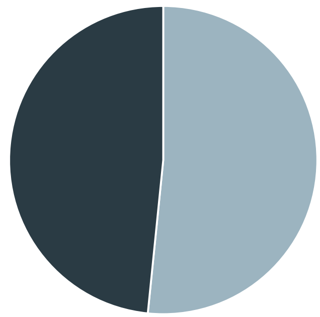
The Arbitrage Event-Driven Fund (AEDNX) returned 0.74% for the second quarter of 2018 and 0.74% for the year-to-date period. The S&P 500 index returned 3.43% and 2.65%, while the Bloomberg Barclays US Aggregate Bond index returned -0.16% and -1.62%, for the same periods, respectively. HFRI Event-Driven – an index of hedge funds focused on event-driven investing – returned 2.26% for the quarter and 2.37% year-to-date.

At quarter-end, the portfolio's strategy allocation was 52% merger arbitrage and 48% special situations.

TRAILING RETURNS (AEDNX) AS OF 6/30/18	
1-Year	2.00%
5-Year	0.77%
Since Inception (10/1/10)	1.63%

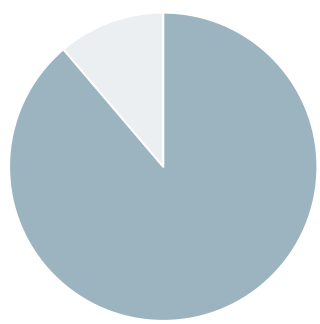
Performance greater than one year is annualized.

STRATEGY ALLOCATION AS OF 6/30/18



Subject to change. Reflects strategy gross exposure as percent of total gross exposure.

GEOGRAPHIC EXPOSURE AS OF 6/30/18



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

MARKET PERSPECTIVE

During the second quarter, US equity and US high yield markets largely recovered from losses experienced during the first three months of the year, while US investment grade credit continued to trend downward. The quarter's returns were accompanied by a generous serving of volatility, as investors struggled to gauge headlines centered around ongoing international trade disputes, particularly between the US and China. With little clarity on the timing or impact of negotiations, fears persist that any escalation could lead to a general tightening in financial conditions or loss of investor confidence. Additionally, fixed-income investors remain focused on global central banks, where plans to remove quantitative easing policies continue to develop.

As it relates to the merger arbitrage sleeve of the portfolio, trade-related uncertainty embodies the primary concern for an arbitrageur in the current climate: heightened political risk. Investors fear – not unreasonably – that regulatory bodies such as CFIUS (Committee on Foreign Investment in the United States) and MOFCOM (Ministry of Commerce of the People's Republic of China) may be used to carry out political agendas, which adds a degree of unpredictability to the regulatory approval process for mergers and acquisitions (M&A). In this environment, success in merger arbitrage investing will likely rely in part on an arbitrageur's ability to properly gauge the impact of an increasingly fickle administration's actions – and any subsequent fallout from other regimes' reactions – on each transaction.

Nonetheless, we still have reason to be optimistic. US economic growth has continued, with unemployment at a 30-year low and consumer confidence at a 17-year high. The passage of a tax reform bill in the US has unleashed a backlog of corporate activity that had been on hold, with M&A deal volume for the first six months of the year reaching record levels. The Fed has raised interest rates twice already in 2018 – four times in the past 12 months – with further hikes likely. Thus, we are currently experiencing favorable conditions for all three of the primary driving factors of merger arbitrage returns: deal flow is healthy, interest rates are on the rise, and the third – market volatility – returned in earnest in the first quarter and shows no signs of abating.

Away from M&A, we are seeing investment opportunities in companies that have entered asset purchases, asset sales, and spin-offs – the latter of which has a robust calendar of announced transactions through the end of 2018. These situations comprise the most promising opportunities for long and short investments in our special situations sleeve in the current environment. Despite record levels of deal volume, the opportunity for speculative M&A investing has been underwhelming, as the flow of rumors has dwindled and the speculative opportunities that have emerged have been unattractive from a risk/reward standpoint.

