**JANUARY 2015 | ANNUAL REPORT**

# Arbitrage Event-Driven Fund

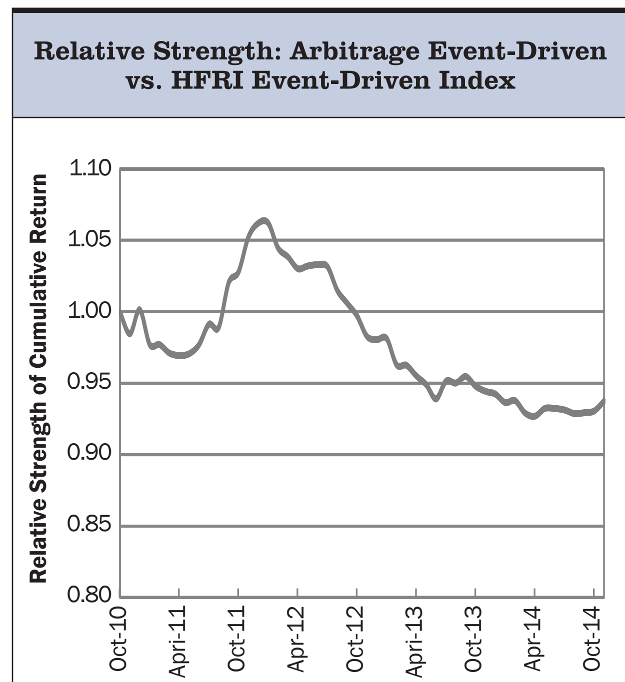
| Fund Information | | |
|---|---|---|
| | **AEDNX** | **AEDFX** |
| **Asset Class Category** | Alternative Strategies | Alternative Strategies |
| **Share Class** | Institutional | Retail |
| **Min. Initial Investment** | $100,000 | $2,000 |
| **Availability**[a] | S,AN,F | SO,AN,FN |
| **Expense Ratio Cap** | 1.44% | 1.69% |
| **Opinion** | *Approved* | *Approved* |
| **Firm** | Water Island Capital | |
| **Managers** | Todd Munn, Roger Foltynowicz, Gregg Loprete, and Ted Chen | |
| **Phone** | 800-560-8210 | |
| **Web Address** | www.arbitragefunds.com | |

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

## Investment Environment & Opportunity Set

"It was the best of times, it was the worst of times . . . it was the spring of hope, it was the winter of despair . . . " Although Dickens certainly did not pen the opening lines of his classic novel *A Tale of Two Cities* to describe the environment for event-driven investing in 2014, they provide a fitting, if overly simplified, narrative. In the recent past, we have discussed how the backdrop for event-driven investing has been largely favorable over the last several years, and in fact became more favorable for the first half of 2014 as mergers and acquisitions activity boomed to levels not seen since before the financial crisis. This increased the attractiveness of outright merger-arbitrage investing (although spreads were generally still narrow due to low market volatility, lack of mega-deals, and few deal failures, among other factors) in addition to what was already a robust environment for spin-offs, asset sales, refinancing transactions, and most other short-term "events." This created a backdrop that we expected would produce strong returns for event-driven investors. We were not alone in thinking this, as surveys of investors in hedge funds conducted by several prime brokers revealed that the event-driven category was a popular pick (within the top two or three in surveys we saw) to be the top performing alternative strategy in 2014. However, having company in being wrong is of little solace to us.

