



**The Arbitrage Funds**

ADVISED BY WATER ISLAND CAPITAL

# Event-Driven Investing

## An Alternative to Beta

### **What is Event-Driven Investing?**

Event-driven investing is a strategy that aims to profit from the outcome of specific corporate events including mergers, acquisitions, spin-offs, and bankruptcies, among other corporate transactions. Each corporate event has unique return drivers that are uncorrelated to market moves. Therefore, a portfolio of distinct corporate events can act as a diversifier within a broader portfolio context.

### **How Does it Complement a Balanced Portfolio?**

In a traditional balanced portfolio, the equity component typically faces pressure when valuations are at all time highs, and the fixed income component can be challenged by both tight credit spreads and the risk of future interest rate increases. In contrast, a diversified portfolio of corporate events has historically provided attractive absolute returns that are largely isolated from these market forces.

### **Why Event-Driven Investing Now?**

Today's environment is particularly supportive of event-driven strategies. Corporate leaders have expressed strong confidence about the economy and their own businesses, which is conducive to ongoing deal activity. At the government level, regulatory bodies have taken a more pro-business stance, which may further encourage CEOs to engage in transformative corporate transactions. At the same time, the current economic recovery is growing long in the tooth. Equities are trading at record valuations, fixed income assets are trading with very tight spreads, and interest rates are likely to trend higher. Against this backdrop, investors may need a different investment approach to insulate their portfolio against market shocks. A market neutral, event-driven portfolio can be that source of low volatility, diversification, and shock absorption.

# Challenges Facing Traditional Asset Classes

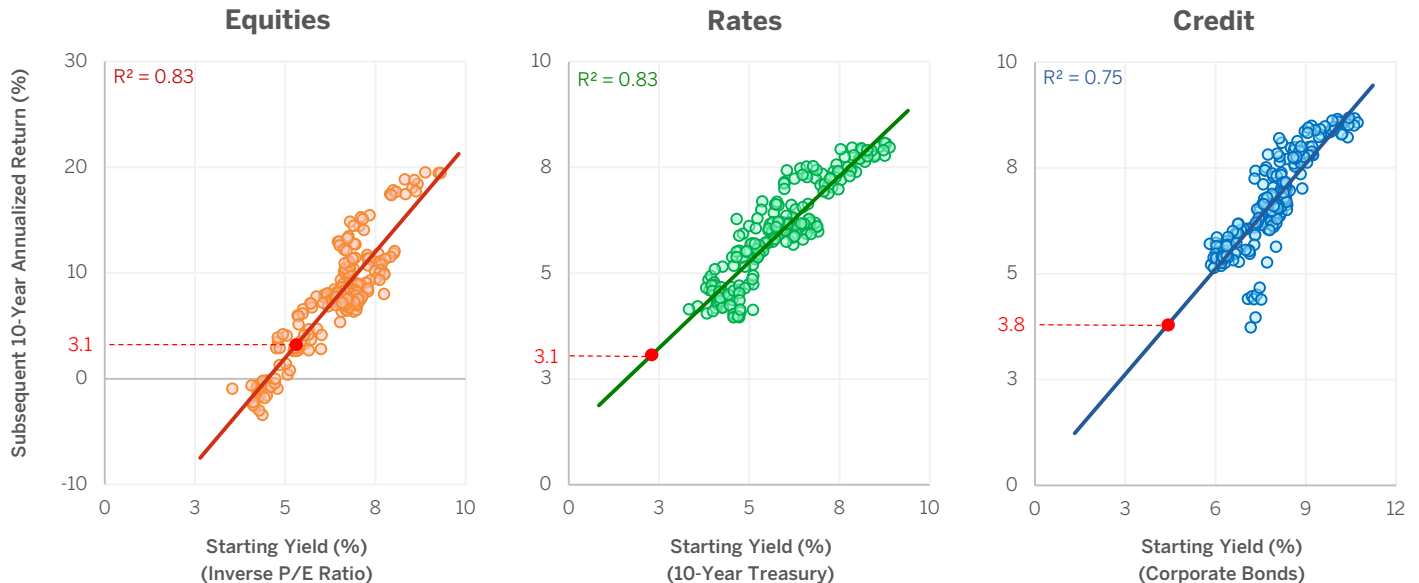
## Market Outlook

Equity valuations are stretched; rates are beginning to rise; and credit spreads remain relatively tight. To examine how these factors may impact portfolios, investors can turn to one of the most reliable predictors of long term market performance – starting yield. **Yields today suggest investors can expect bottom-decile performance across each major asset class over the next decade.**

