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FUND UPDATE

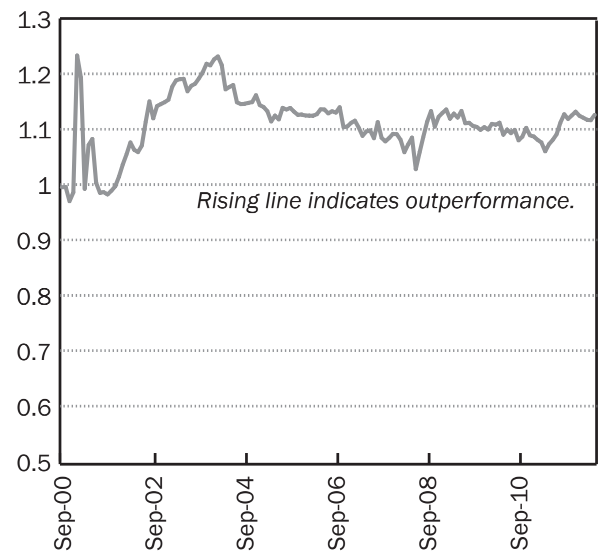
Arbitrage Fund (ARBNX; ARBFX)

CATEGORY: Arbitrage Funds
MANAGERS: John Orrico, Todd Munn, and Roger Foltynowicz of Water Island Capital
DATE OF INTERVIEW: 11/16/12
WITH: John Orrico

Difficult conditions for broad equity markets typically provide opportunities for the Water Island Capital team to put money to work in their higher conviction ideas. Portfolio manager John Orrico says that coming into the fourth quarter of 2012, his team observed specific stress in the marketplace of event-driven investors, including hedge funds. Over the summer, there was a series of European deals that weren't completed. While some of these involved more speculative situations outside the bounds of the fund's requirement for defined spreads over definitive time frames, Orrico says they "began to weigh on the event-driven community, in terms of lackluster performance and taking some hits around their portfolios." As a result, he says several funds in Europe and Asia have closed shop. The team has also seen an elevated level of redemptions taking place from hedge funds, forcing these funds "to start raising cash ahead of year-end…so they're not going to be committing capital to spreads on thinner deals as they widen."

Against this backdrop, in October the team had to contend with setbacks in several deals involving Canadian companies, which directly and indirectly impacted several of the fund's largest positions. On October 18, 2012, Canada's broadcast regulator, the Canadian Radio-Television and Telecommunications Commission (CRTC), vetoed a three billion Canadian dollar (US$3 billion) takeover of **Astral Media** by media conglomerate **BCE**, on concerns that the combined entity would have excessive control of the country's television market. The next day, the Canadian government blocked the C$5.2 billion sale of **Progress Energy Resources** to Malaysian oil firm **Petronas**. Other pending deals involving Canadian firms were caught up in a selloff

Relative Strength: Arbitrage Fund vs. Dow Jones/Credit Suisse Risk Arbitrage Index



as investors reacted to the rejections. This included another energy-related transaction, the C$15.1 billion purchase of oil producer **Nexen** by China's **CNOOC**. Even the acquisition of Canadian grain company **Viterra** by Swiss-based **Glencore International**, which was cleared by Canadian regulators in July, came into doubt as investors feared a potential rejection of CNOOC's bid could lead to retaliation by the Chinese regulators, who also must approve the deal due to Viterra's interest in a Chinese canola processing plant through a joint venture. All four of these deals were among the Arbitrage Fund's top-10 investments entering the quarter, and their price declines were material contributors to the fund's 2.5% loss in October.

"If we have conviction around these deals, we're typically going to be adding during these stressful periods," Orrico explains, but "it wasn't just about the market being stressed and these spreads blowing out because hedge funds had to de-risk…these deals [experienced] some issues themselves, which caused us to reprice our risk." Orrico says the team has to adjust its return estimates due to the timing extension, but they also must factor in greater uncertainty in terms of the regulatory reviews. The Astral-BCE rejection was a shock to the markets, as the decision seemed counter to the CRTC's guidelines, and Astral and BCE are pressing forward in their efforts to have the deal approved. Based on the team's research, Orrico believes a resubmitted proposal that includes an asset divestiture package is likely to be approved by the regulator, and a revised deal "could close within 60 to 90 days." In the case of another rejection, Astral could reopen the auction process and sell itself within the first half of 2013. Still, Orrico says "we have to size ourselves appropriately . . . while we have high expectations around the asset valuation here [if the deal falls through] it's about risk-reward and putting money to work in terms of capturing spread." For this reason, the team did not want to add to the position, but Orrico says "we weren't going to sell on day one," as their fundamental value assessment suggested "Astral was worth at least $40 per share [while] the opening trade on day one was [around] $37." Shares have since recovered into the mid-$40s, and the team has now reduced the position in the fund.

