DUE DILIGENCE REPORT

Arbitrage Event-Driven Fund (AEDFX, AEDNX)

CATEGORY: Alternative Strategies
MANAGERS: Todd Munn, Roger Foltynowicz, Gregg Loprete, and Ted Chen

We have known Water Island Capital since 2003 and have invested in the firm's Arbitrage Fund since 2010. Since the firm's inception in 2000, founder and chief investment officer John Orrico has continuously added resources and personnel, with the vision of expanding beyond the original merger-arbitrage strategy to offer other alternative strategies to investors in the mutual fund world. After adding significant expertise over the years, the firm launched the Arbitrage Event-Driven Fund in late 2010, and subsequently the Arbitrage Credit Opportunities Fund in late 2012. There are currently 16 investment professionals at Water Island, with significant senior-level hires continuing into 2013.

The Arbitrage Event-Driven Fund is a natural extension of the investment style and philosophy that the firm has implemented and refined over the course of the last 13 years, as many of the events that make up the fund's opportunity set have some degree of linkage to the firm's traditional mergers and acquisitions (M&A) business. However, rather than being limited to investing only in the stocks of announced M&A targets, the fund can invest across the capital structure in any corporate event (e.g., M&A, restructuring, recapitalization, spin-offs, etc.), wherever the investment team believes there to be the best risk/return potential. This broader mandate allows the portfolio managers to create a best-ideas portfolio that draws on the increased talent and global research capabilities the firm has added, and benefits from the synergies across the different research groups.

Given our familiarity with a number of the investment professionals, the firm's general philosophy, and the investment process for the Arbitrage Fund, our due diligence over the last several months focused mainly on getting to know newer investment team members, drilling down to position-level examples across the different strategies, and understanding the decision-making framework of the portfolio managers. As a result of our work, continued exposure to the firm, and increasing confidence in the firm's ability to successfully invest in a broader set of opportunities, we are adding the fund as an *Approved* option in the Alternative Strategies category.

Below, we discuss the key elements of the managers' investment philosophy, strategy, and process; capital allocation, portfolio construction, and risk management; the fund's historical performance and our expectations going forward; and conclude with our opinion on the fund.

Investment Team

Todd Munn, Roger Foltynowicz, Gregg Loprete, and Ted Chen are the named portfolio managers on the Arbitrage Event-Driven Fund. Although he is technically not a portfolio manager, John Orrico coordinates and presides over the capital allocation discussions and is involved to varying degrees with the vetting of all potential positions (more deeply involved for larger positions, as would be expected).

We have known Munn and Foltynowicz for a number of years as they have been with Water Island since 2003 and are portfolio managers on the Arbitrage Fund. Loprete, who manages the credit positions in the fund, has been with the firm since 2009 and has a deep background in credit, having worked both on the sell side and buy side of the market. Chen, who joined Water Island earlier this year and manages equity special situations, started in investment banking and also worked as an event-driven strategist on the sell side before joining the firm.

Additionally, there are a number of analysts working with the portfolio managers, several of whom split time between groups, facilitating smooth sharing of information and investment insight. The firm maintains a London office with three analysts focusing on European investment opportunities. Although they have no urgent need, Water Island is actively talking to new candidates in several areas and expects to opportunistically add to the investment team as they grow.

Investment Strategy and Process

The fund is a best-ideas portfolio across the event-driven landscape. Event-driven investing is a broad description of a series of specialized strategies designed to profit from specific corporate events. These events can include M&A, asset sales, spin-offs, refinancings, restructurings, recapitalizations, litigation, and distress or bankruptcy. Event-driven investors may utilize a number of investment strategies, including merger-arbitrage (owning the target company's stock at a discount to the deal price); capital structure arbitrage (being long one part of a company's capital structure and short another part in order to capture a relative mispricing between the two); or distressed investing (owning the discounted debt securities of a company in operational and/or financial distress to profit from a turnaround or corporate reorganization, often in bankruptcy). As we have described these strategies in somewhat more detail in the original due diligence report on the Arbitrage Fund, and in the December commentary on alternatives research, we will not provide a lengthy description here.

The Arbitrage Event-Driven Fund typically tries to hedge out as much market and sector risk as possible in order to isolate the "bet" on the event and resulting value of the securities it owns, and will often utilize options, short sales, and currency forwards to do so. (The fund is in the process of negotiating the necessary contracts with counterparties in order to use swaps as an additional hedging tool.) Through its hedging activity, the fund seeks to generate attractive absolute returns that exhibit low volatility and relatively low correlation to the equity and credit markets. In seeking to hedge out much of the residual market exposures, the managers try to guard against broad market or sector losses overwhelming the company-specific and event-specific gains the fund will realize if the investment thesis proves correct. However, doing so also has costs, either explicit, in paid option premium, or implicit, by negating the tailwind of rising markets. We certainly do not fault the managers for their disciplined approach to hedging, as the tailwind of the last several years could easily have been a headwind that would have made the fund's returns look comparatively quite strong if markets had been down. We point this out simply to sensitize investors to the conservative nature with which the fund is managed.