Clearly, these factors will present challenges for long-only equity and long-only credit strategies as well as any portfolios (such as a traditional balanced portfolio) which rely largely on these strategies to generate compelling returns.

## Yields and Subsequent 10-Year Total Return

● = Subsequent Annualized 10-Year Return as of 6/30/2017



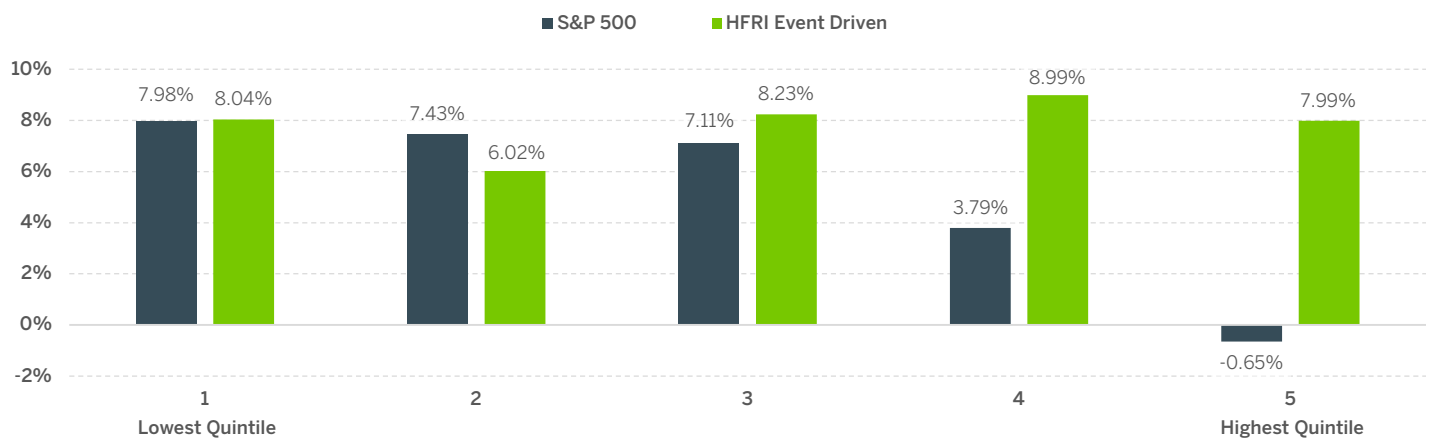
Sources: US Federal Reserve, Bloomberg, Morningstar, Water Island Capital. Date Range: 1/1/1990 – 6/30/2017. Past performance is no guarantee of future results. Equities starting yield represented by inverse of Bloomberg Blended Forward 12-month BEst P/E Ratio, Rates starting yield represented by US 10-Year Treasury, and Credit starting yield represented by Moody's Seasoned Baa Corporate Bond. Rates subsequent returns represented by Bank of America Merrill Lynch US Treasury Master Index, Credit subsequent returns represented by Bank of America Merrill Lynch US Corporate Master Index, and Equities subsequent returns represented by S&P 500 Index. See glossary for index definitions. Index returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

# Outlook for Event-Driven is Optimistic

## Consistent Return Potential Regardless of Equity Market Valuations

On a P/E basis, the S&P 500 is not cheap. The market's impressive run since the end of the financial crisis has investors cautious about the US equity market, and rightfully so. While it is impossible to predict the future direction of equity markets, historical analysis indicates that event-driven strategies have demonstrated consistency and resilience across a variety of different equity market environments.