**Relative Strength: Arbitrage Event-Driven vs. HFRI Event-Driven Index**




*Past performance is not a guarantee of future results. Data as of 11/30/2014.*

The event-driven investing environment was largely a tale of two halves in 2014. Despite the strong environment for corporate activity, there were a number of factors that contributed to the poor performance of many event-driven funds over the last several months. In addition to losses on specific positions, many managers were hurt by the negative effects of position-crowding and the "de-risking" contagion that can spread across the event-driven landscape as hedge funds reduce leverage and sell unrelated positions in order to avoid further losses. To a degree, this risk is inherent in event-driven investing and is a feature of the landscape with which managers must contend. Talk from the Obama administration about plans to make tax inversion takeovers more difficult and less lucrative during the summer started the discord, while a negative court ruling in a lawsuit regarding the legality of the U.S. Treasury's actions relating to **Fannie Mae** and **Freddie Mac** seemed to mark the beginning of the acute phase in early October. Fannie Mae and Freddie Mac common and preferred shares are relatively widely held in the event-driven community, and the ruling sent shares down quite sharply, igniting selling pressure by some funds with significant exposure. Event names in the energy space also performed poorly due to the drop in oil prices. The culmination of the pain came in the middle of October, as **AbbVie** called off its planned takeover of **Shire**, reversing what had been seen (at least in part due to company management's continued public support) as a deal with an extremely high likelihood of closing, despite the tax inversion aspect of the transaction. Shire's stock, which was a large position in many merger-arbitrage and event-driven funds, plunged by 30% in one day, resulting in significant losses for many funds (including Arbitrage Event-Driven, although it was a relatively small position) and sparking "risk-off" selling almost across the board in merger and event-driven names.

## Investment Philosophy & Process

The fund is a diversified portfolio combining the team's best ideas from 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 or financial distress to profit from a turnaround or corporate reorganization, often in bankruptcy). Chief Investment Officer John Orrico and the Water Island investment team allocate capital across three broad strategy buckets: merger arbitrage, equity special situations, and credit, which is further subdivided into merger-related credit and credit special situations.

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 change of the securities it owns and will often utilize options, short sales, and currency forwards to do so. Through its hedging activity, the fund seeks to reduce volatility and correlation to the equity and credit markets.

| Arbitrage Event-Driven Portfolio Characteristics (9/30/14) | |
|---|---|
| Long Exposure | 91.1% |
| Short Exposure | -26.0% |
| Gross Exposure | 117.1% |
| Net Exposure | 65.1% |

| Arbitrage Event-Driven Strategy Allocations (9/30/14) | |
|---|---|
| Merger Arbitrage | 38.2% |
| Equity Special Situations | 20.4% |
| Credit Opportunities | 32.6% |
| Cash | 8.9% |

| Arbitrage Event-Driven Top 10 Holdings (9/30/14) | |
|---|---|
| Tokyo Electron | 2.2% |
| TriQuint Semiconductor | 2.0% |
| tw telecom | 2.0% |
| American Realty Capital Healthcare Trust | 1.8% |
| Safeway | 1.7% |
| Foster Wheeler | 1.7% |
| URS | 1.7% |
| DIRECTV | 1.7% |
| Protective Life | 1.6% |
| Shire | 1.5% |
| **Total** | **17.9%** |

| Arbitrage Event-Driven Top Five Regions (9/30/14) | |
|---|---|
| United States | 78.7% |
| Europe (ex U.K.) | 5.3% |
| Canada | 4.3% |
| Japan | 2.2% |
| United Kingdom | 0.6% |
| **Total** | **91.1%** |

*Subject to change.*

## Highlighted Positions

In order to highlight the fund's approach, it is more useful to discuss the category as a whole rather than any specific position within the merger-arbitrage strategy. While merger activity was strong throughout most of the year, deal spreads on safe deals were still relatively modest, in the low to mid-single digits (annualized), offering relatively little compensation for the risk of deal breaks. As such, the fund had reduced exposure to the equity merger-arbitrage strategy, dropping to close to one-third of the portfolio earlier in the year. After the AbbVie/Shire deal broke, spreads for "safe" deals widened by 50%–100%, according to Water Island. In one deal in the energy industry that subsequently closed in November, the spread blew out at one point to about 20% annualized from 3%–4% in mid-October. Recognizing the increase in risk-adjusted returns in this opportunity set, the portfolio managers increased exposure to merger arbitrage in the fund to approximately 50% as of the end of November.