Orrico has higher conviction in the Progress Energy Resources deal. Petronas has submitted a revised bid that it believes will meet the conditions laid out by the Canadian government. "We're still comfortable that there will be a deal here," he says, noting the team is aware of another buyer prepared to pay the $22 per share that Petronas offered. They added to the fund's position as the stock fell, with subsequent sales made as shares rebounded. The team also maintains confidence in the Nexen deal, despite timing delays related to the government's redrawn policies for takeovers by state-owned enterprises, and they again added to the position on price declines. Orrico notes Nexen's stock has recovered to the price at which it traded prior to the Progress Energy Resources rejection, leading the team to sell the shares they added on the dip.

With the Viterra deal, Orrico believes it is only a timing issue, as the close "could get pushed into January or February, but we don't think there's any risk of a block." The companies are maintaining a December 15, 2012, close date, but Orrico thinks the timing could push out as far as 90 days due to backlog in the Chinese merger-review office. Based on the current price (as of our conversation) he says they expect a return of 4% even in this worst-case scenario.

Another of the fund's top exposures entering October was the acquisition of rental-car company **Dollar Thrifty** by its competitor **Hertz**. According to Orrico, the deal was widely owned within the merger-arbitrage community and expected to close on October 31, 2012, but in mid-October, Hertz announced an extension to November 16, 2012, for final review by the Federal Trade Commission. Prior to this announcement, the stock had traded around $87 compared to a cash deal price of $87.50. While this wasn't a large spread, Orrico says the annualized return of 4%–5% with a short horizon to close was attractive. But as the Canadian deals began to decay, Orrico says there appeared to be wholesale forced selling in Dollar Thrifty as well, which they attributed to prime brokers forcing clients to deleverage. The stock fell into the $73 range at the beginning of November amid "intense selling [during which] over one-third of the company's shares traded."

Orrico's team had calculated a downside value of approximately $67 in the event of a full deal break. However, Orrico explains the terms of the deal obliged Hertz to litigate against any injunction

The Arbitrage Fund Top 10 Deals (9/30/12)

Viterra Inc/Glencore Int'l PLC	5.8%
Cooper Industries/Eaton Corp	5.8%
TNT Express/ United Parcel Service	5.3%
Astral Media/BCE Inc	5.0%
Progress Energy/ Petroliam Nasional Bhd	4.7%
Dollar Thrifty Automotive Group/Hertz Global	4.4%
Ariba/SAP	4.3%
Nexen/CNOOC Ltd	3.8%
Par Pharma./TPG Capital	3.7%
Aegis Group/Dentsu	3.6%

The Arbitrage Fund Sector Exposure (9/30/12)

Industrials	22.6%
Consumer Discretionary	16.2%
Health Care	15.3%
Energy	13.5%
Technology	9.1%
Consumer Staples	7.5%
Materials	7.0%
Utilities	4.5%
Financials	4.4%
Total	**100.0%**

The Arbitrage Fund Region Exposure (9/30/12)

United States	50.5%
Canada	20.2%
Europe (ex United Kingdom)	11.0%
Australia	7.7%
United Kingdom	4.3%
Asia (ex Japan)	3.4%
Japan	1.6%
Latin America	1.3%
Middle East & Africa	0.0%
Total	**100.0%**

or other attempt to block the deal. In such cases, shares will typically trade around the midpoint between the deal price and their downside value, but in this case the assumed midpoint of $77 did not hold. Confident in their analysis of the company's value and the likelihood that the transaction would go through, Water Island increased the fund's exposure to the deal in the $74–$75 range. However, to limit its potential negative impact to the portfolio, they also bought put options at $72 and offset the cost of this protection by selling puts at $65 and selling calls at $82. While this combination capped the upside of the additional Dollar Thrifty exposure, it also lowered downside risk as long as the stock did not fall well below Water Island's estimate of the company's stand-alone value. Subsequently, the stock rebounded, the FTC granted its approval, and the deal closed on November 16, 2012.

Another example of how the team has taken advantage of fears hitting the market is their recent activity in **Medicis**, a company being acquired by **Valeant Pharmaceuticals** for $44 per share. The stock fell in early November when one of Medicis' licensing partners filed a merger-related lawsuit regarding contracts for several products distributed by Medicis. "The market sold first, before they understood the issues here," Orrico explains, and this gave the team an opportunity to add to the fund's position at very attractive levels. They were already aware that this merger agreement was not conditional upon third-party consents. Also, the team's familiarity with the supply agreements' arbitration requirements and their past experience with similar legal maneuvers gave them confidence the plaintiff would not be able to secure an injunction blocking the merger, a stance endorsed by multiple outside counsels. Finally, Water Island's conviction in the stock was reinforced by their knowledge of other buyers for Medicis, including the plaintiff's parent company. Orrico says Medicis "didn't qualify to be a top-10 position when it was trading at $43.50 [per share], but when it traded at $40 last week, it certainly became a top-10 position." With the stock having since recovered to above $43, Orrico says they have now trimmed the fund's stake.