**S&P 500 vs. HFRI Event-Driven**  
Average 10-Year Annualized Returns Following Starting P/E Quintiles

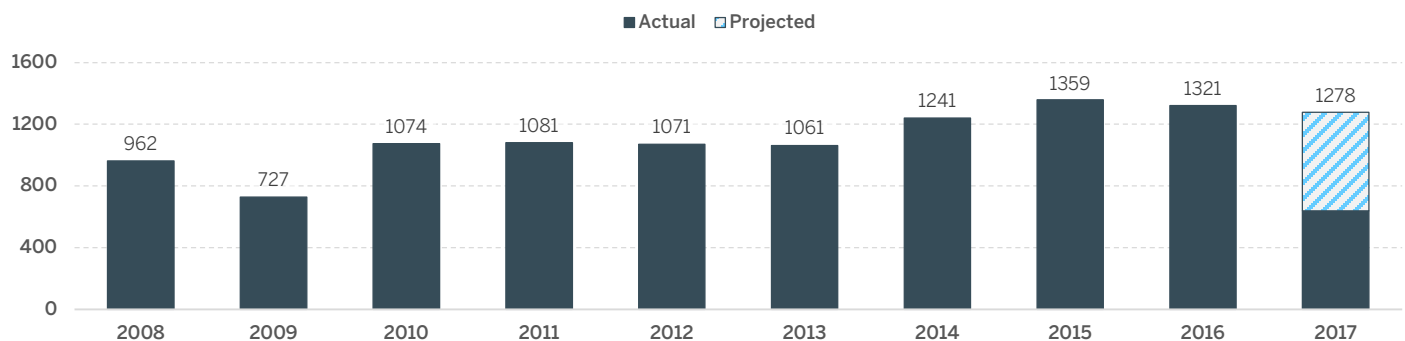


Source: Bloomberg, Morningstar, Water Island Capital. Date Range: 1/1/1996 – 6/30/2017. Past performance is no guarantee of future results. P/E quintiles are represented by Bloomberg Blended Forward 12-month BEst P/E Ratio. See glossary for index definitions. Index returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

## Corporate Activity Supportive of Event-Driven Strategies

Corporations, flush with cash, are under pressure to deliver value to shareholders. This has led to a growing amount of corporate activity, which in turn has led to more investment opportunities. In addition, the new White House administration has committed itself to creating a more corporate-friendly environment. A focus on deregulation, repatriation of overseas cash, and lower tax rates could lead to increased corporate activity in the months and years ahead.

**Number of Corporate Events by Year**



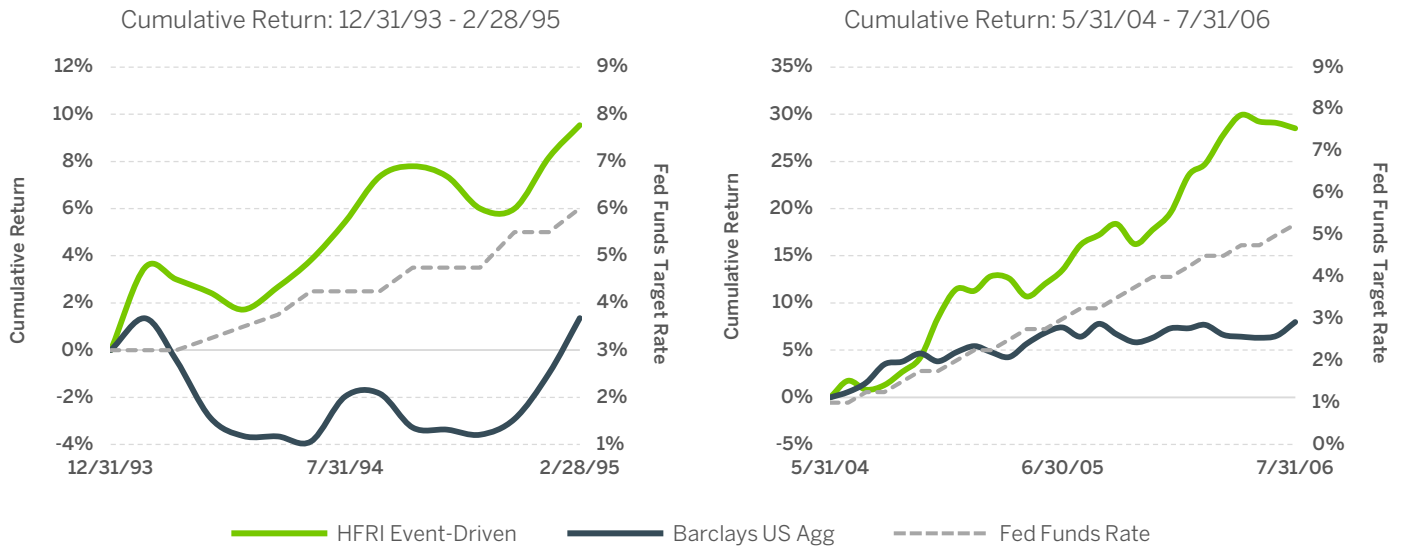
Source: Dealogic. Date Range: 1/1/2008 – 6/30/2017. Projected deal flow for 2017 calculated by doubling the number of deals announced from 1/1/2017 – 6/30/2017.