While there have been winners in the fund over the year, given the weak recent performance, our recent discussions with the team have focused on unsuccessful positions. A brief recap of two of those may be useful to illustrate the differences in the portfolio management of two positions both negatively impacted by the drop in oil prices (among other factors).

**Civeo** and **Peabody Energy** are two holdings that were both significant detractors during the third quarter. Without going into the level of detail we did in our discussions with Water Island, we will briefly summarize the investment thesis for Civeo. The company, a temporary lodging provider to natural resource companies, was spun off from **Oil States International** earlier in the year. Water Island believed (as did much of the investment community) that as an independent company, Civeo would be able to drive additional value through conversion to a REIT. Water Island also believed, based on their extensive research, that the longer-term growth opportunities for the company were underappreciated by many event-driven investors who were focused solely on the REIT conversion. The company suffered a steep drop in price in September when it announced that it would not be converting to a REIT, and further, the outlook for future opportunities had deteriorated sharply in a very short time due to the impact of the fall in oil prices on the exploration and drilling plans of its customers. Complicating matters was the relative difficulty in hedging the position, for a number of reasons beyond the scope of this discussion. Given the essentially broken thesis (i.e., the lack of a REIT conversion *and* lack of clarity around future ongoing business, much less growth), Water Island decided to work their way out of the position.

In contrast, Peabody Energy, a coal company with a diversified asset base (both in terms of geography and coal type) and a relatively strong balance sheet, is being held despite price weakness in the last two quarters. Water Island has been familiar with the company for almost a decade, based on the company's historical acquisition activity, and views Peabody as one of the long-term survivors in an industry that will continue to consolidate. In this instance, industry headwinds (regulation, commodity price declines, etc.) have exacerbated company-specific issues (logistical and operational issues at various mine sites), leading to the stock price declines. Hedging has been easier in this case, however, allowing the fund to largely maintain its position despite some losses. Water Island believes the stock has dramatic upside potential if and when operational issues are fixed and industry conditions normalize. This seems to be starting, as industry capacity is being significantly reduced voluntarily and weaker players are now unable to refinance their liabilities, which could lead to bankruptcies and accelerated reductions in capacity, contributing to the longer-term health of the industry for surviving companies.

## Performance Analysis & Opinion

There is no way to deny that the fund's performance over the last several months and trailing year has certainly been underwhelming. Just like every other investor, we struggle against recency bias; one way to avoid overemphasizing the most recent performance is to put it in a broader context. Depending on which index one chooses to look at, through November, the performance of event-driven hedge funds ranges from mediocre to very disappointing; reported performance across different indexes shows a range from low single-digit positive returns to low single-digit negative returns. The variance in reported returns is significant, and we note as always one should not place much weight on the accuracy of hedge fund index returns. However, the commonality across these reported results is that they did not deliver the type of performance the investor community expected coming into the year. There have also been dramatic

reported losses by some prominent event-driven hedge funds that dwarf the mediocre returns experienced by the broader indexes (concentrated in October, but with at least one well-known fund suffering year-to-date losses well into double digits). Against this backdrop, the fund's modest decline of 0.8% through the end of November is reasonable, though of course unsatisfying.

The fund's longer-term returns are in line with (although at the low end of) our expectations given the relatively short track record, the resulting high end-point sensitivity, and the continuing shift to more equity special situations and credit investments in the fund. Through November 30, 2014, the fund has produced an annualized performance of almost 3% since inception, obviously having been dragged down by the last year's results. This trails the HFRI Event-Driven Index's return of 5.7%, as we would expect in a period of generally rising prices, given that some, if not most, hedge funds in that index use leverage. The fund's volatility has been lower than that of the index, whether using monthly (4.1% versus 5.1%) or rolling 12-month (2.4% versus 6.1%) returns. We expect this type of return pattern, with the fund trailing the hedge fund index during strong periods of market performance, while outperforming in difficult markets, with lower volatility throughout. However, over time we expect the fund's absolute returns to be higher, hopefully in line with its stated goal of 500–800 basis points over cash.