Orrico and the investment team allocate capital across three broad strategy buckets: equity merger-arbitrage, equity special situations, and credit, which is further subdivided into merger-related credit and credit special situations:

Equity Merger-Arbitrage: This sleeve of the strategy is an optimized portfolio of deals selected by the merger-arbitrage team on a risk/reward basis regardless of market cap or geography. More than the other strategies within the fund, this sleeve seeks to provide consistent, low volatility positive returns and low correlation to the capital markets. The Arbitrage Fund typically holds 40-80 deals, while this portfolio holds a more concentrated set of 25-35 deals. While many of these ideas overlap with the Arbitrage Fund, the weightings may be substantially different.

Equity Special Situations: Positions in this sleeve include:

- merger-related situations—companies speculated to be involved in M&A or targets of potential bidding wars;
- "re-rating" opportunities—positions where the team believes the market's perception of the company will be dramatically altered by a spin-off, asset sale, or "transformational" M&A;
- mean reversion trades—arbitraging different share classes of the same company that temporarily diverge in value, or stub trades where the fund is able to isolate an undervalued business in a parent company or conglomerate by shorting out publicly traded subsidiaries; and
- value-with-a-catalyst—cheap stocks where the investment team believes some event will happen within a year to highlight or create value, but the exact event is unclear.

These positions tend to have the most potential for volatility, sometimes even with hedges, so they are often sized to be below the firm's general 100 basis point, position-level loss limit in recognition of that potential for volatility (and downside) in excess of the investment team's estimates.

Credit: The overall allocation to credit breaks down further to merger-related and special situations. Merger-related credit, as its name suggests, is composed of positions where the credit team, working in concert with the equity team, determines that a position in the target company's debt securities rather than equity is a more attractive way to invest in a transaction. This

Arbitrage Event-Driven Fund Top 10 Holdings (9/30/13[a])

NYSE Euronext	3.6%
Sourcefire	3.3%
Molex	2.6%
Hudson City Bancorp	2.6%
Onyx Pharmaceuticals	2.5%
Kabel Deutschland Holding	2.3%
Shoppers Drug Mart	2.3%
Dell	2.2%
Life Technologies	2.2%
Belo	2.0%
Total	**25.6%**

Arbitrage Event-Driven Fund Strategy Allocation (9/30/13[a])

Equity Merger-Arbitrage	59.8%
Equity Special Situations	5.6%
Credit Special Situations	22.9%
Merger-Related Credit	11.8%

Arbitrage Event-Driven Fund Top Five Regions (9/30/13[a])

United States	77.0%
Canada	8.0%
Europe (ex U.K.)	6.6%
Asia (ex Japan)	3.1%
Japan	2.4%
Total	**97.1%**

[a]*Subject to change.*

approach broadens the investable universe since certain companies are not publicly traded on the equity side but do have tradable debt securities. Additionally, investing in a merger deal through the debt can offer a different and sometimes more advantageous risk/return profile than an equity-based approach.

Special situations credit is essentially catalyst-driven credit investing, seeking to capture returns from longer-maturity bonds or bank debt over a shorter time frame (typically under two years) as a result of a corporate event, while avoiding as much credit and interest-rate risk as possible. In many cases, corporate actions that will be beneficial to a company's equity are restricted by the covenants governing the company's debt, so in order to spin-off a division or complete a merger, for example, the company may have to retire its debt according to the governing provisions of each particular issue (which can be analyzed by the investment team), producing an opportunity to profit from that transaction. Other opportunities include:

- deleveraging situations, where reducing debt increases the value of the remaining securities in a company's capital structure because the market perceives less risk of default;
- regulatory and legal trades, where changes in laws or regulations reduce the attractiveness of existing debt and prompt the company to retire it early;
- deep value credit (stressed or distressed positions purchased well below par), where the investment team expects to benefit from either a company's recovery or corporate reorganization; and
- other opportunistic positions, including attractively priced new issues, capital structure arbitrage, and market dislocation trades.

Portfolio Construction and Risk Management

One of the key considerations in a fund that manages multiple substrategies is capital allocation. We discussed this at length with the investment team to better understand that process. The investment team meets monthly to review, discuss, and adjust their strategic allocations between the three strategies, if necessary. Orrico and the portfolio managers discuss the opportunity sets in their respective areas, the macro outlook, capital markets conditions, and any other relevant factors before agreeing to a target allocation, which typically does not dramatically change month to month. Between monthly meetings, the portfolio managers have regular, informal dialogue to understand when there may be excess cash coming into the fund from deals closing or positions being sold, or if there is a lack of opportunity in an area that is preventing that sleeve from using its full allocation. Importantly, because individual compensation is tied to both personal performance *and* firm performance, all investment professionals are motivated to ensure that capital is allocated to its best use, as opposed to hoarding it and investing in subpar opportunities; this aligns the investment team's interests with investors in the fund.