# Outlook for Event-Driven is Optimistic

## Strength in a Rising Rate Environment

Recent rate hikes by the Federal Reserve (“Fed”) signal an end to the ultra-low interest rate policy that defined most of the post-financial crisis era. Long-only credit, in particular, will likely struggle against a backdrop of rising rates. In contrast, event-driven strategies have historically demonstrated resilience in these environments.

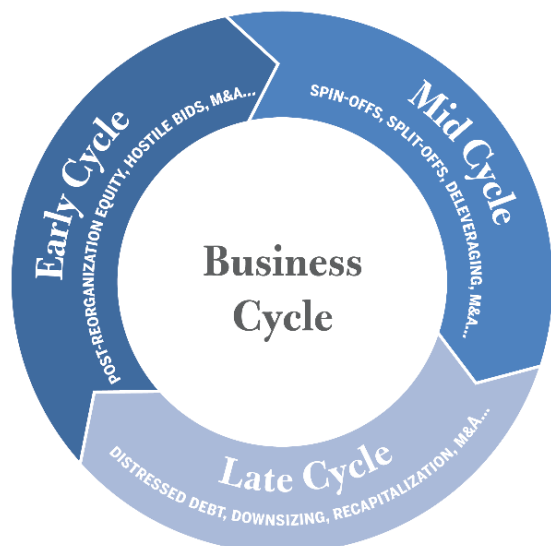
### Performance In Rising Rate Environments



Source: Bloomberg, Morningstar. Time periods represent the two largest increase in the Fed Funds Target Rate since HFRI Event-Driven inception (January 1, 1990). See glossary for index definitions. Index returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

## Opportunities Across the Business Cycle

An event-driven strategy can harvest opportunities throughout the business cycle and across the capital structure, regardless of market conditions, thereby providing an “all weather” investment solution.



### Stage 1: Early Cycle

A period marked by wider spreads and a high level of defaults. Companies often undertake operational and financial reorganizations in order to improve their business prospects.

### Stage 2: Mid Cycle

Business prospects are improving and the economic cycle continues to recover. Companies begin to focus on business reinvestment and growth rather than cost cutting.

