FINANCIAL ADVISOR

PORTFOLIO SPOTLIGHT

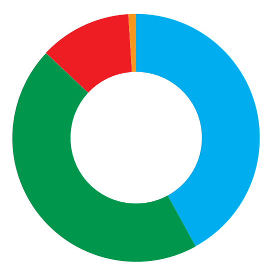
Todd Munn and Roger Foltynowicz

The Arbitrage Fund

TICKER	ARBNX			
ASSETS	$2.1 billion			
PERFORMANCE*	YTD **-0.84%**	1 yr. **0.16%**	3 yr. **0.92**	5 yr. **1.39**
TOP FIVE HOLDINGS	MeadWestvaco Corp., Rock-Tenn Co., DIRECTV, AT&T Inc., Hospira Inc.			

As of 9/30/2015. Three- and five-year figures are annualized. Source: Morningstar

CONTACT INFO 800-295-4485
arbitragefunds.com



Cash	**41.17%**
U.S. Stock	**45.39%**
Non-U.S. Stock	**12.87%**
Bonds	**0%**
Other	**0.57%**

Note: Contains derivatives or short positions.
*As of 5/31/15. Source: Morningstar

A Port In Market Storms

This fund bets on the fluctuating values of companies being acquired. **By Marla Brill**

THE 15-YEAR HISTORY OF THE ARBITRAGE FUND illustrates that merger arbitrage can be an all-weather strategy with a low correlation to the stock and bond markets and a low volatility port during market storms. At the same time, its comparatively sedate returns also make it something of a dark horse when the stock market is galloping ahead.

The Arbitrage Fund is one of a handful of funds that seek to profit from capturing the difference, or spread, between the price of a target company's stock after the announcement of an acquisition and the acquiring company's offer. The strategy follows well-documented patterns that show a target's stock price will jump on the announcement of an acquisition, since the acquirer offers a premium over the prevailing market value to sweeten the deal. But it won't rise to the full offer because the transaction could hit a snag before it's completed and fall through.

Although the strategy may sound complex and risky, the risk-return profile for the Arbitrage Fund is fairly conservative. Since its inception in the year 2000, the calendar year returns for the fund have fluctuated in a narrow band, from a low of negative 0.63% in 2008 to a high of 15% in 2003. There were only two years of negative returns, and both were less than 1% drops. The fund's three-year standard deviation is a modest 2.6%, and it has a 0.20 correlation to the S&P 500 Index and a 0.06 correlation to the Barclays U.S. Aggregate Bond Index.

The fund was a small niche offering during its first eight years, when the bull market made its returns look modest by comparison. But by 2009, assets in the fund had quadrupled to $1 billion as investors migrated to safer investment pastures, and it now stands at $2 billion.

"In times of turmoil, people really start to appreciate what we offer," says Roger Foltynowicz, who manages the fund with Todd Munn and John Orrico at Water Island Capital, a New

York City-based investment advisor that oversees a total of $3.3 billion, including the $2 billion in the Arbitrage Fund. "They know we put capital preservation first, and that we won't be cowboys with their money."

Because of its low correlation to the stock markets, some of the fund's investors use it in the alternative investments sleeve of their portfolios. Others see it as a fixed-income substitute because of its low volatility and decent, if not spectacular, returns. (As a rule, unlevered merger arbitrage investors have traditionally sought to capture returns of two to three times the risk-free rate of 90-day Treasury bills, although that can vary widely from year to year.)

Most of the last five years have not been accommodating for merger arbitrage practitioners. Many companies seemed more interested in using cash to buy back stock or raise dividends than to expand through acquisitions, and light M&A deal calendars limited investment opportunities. Merger arbitrage returns were well below those generated by U.S. stock or bond indices. The Arbitrage Fund's expense ratio of 1.19% for institutional class shares, while low for a fund of its type, still puts a big dent in returns when internal investments are generating razor-thin profits. And because the average deal plays out in three to four months, the fund's portfolio turnover is high, creating a high level of taxable distributions for taxable accounts.

But the managers believe the benefits of merger arbitrage could come into clearer focus for investors as the bull market starts to show its age and market turbulence sets in. As for bonds, investors may come to see them as a less-than-sedate investment if interest rates rise and prices fall. By contrast, history shows that merger arbitrage strategies tend to do well compared with stocks when bear markets set in; and unlike bonds, which lose value when interest rates rise, arbitrage strategy returns follow the upward march of interest rates.

"Rising rates are a headwind for bond funds," says Foltynowicz. "For us, they're a tailwind."