The allocations may change intramonth from the strategic targets based on changes in the opportunity set, but the deviations are typically within five percentage points on either side of the target. Because traditional equity merger-arbitrage is the most liquid strategy in the fund, this sleeve of the portfolio serves as a "shock absorber" for excess cash, where it can be invested until it is put to work in other strategies. The fund is generally fully invested, which is defined as holding up to 5% cash. The managers like to maintain a small cash position in order to be opportunistic buyers of positions they like when sellers are price-insensitive due to market dislocations or a need for liquidity.

While the investment team tries to maintain flexibility in capital allocation by shifting capital to the most attractive opportunity set, they intend to always maintain some degree of balance across the different strategies so as not to become overly concentrated in one set of positions. The current target allocations as of November are 40% equity merger-arbitrage, 40% credit, and 20% equity special situations. Over time, the average allocations, using quarter-end data, have been approximately 50%/35%/15%. Based on our discussions with the firm, we expect the longer-term mix to become closer to 20%/40%/40%. This will evolve over time as the equity special situations team grows and continues to demonstrate success. Non-U.S. exposure was 23% as of September 30, 2013, and has been as high as 41%, with an average of around 30%, again using quarter-end data since inception. The firm has continued to build its capability to invest globally, and we expect non-U.S. exposure to remain significant.

As previously mentioned, the Arbitrage Event-Driven Fund is quite diversified. The top 10 positions have historically accounted for between 25% and 40% of total assets, but the fund typically holds well over 100 positions (including short positions in arbitrage trades, and other hedges associated with long positions). As of September 30, 2013, the fund held 183 positions. In addition to diversification as a risk mitigant, the fund adheres to the same position-sizing rule that governs the Arbitrage Fund, namely that single positions are sized so as not to cost the fund more than 100 basis points in the event of a deal break or an event not playing out as expected. In our experience, we have found the firm to be consistently conservative in its combination of estimated downside and position sizing, with most position-level losses well inside the 100 basis point limit. The managers' willingness to approach the maximum 100 basis point downside limit for a particular position also depends on the magnitude of the upside opportunity and the managers' level of confidence in the event.

Additional risk management guidelines include:

- 20% exposure to a single sector
- 5% exposure to any single transaction (net exposure including long and short exposure)
- Hedge currency-exposure risk through forwards
- Hedge interest-rate risk
- No illiquid positions
- Favor bonds with multiple market makers
- Bond-position liquidity generally restricted to position sizes that would typically permit entering or exiting positions within one to five business days
- Equity-position liquidity generally restricted to position sizes that would typically permit entering or exiting position sizes within one to three business days
- Equity positions limited to no more than 10% of the float
- Measure sensitivities of options to time, interest rates, volatility, etc., in real time where applicable

Historical Performance

Performance analysis is of limited value at this point due to the fund's relatively short life (October 2010 inception) and the evolution of its portfolio construction (i.e., shifting toward a lower merger-arbitrage allocation over time from a relatively heavy weighting there at inception). With that said, the fund has underperformed the HFRI Event-Driven Index over the trailing one year (7.3% annualized compared to the index at 13.5%) and three years (3.7% versus 6.4%) through November 30, 2013. Comparisons with the index are imperfect, however, due to the fact that some included hedge funds use leverage, which is clearly additive to returns when markets perform as well as they have in recent years, while the fund is unlevered. The fund has modestly lower volatility over the trailing three-year period (4.6% annualized monthly standard deviation versus 5.5%), and although we expect both to rise when volatility returns to financial markets at some point, we expect the fund's relative advantage to persist because it is unlevered and well-hedged. In short, our investment thesis here is not based on statistical measures over a relatively brief time period,

Performance Table

		Calendar Year Returns			Trailing Returns[a]		
	YTD thru 12/31/13	2012	2011	2010	1-Yr	3-Yr	Since Inception
Arbitrage Event-Driven Fund	5.7%	2.0%	3.5%	1.8%	7.3%	3.7%	3.9%
HFRI Event-Driven Index	11.3%	8.9%	-3.3%	11.9%	13.5%	6.4%	6.7%

[a]*Compound annual returns through 11/30/13. Inception Oct-2010.*

but on an expanded opportunity set for a skillful and risk-conscious investment team. We will of course monitor the fund's performance going forward and revisit our assumptions if it does not develop as we anticipate.