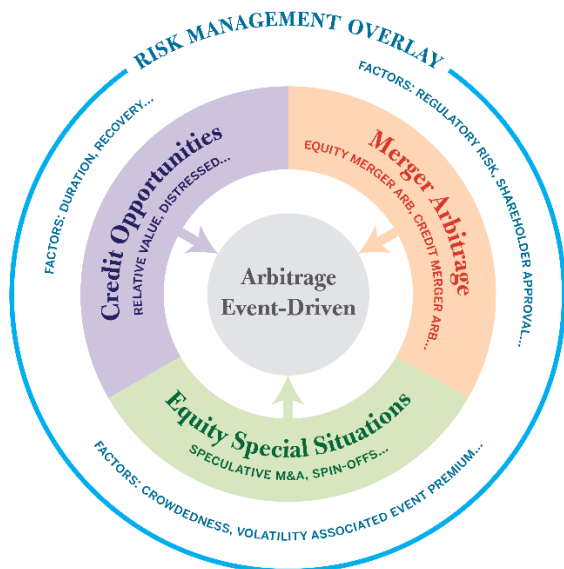
### Stage 3: Late Cycle

Business growth and corporate profitability begin to taper off. During this phase, corporations may re-evaluate their capital expenditures and may have difficulty servicing their debt. High yield spreads begin to widen and corporate defaults increase.

# Our Solution: Arbitrage Event-Driven Fund

## Our Investment Approach

The Arbitrage Event-Driven Fund (AEDNX) is an event-driven portfolio composed of three sub-strategies: merger arbitrage, credit opportunities, and equity special situations. Each sub-strategy seeks to capitalize on the mispricing of stocks, bonds, or other securities caused by the announcement of or anticipation of corporate events throughout the business cycle.



### Merger Arbitrage

Invests in the equity and credit securities of companies subject to definitive, publicly-announced mergers, takeovers, tender offers, and other corporate reorganizations.

### Equity Special Situations

Invests long and short in equity securities in order to realize gains from corporate events such as spin-offs, recapitalizations, and other corporate restructurings, whether company-specific or as a result of industry or economic conditions.

### Credit Opportunities

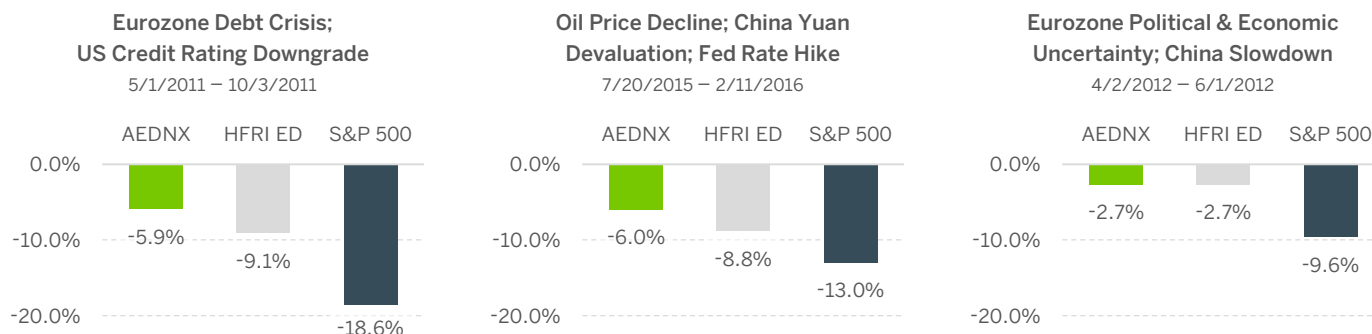
Invests in fixed income securities in order to exploit security mispricings that may arise from refinancings, corporate deleveragings, litigation, regulatory events, and asset sales.

## Our Risk Management Process

Risk management is a fundamental part of our investment approach. Our process is focused on minimizing systematic risk factors (such as equity risk, credit risk, interest rate risk, or currency risk) at both the position level and the portfolio level. This is critical to achieving our goal, as event-driven investors, of delivering returns associated with the outcomes of idiosyncratic corporate events, rather than the direction of broader equity or credit markets.

The benefits of this process can be seen when analyzing the portfolio's performance during bouts of market volatility:

### Three Largest S&P 500 Drawdowns Since AEDNX Inception



Source: Morningstar. AEDNX Inception Date: October 1, 2010. AEDNX represents Arbitrage Event-Driven Fund Institutional Share Class. See glossary for index definitions. Index returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

## GLOSSARY

**Bank of America Merrill Lynch US Corporate Master Index:** A measure of the broad US investment grade market, this index includes publicly-issued, fixed-rate, nonconvertible investment grade dollar-denominated, SEC-registered corporate debt having at least one year to maturity and an outstanding par value of at least \$250 million.