On the credit side, we are currently focused primarily on short duration, hard catalyst events (such as M&A). Softer catalysts such as stressed/distressed have been less compelling from a risk/reward standpoint, although such situations can present opportunities for taking a short approach.

While the markets appear to be in a holding pattern brought about by both political and macro factors, our universe of catalyst-driven investment remains attractive. 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 AEDNX is 2.35%. The Advisor has agreed to waive fees in excess of 1.44% for AEDNX until September 30, 2018, excluding the effects of interest, dividends on short positions, brokerage commissions, acquired fund fees and expenses, taxes, or other extraordinary expenses. Without such fee waivers, performance numbers would have been reduced.

TOP CONTRIBUTORS

Monsanto Co / Bayer AG — In September 2016, Bayer – a German global enterprise with core competencies in the fields of health care, agriculture and high-tech polymer materials – entered into a definitive agreement to acquire Monsanto – a US life sciences firm focused on agricultural products and solutions – for $66 billion. The combination would create the world's largest agriculture company with leading positions in both seeds & pesticides. Given the complexity of the deal and consolidation in the overall agriculture market, it was not surprising to see this deal receive second requests from global regulators during Q1 2018 (specifically US and European regulators). During Q2 2018, the deal received both US and EU approval and was subsequently completed, leading to positive contribution for the fund.

Microsemi Corp / Microchip Technology — In March 2018, Microchip – a US developer and manufacturer of field programmable 8-bit microcontrollers and related products – entered into a definitive agreement to acquire Microsemi Corp – a US peer – for $9.8 billion. While the deal experienced volatility during Q2 2018 over fears that it would be used as a bargaining chip in the continuing trade dispute between the US and China, the companies ultimately received all necessary regulatory approvals and successfully completed the acquisition in May.

Sky PLC / Twenty-First Century Fox Inc — In December 2016, 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), Twenty-First Century Fox itself became the subject of a bidding war between Disney and Comcast. As evidenced by the ongoing bidding war, we believe that SKY is an extremely attractive asset that will ultimately be acquired. We maintain a core position in the company and expect the deal will successfully complete – perhaps even with an increased bid – before the end of the year.

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. While NXP's share price has fluctuated wildly on the back of both good and bad rumors regarding developments in the deal, we remain steadfast in our conviction that China will ultimately approve the merger, though we have pared our exposure in line with our risk management guidelines.

Xerox Corp — In early January we established a position in Xerox following a public dispute with their largest shareholder as well as rumors surrounding a merger with their longstanding partner Fuji Xerox (owned by FujiFilm Holdings). On January 31, Xerox announced a merger with Fuji Xerox, whereby Xerox shareholders would receive a one-time special dividend of $9.80 and a 49.9% stake of the new larger entity. Subsequently, one of Xerox's largest shareholders successfully sued the company for a breach of their fiduciary duties in negotiating the Fuji Xerox transaction, preventing the transaction from proceeding. This development and public disclosure of the flawed sales process run by Xerox, led to the replacement of their CEO and majority of their board of directors. These decisions were pursued and supported by Xerox's two largest activist investors. With a new management and board of directors in place, the company plans to run a new strategic alternatives process. While uncertainty may create volatility in the share price, we continue to own shares focused on the underlying cash flow generation of the business, alongside a shareholder friendly board of directors seeking to maximize the company's value through a sales process.

Tribune Co / Sinclair Broadcast Group — 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 experienced widening spreads on news that the FCC would solicit additional comments and may wait to render a decision until after a federal appeals court ruling on whether the agency can continue to allow companies to partially count some stations against an ownership cap (which does not allow any one company to serve more than 39% of US television households). We ultimately believe the deal will close during Q3 2018. As of the writing of this letter, FCC officials have expressed skepticism that the deal can be approved under its current structure and certain divestitures may be required, leading to further volatility in the spread. We believe Sinclair is willing to consider any necessary divestitures, though the completion of the deal – which had been estimated to occur in August – may now need to be extended into Q4 2018.

GLOSSARY: *Deal flow* refers to the volume of announced mergers and acquisitions activity. *Quantitative easing* is a monetary policy whereby a central bank purchases government other securities from the market in order to lower interest rates and increase the money supply. 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.