Litman Gregory Opinion

The firm's mandate is to maintain a tightly hedged portfolio, sacrificing some upside in exchange for lower volatility and capital preservation. The fund's performance should be materially driven by its analysis of events and trade construction rather than broader capital markets returns. The positive elements we see include:

- An experienced team with diverse backgrounds and skill sets. Most of the senior team has worked together for four years, and three have worked together for 10 years. This cohesiveness and familiarity should facilitate teamwork and a smooth flow of information and capital across groups, which is particularly important in a portfolio that incorporates multiple strategy sleeves. Furthermore, the team's backgrounds are highly complementary, which has led to better investment decisions in several cases due to deeper understanding of events from multiple angles (e.g., the credit team's evaluation of the market's receptiveness of a debt issue necessary to finance an acquisition in which the merger team was investing). We expect this dynamic will increase going forward as the team works together longer and becomes even more tightly integrated.
- A strong risk-management discipline and capital preservation mindset. Orrico and the rest of the investment team take risk control extremely seriously and tightly hedge the portfolio. Additionally, one of the senior investment professionals in the firm will be transitioning to focus on building out a separate, more comprehensive risk management function, which we anticipate will be additive to the firm over time.
- The fund has the ability to be flexible in its capital allocation, which should allow it to overweight more attractive areas of the event universe and underweight less attractive ones, adding marginal value over a pure merger-arbitrage strategy that should become material when compounded over time. The broad investment mandate should allow the fund to be more of an "all-weather" offering than other narrowly focused competitors that may struggle when one particular strategy offers less opportunity.

We have some potential concerns, of course, that bear ongoing attention. First, the performance since inception has been relatively modest compared to stated expectations (3.9% annualized since inception). Second, the relatively rapid growth of the organization has the potential to cause distraction for senior portfolio managers as they deal more with managing people than positions, which could reduce the anticipated benefits of having additional resources on the investment team. We have not seen evidence of this, but it is something we will try to explore in our continuing dialogue with the firm, as it has been an issue at other firms when not managed thoughtfully.

We are rating the fund *Approved* and are assessing how it can best complement our current portfolios and alternative strategies line-up.

–Jason Steuerwalt, CFA

Contact & Purchase Information

PHONE: 800-560-8210
WEB ADDRESS: www.arbitragefunds.com

FUND	MIN. INITIAL	AVAILABILITY[a]	EXPENSES
Inst'l (AEDNX)	$100,000	S,AN,F	1.44%
Retail (AEDFX)	$2,000	SO,AN,FN	1.69%

[a]*Certain restrictions may apply. Please check with your broker/dealer for details.*

The Arbitrage Event-Driven Fund Investment Objective: The Fund seeks to achieve capital growth.
The Arbitrage Fund Investment Objective: The Fund seeks to achieve capital growth by engaging in merger arbitrage.

Annualized performance through 9/30/2015 for AEDFX: -9.83% (one year); 0.40% (five years); N/A (ten years); 0.40% (since inception); for AEDNX: -9.63% (one year); 0.63% (five years); and N/A (ten years); 0.63% (since inception); for ARBFX: -0.15% (one year); 1.13% (five years); 2.88% (ten years); 4.19% (since inception); for ARBNX: 0.16% (one year); 1.39% (five years); 3.12% (ten years); 2.92% (since inception).

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 AEDFX is ***2.52%****; Total Annual Fund Operating Expenses Excluding the Effect of Dividend and Interest Expense on Short Positions for AEDFX is 1.69%. The Total Annual Operating expense for AEDNX is* ***2.27%****; Total Annual Fund Operating Expenses Excluding the Effect of Dividend and Interest Expense on Short Positions for AEDNX is 1.44%. 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 ARBNX 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 Event-Driven Fund also invests in debt securities, which decrease in value as interest rates increase.

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

The HFRI (Hedge Fund Research, Inc.) Event-Driven (Total) Index includes Investment Managers 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. Security types can range from most senior in the capital structure to most junior or subordinated, and frequently involve additional derivative securities. Event-Driven exposure includes a combination of sensitivities to equity markets, credit markets and idiosyncratic, company specific developments. Investment theses are typically predicated on fundamental characteristics (as opposed to quantitative), with the realization of the thesis predicated on a specific development exogenous to the existing capital structure.

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 of The Arbitrage Event-Driven Fund as of 9/30/15: PartnerRe Ltd, Cytec Industries Inc, Chubb Corp, Thoratec Corporation, IPC Healthcare Inc, Precision Castparts Corp, Sigma-Aldrich Corp, Symetra Financial Corp, Dealertrack Technologies Inc, KYTHERA Biopharmaceuticals Inc. Top ten holdings represent 30.5% of the portfolio. Holdings are subject to change. Current and future holdings are subject to risk.

[ARB000795 2015-12-31]