While the elevated volatility of the fund's top positions has presented the Water Island team with short-term trading opportunities, it has also offered them several lessons. First, Orrico acknowledges they did not properly handicap the odds of a stressful market, thus a number of the fund's deals entering this period were too close to their individual position size limits (which are based on downside-risk constraints). "We tend to forget how weak the hands are in so many of these transactions," Orrico says, which "has to make us think twice about sizing [deals], because the opportunity that comes with stressful selling is one that we want to be able to take advantage of to a greater extent than we did this time around." Going forward, he intends to allow greater margin for opportunistic purchases during these kinds of episodes. Second, the experiences with Viterra and other recent deal delays requiring Chinese approval have led to shifts in the team's timing assumptions for cross-border deals. "I think what we got wrong on the margin was timing [of Chinese regulatory reviews] given how strained and overburdened they are in terms of manpower," Orrico explains, "[which has] given us a newfound appreciation for being more conservative on our timing construction." Finally, he says the team must continue to broaden the "jurisdictional scope" of its relationships with legal contacts and other consultants, and to intentionally seek out divergent views, particularly with respect to regulatory expertise.

Litman Gregory Opinion

The Arbitrage Fund lost 2.9% for the year through October 31, 2012, heavily impacted by the

Performance Table

		Calendar-Year Returns					Trailing Returns*				
	YTD thru 10/31/12	2011	2010	2009	2008	2007	1-Yr	3-Yr	5-Yr	10-Yr	Since Start of Record
The Arbitrage Fund	-2.9%	4.7%	1.8%	10.2%	-0.5%	7.5%	-2.4%	1.6%	2.5%	4.3%	5.0%
Dow Jones/Credit Suisse Risk Arbitrage Index	0.2%	0.8%	3.2%	12.0%	-3.3%	8.8%	-0.4%	1.9%	2.2%	4.7%	4.2%

**Compound annual returns through 31 October 2012. Start of record October 2000. Prior to the institutional share class' inception in November 2003, we use returns from the retail class share.*

challenging month of October. This performance is disappointing in the context of the fund's absolute-return orientation. However, there have been periods of similar short-term volatility throughout the fund's history, yet it has only experienced losses in 12% of rolling 12-month periods and has never produced a loss over a 36-month time frame. Orrico has stated he expects the fund to deliver long-term returns of approximately three times the annualized 90-day Treasury bill returns. (In the current low-rate environment, he is aiming for annualized returns of 4%–6%.) Since the fund's inception in 2000, it has returned 5% annualized through October, compared to 2% annualized for Treasury bills.

There is not an ideal benchmark index for the merger-arbitrage space, but we monitor the fund's performance against the Dow Jones Credit Suisse Risk Arbitrage index and the HFRI Merger Arbitrage index. These are composites of hedge funds in this category, which often utilize significant leverage. The indexes are also subject to survivorship bias, which tends to skew index returns upward as better performing funds remain and poor performing funds exit. In spite of this, the fund has outperformed both the Dow Jones Risk Arbitrage and HFRI indexes since inception, by annualized margins of 46 and 83 basis points, respectively. It has done so with similar volatility as measured by standard deviation over rolling 12-month periods.

The team's experience is a key reason for our continued confidence. Orrico's investments using merger-arbitrage strategies date back to 1994. Co-managers Todd Munn and Roger Foltynowicz have worked with him at Water Island Capital for almost a decade, and Orrico has gradually expanded the team over time to extend the team's expertise across global markets. The team's cohesion is important, as merger-arbitrage investors must be able to quickly reach decisions and constantly assess new information before deals close. We believe the team has a good process in place to rank the evolving opportunity set as deal spreads move around, and we think their active trading around positions, including the use of options (as illustrated with Dollar Thrifty), can add value at the margins.

We further appreciate the team's disciplined risk management process, which is especially important given the fund's relatively concentrated portfolio. As October proved, losses due to deal breaks (and shifts in merger-related sentiment) cannot be entirely avoided, but the team's downside loss rules limited the damage. We are pleased with their strict adherence to these standards even as they saw compelling upside opportunities following the October price declines. The team also mitigates risk by investing only in deals they believe serve a strategic purpose.