A number of other trends point to the possibility of better days ahead. The lackluster environment for merger arbitrage is beginning to change as more deals come to market. Shareholder activists, who once pushed for buybacks and dividend hikes, are increasingly pressing boards to elevate growth and shareholder value through acquisitions. Companies that have been hoarding cash may finally decide it's time to go into growth mode, and acquisitions are a quick way to do that. A number of sectors, such as banks, technology and utilities, are still in the early stages of consolidation, and activity in the energy sector could perk up as large, healthy companies buy up smaller ones that have been socked by low commodity prices. And the healthier environment for M&A has generated more competing bids for companies, which could help boost returns for merger arbitrage transactions.

Lately, Munn says he is seeing 4% to 6% annualized returns for safer transactions, compared with 3% to 4% in previous years. As the U.S. strengthens and the global economy stabilizes, boardroom confidence around the world usually grows, which should result in more transactions across a wider swath of industries, geographies and market capitalizations.

The path to profits for the fund depends on how the acquirer plans to finance a takeover. In a transaction where a company plans to acquire shares with cash, the fund may simply buy shares of the target company and wait for them to go up to the takeover price when the deal is completed. If an acquirer is using its stock to bring about the takeover, there's a risk that the stock will fluctuate in the months it takes to complete the deal. To defuse that risk, the fund will typically purchase the target's stock, while simultaneously selling short the shares of the acquirer. This hedging strategy helps ensure that even if the acquirer's stock declines, the fund has locked in its return by selling short. In cases where acquirers use both cash and stock as currency, the managers will combine the two strategies.

Returns are calculated on an annualized basis. If a merger arbitrage transac-

Region Exposure

U.S.	**84.0%**
Canada	**0.6%**
U.K.	**1.1%**
Europe (ex-U.K.)	**9.3%**
Middle East & Africa	**1.0%**

As of 6/30/2015
SOURCE: Water Island Capital

Portfolio Characteristics

Long Exposure	**96.1%**
Short Exposure	**-25.6%**
Gross Exposure	**121.7%**
Net Exposure	**70.4%**
New deals for Quarter	**38**
Weighted avg. market cap	**$11.1 B**
Median market cap	**$2.7 B**
Closed deals for Quarter	**37**

As of 6/30/2015
SOURCE: Water Island Capital

Fees And Expenses

Net Expense Ratio	**1.19%**
Deferred Load	**0%**
Minimum Investment	**$100,000**

As of 6/30/2015
SOURCE: Water Island Capital

Sector Exposure

Consumer Discretionary	**12.4%**
Consumer Staples	**0.2%**
Energy	**8.6%**
Financials	**12.8%**
Health Care	**18.4%**
Industrials	**9.0%**
Information Technology	**14.4%**
Materials	**14.4%**
Telecommunications	**5.8%**

As of 6/30/2015
SOURCE: Water Island Capital

tion that takes four months to complete produces a return of 1.5%, for example, its annualized return is 4.5%. Because deals usually close in a few months, almost all gains are short term.

A big disparity between the post-announcement and acquisition offer signals that investors believe the deal is risky, perhaps because it could be canceled or delayed by regulatory snags or objections from shareholders. Transactions involving these deals have higher risks—and the potential for higher reward. A narrow spread indicates confidence in a swift and successful conclusion. Market conditions also play a role. An environment of low risk and low volatility generally translates into narrow spreads, while greater volatility widens them.

The fund's managers focus on how likely, and how quickly, a publicly announced deal will get done. To find these deals, they screen a universe of 150 to 250 U.S. and foreign merger transactions around the world. After an analysis, they decide whether they will jump in or sit it out because of potential gotchas, such as antitrust issues or activist shareholders opposing a merger. The selection process winnows the universe down to the 40 to 80 mergers in progress in the portfolio at any given time.

Strategic, friendly transactions with low leverage and a high probability of completion offer the most appeal, and an optimal situation involves a high-caliber buyer, such as Warren Buffett or Oracle, with a history of long-term commitment to acquisitions and a track record of seeing deals to completion. "We like deals with a clear path to success," says Munn. "We want to invest in those with the best risk-adjusted returns and the highest probability of closing." About 98% of the deals in the fund eventually close, he adds.

Examples of deals in the fund working their way toward completion include insurer Ace Group's bid for Chubb, another insurer. Foltynowicz believes Chubb's higher-end, higher-premium business complements Ace's expansive line of insurance products.