**Bank of America Merrill Lynch US Treasury Master Index:** A measure of the broad US Treasury market, this index includes prices of US Treasury bonds with maturities of 1 to 30 years.

**Bloomberg Blended Forward 12-month BEst P/E Ratio:** Bloomberg's forward looking estimate of earnings relative to price over the next 12 months.

**Bloomberg Barclays US Aggregate Index ("Barclays US Agg"):** Covers the US investment-grade fixed rate bond market.

**Corporate Deleveraging:** A company's attempt to decrease its financial leverage (debt).

**Credit Spread ("Spread"):** The difference in yield between a US Treasury bond and a debt security with the same maturity but of lesser quality.

**Decile:** 1/10 of a sample or population.

**Federal Funds Target Rate ("Fed Funds"):** The interest rate at which a depository institution lends funds maintained at the Federal Reserve to another depository institution overnight.

**HFRI Event-Driven Index ("HFRI Event-Driven"):** The HFRI Event-Driven Index includes funds who maintain 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.

**Moody's Seasoned Baa Corporate Bond:** An investment bond that acts as an index of the performance of all bonds given a BAA rating by Moody's.

**P/E Ratio:** The price-earnings ratio (P/E ratio) is the ratio for valuing a company that measures its current share price relative to its per-share earnings.

**R<sup>2</sup>:** A statistical measure of how close a set of data is to a fitted regression line on a scale from 0 to 1. In general, the higher the R-squared, the better the model fits the data.

**Recapitalization:** A type of corporate reorganization involving substantial change in a company's capital structure. Typically a large portion of equity is replaced with debt or vice versa.

**Refinancing:** When a business or person revises a payment schedule for repaying debt.

**S&P 500 Index ("S&P 500"):** An index of US equities meant to reflect the risk/return characteristics of the large cap universe, and one of the most commonly used benchmarks for the overall US stock market.

**Spin-Off:** A type of divestiture involving the creation of an independent company through the sale or distribution of new shares of an existing business or division of a parent company.

**Tender Offer:** A public, open offer by a prospective acquirer to stockholders of a publicly traded corporation to tender their stock for sale at a specified price over a specified time, subject to a minimum and maximum number of shares.

**Traditional Balanced Portfolio:** An investment portfolio with a 60% allocation to equities and a 40% allocation to bonds. For our purposes, the equity allocation is represented by the S&P 500 Index and the bond allocation is represented by the Bloomberg Barclays US Aggregate Index.

**Yield:** The income return on an investment, such as the interest or dividends received from holding a particular security.

## IMPORTANT INFORMATION

**Performance through 6/30/17: AEDFX (R class), 4.46% (one year), -0.60% (three year), 1.33% (since inception 10/1/10); AEDNX (I class), 4.76% (one year), -0.52% (three year), 1.57% (since inception 10/1/10); AEFCX (C class), 3.71% (one year), -0.80% (three year), 0.14% (since inception 6/1/12); AGEAX (A class), 4.57% (one year), -0.58% (three year), 0.26% (since inception 6/1/13).** *Performance greater than one year is annualized. 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. Contractual fee waivers are currently in effect. Without such fee waivers, performance numbers may have been reduced. Total Annual Fund Operating Expenses for AEDFX, AEDNX, AEFCX, and AGEAX (excluding sales charge) are 2.64%, 2.39%, 3.39%, and 2.64% respectively. The Advisor has agreed to waive fees in excess of 1.69%, 1.44%, 2.44%, and 1.69% for AEDFX, AEDNX, AEFCX, and AGEAX (excluding sales charge) respectively, until September 30, 2018. Class A shares have a maximum front-end sales charge of 3.25%.*

**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.**

Information contained in this paper is the opinion of the author and is not intended to be investment advice.

*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.*

Distributed by ALPS Distributors Inc., which is not affiliated with the Advisor or any other affiliate. [ARB001163 2018-08-31]