Our greatest concern revolves around the growth of assets under the team's management, which now exceed $3 billion. While the fund still invests across the market-cap spectrum, its current exposure to deals under $1 billion is about 11%, and the team no longer enjoys the degree of flexibility that it had at smaller asset levels. This is offset somewhat by expansion of the global opportunity set, with deals outside of North America representing almost 30% of the fund's assets, as of September 30, 2012. This expansion, supported by growth of the firm's research team, was the catalyst for reopening the fund to new investors earlier this year. Water Island also launched an event-driven fund in late 2010 and a dedicated credit opportunities fund in 2012. On the plus side, these strategies enhance the firm's ability to hire and retain analysts with a broad range of expertise that can benefit the core Arbitrage Fund, but they also create potential for distraction. While our recent conversations haven't indicated a lack of attention to the Arbitrage Fund, we remain alert to this risk.

Despite the proliferation of "alternative" mutual funds in recent years, there remain very few options for investors to access merger-arbitrage strategies. We have invested in the Arbitrage Fund for several years in our balanced portfolios, and over time our confidence in the team at Water Island Capital has increased. Investors should bear in mind that merger-arbitrage investing, while often classified as a market-neutral approach, underwrites the risks of deal failure. Although stock values tend to anchor to announced transaction prices and significantly dampen a deal target's sensitivity to

Contact & Purchase Information

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Fund	Min. Initial	Availability†	Expenses
Inst'l (ARBNX)	$100,000	S, AN, F	1.20%
Retail (ARBFX)	$2,000	SO, AN, FN	1.44%

†*Certain restrictions may apply. Please check with your broker/dealer for details.*

broad market movements, occasional bouts of heightened volatility and even realized losses will occur due to specific deal delays, outright failures, and difficult conditions for merger financing and approvals. Therefore, we expect the fund to encounter rough patches from time to time, but over periods of a year or longer we believe realized volatility will consistently be much lower than equity markets. We continue to rate the fund as *Approved* and believe it can deliver mid-single-digit returns over our five-year time horizon.

–Chris Sawyer, CFA

The views expressed are those of the portfolio manager and Litman Gregory Asset Management, LLC as of the date indicated, are subject to change, and may differ from the views of other portfolio managers or the firm as a whole. These opinions are not intended to be a forecast of future events, a guarantee of future results, or investment advice. References to specific securities are not intended and should not be relied upon as the basis for anyone to buy, sell, or hold any security. Investors seeking financial advice regarding the appropriateness of investing in any securities or investment strategies should consult their financial professional.

Annualized performance through 9/30/2015 for ARBFX: -0.15% (one year); 1.13% (five years); 2.88% (ten years); for ARBNX: 0.16% (one year); 1.39% (five years); 3.12% (ten years).

The y axis of the graph on page 1 represents the ratio of cumulative performance since inception to 10/31/12 relative to the index. The source of the graph is from a proprietary database produced by Litman Gregory, with the original data sources being Morningstar for fund returns and Credit Suisse for index returns. The Arbitrage Fund Top 10 Deals listed on page 2 represent a snapshot of the top deals in the portfolio as of 12/31/12.

The performance data 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 costs. 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 redeemed within 30 days of purchase. Contractual fee waivers are currently in effect. Without such waivers, performance numbers may have been reduced. 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%. The Total Annual Operating expense for ARBNX is* ***2.06%****; Total Annual Fund Operating Expenses Excluding the Effect of Dividend and Interest Expense on Short Positions for ARBFX is 1.20%.*

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.

The Arbitrage Fund is distributed by ALPS Distributors, Inc., which is not affiliated with Water Island Capital, LLC or Litman Gregory Asset Management, LLC.

The Dow Jones Credit Suisse Risk Arbitrage Index measures the performance of risk arbitrage funds. Risk arbitrage funds typically invest in mergers and acquisitions involving public companies, attempting to capture the underlying spreads. The HFRI (Hedge Fund Research, Inc.) Merger Arbitrage Index includes funds which employ an investment process primarily focused on opportunities in equity and equity related instruments of companies which are currently engaged in a corporate transaction. One cannot invest directly in an index. Annualized performance through 9/30/2015 for the Dow Jones Credit Suisse Event Driven Risk Arbitrage Index is: -6.13% (one year); 3.70% (five years); and 5.25% (ten years).

Standard Deviation measures the degree of variation of returns around the average return. In finance, it is commonly used as a representation of the risk associated with price-fluctuations of a given asset. Basis points are commonly used to refer to changes in financial instruments. One basis point is equal to 1/100th of 1%. Options represent the right to buy or sell a specified measure of an asset at an agreed upon price for a fixed cost before a stated expiration date. A call option represents the right to buy, and a put option represents the right to sell.

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.

[ARB000794 2015-12-31]