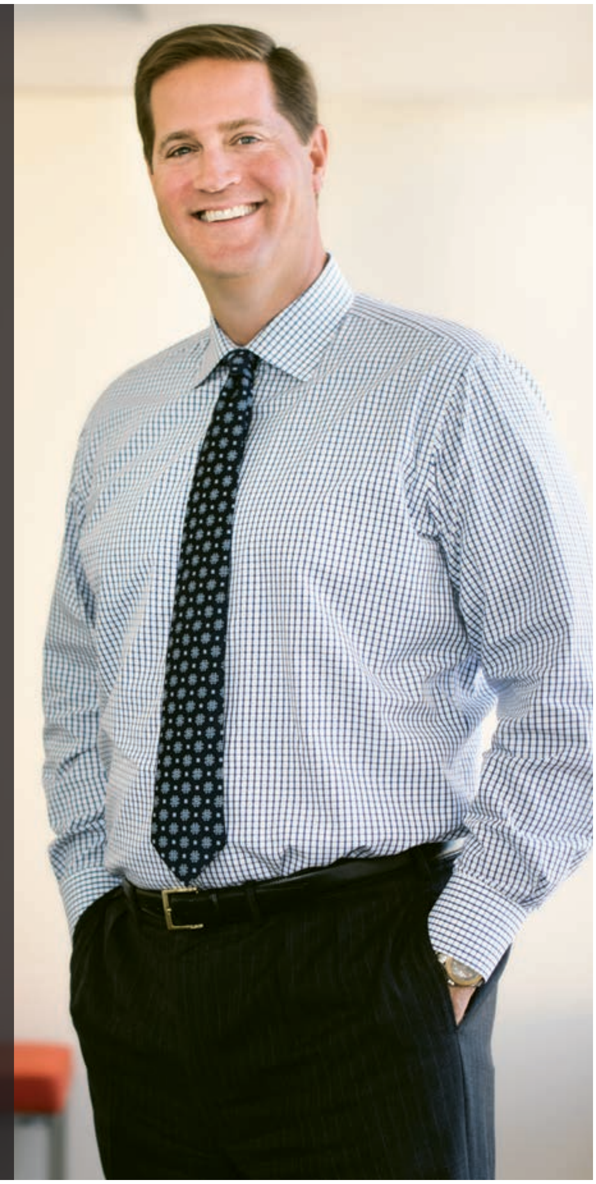
Manager
Todd Munn

Age
44

Education
Bachelor's degree, Gettysburg College; master's degree, Fordham University

Professional Background
Senior arbitrage trader, Lipper; senior operations analyst, Bear Stearns. Joined Water Island Capital in 2003.

Outside Interests
Coaching children's sports teams



"The combination of the two insurers will create one of the largest insurance companies in the world," he notes. "And if Ace walks away for some reason, there will probably be a long line of other acquirers looking to take its place." The stock and cash transaction, scheduled to close in January, is expected to return 6.5% on an annualized basis.

Another deal, Berkshire Hathaway's bid for industrial goods and metal fabrication company Precision Castparts, was announced in August. Foltynowicz says Berkshire Hathaway is well-positioned to finance the $35 billion, all-cash acquisition, and he expects a 6.5% annualized return on the transaction. Another acquirer in the portfolio, Schlumberger, made an offer for Cameron International in late August. The latter company, which makes valves and equipment for the oil and gas processing industry, established a joint venture with Schlumberger in 2013 called OneSubsea. "These companies have worked successfully together, so they know what to expect from each other," says Munn. "The long-term top-line growth potential is huge." The cash and stock deal is expected to close in March 2016. FA

DEFINITIONS

M&A: mergers and acquisitions; *Risk-free rate:* the theoretical rate of return of an investment with zero risk; *Bear:* a pessimistic investor who believes markets will fall; *Bull:* an optimistic investor who believes markets will rise.

IMPORTANT INFORMATION

The Arbitrage Fund seeks provide capital growth and absolute returns by investing in equity securities involved in mergers and acquisitions transactions.

Holdings and portfolio exposure are subject to change.

Performance through 9/30/15 for Arbitrage Fund: ARBFX (R class), -0.15% (one year), 1.13% (five year), 2.88% (ten year); ARBNX (I class), -0.84% (one year), 1.39% (five year), 3.12% (ten year); ARBCX (C class), -1.60% (one year), -0.10% (three year), -0.14% (since inception 5/31/12); ARGAX (A class), -0.15% (one year), 0.71% (since inception 5/31/13). 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 higher or lower than the performance quoted. For performance data current to the most recent month end, please call (800) 295-4485. The fund assesses a 2% redemption fee on shares that are redeemed 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 be reduced. The Total Annual Fund Operating Expenses for ARBFX, ARBNX, ARBCX, and ARGAX (excluding sales charge) are 2.31%, 2.06%, 3.06%, and 2.31%, respectively. Total Annual Fund Operating Expenses Excluding the Effect of Dividend and Interest Expense on Short Positions for ARBFX, ARBNX, ARBCX, and ARGAX (excluding sales charge) are 1.45%, 1.20%, 2.20%, and 1.45%, respectively. Class A shares have a maximum front-end sales charge of **2.50%**.*

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, 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. Foreign investing involves special risks such as currency fluctuations and political uncertainty.

Top ten holdings as of 9/30/15: Ansaldo STS SpA; Chubb Corp; Cytec Industries Inc; HCC Insurance Holdings Inc; PartnerRe Ltd; Precision Castparts Corp; Sigma-Aldrich Corp; Symetra Financial Corp; Thoratec Corp; 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.

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