Contextualizing performance can be a slippery slope, and we are conscious of not allowing it to morph into an exercise in excuse-making. We have had a number of detailed conversations with various members of the investment team in recent months to understand and challenge the investment thesis and decision-making process behind various positions, as well as the capital allocation across strategies. While it is always possible to second-guess specific decisions with the benefit of hindsight, our discussions largely confirmed our existing investment thesis on the fund, despite its weak short-term performance. Evaluating a fund, particularly an alternative investment strategy that can allocate across several sub-strategies, is by nature an inexact science. We are mindful that idiosyncratic losses happen to even the best managers, and when they occur in concert with a period of distinct negative performance for one of the strategy's major return drivers (the "beta" or "alternative risk premium" of merger arbitrage), results are likely to disappoint. The period (several quarters or so) after a significant drawdown is in some ways a "show me" time for the strategy. All else being equal, we expect performance to rebound because spreads on merger deals widened significantly, setting the stage for higher annualized returns on the deals that do close. Additionally, risk premia have widened across the board in the event-driven space, creating more attractive entry points. We have seen this pattern previously in the fund's history, and we believe it should repeat this time as well.

We will of course be watching to see how events unfold going forward in order to ensure that our continued confidence is warranted. Evidence of a lack of investment discipline, consistent position-level analytical mistakes, or sloppy portfolio management would of course make us re-evaluate our thesis on the fund. One area we continue to pay close attention to is the effectiveness of the fund's hedging, as the perpetual balance between cost and basis risk (less than perfect correlation between the underlying long position and its hedge) has been particularly challenging to achieve this year. In addition to the obvious problem of looking bad by comparison when traditional equities are up, event-driven strategies often suffer disproportionately during position- or thematically driven hedge fund de-risking periods because their long positions drop while the market and industry hedges rise, causing losses on both sides of the book.

One of the cited benefits of alternative investment strategies is that they reduce correlation with long-only assets in an investor's portfolio, but low correlation can cut both ways and be painful in a

**Performance Table**

| | | Calendar Year Returns | | | Trailing Returns[a] | | |
|---|---|---|---|---|---|---|---|
| | YTD thru 11/30/14 | 2013 | 2012 | 2011 | 1-Yr | 3-Yr | Since Inception |
| Arbitrage Event-Driven Fund | -0.78% | 5.68% | 1.99% | 3.49% | -0.37% | 2.33% | 2.89% |
| HFRI Event-Driven Index | 1.53% | 12.51% | 8.89% | -3.30% | 2.74% | 7.47% | 5.73% |

[a]*Compound annual returns through 11/30/14. Inception Oct-2010.*

time when equities continue to march steadily higher, as has been the case this year. We encourage investors to remain patient and remember the role in a portfolio for alternative investments like Arbitrage Event-Driven Fund. The factors that initially drew us to the fund, namely an experienced team with complementary skill sets, strong risk management, and flexible capital allocation, remain in place. Despite the underwhelming recent performance, we continue to rate the fund *Approved* and expect better days ahead.

*–Jason Steuerwalt, CFA*

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## DEFINITIONS

*M&A:* mergers and acquisitions; *REIT:* real estate investment trust; *Beta:* a measure of the volatility of a portfolio in relation to the market as a whole, indicating the tendency of a portfolio to respond to swings in the market; *Basis point:* a unit that is equal to 1/100th of 1%; *Risk-off:* refers to an investment setting in which there is pessimism in the market, and investors thus tend to gravitate toward lower-risk investments.

## IMPORTANT INFORMATION

The Arbitrage Event-Driven Fund seeks to achieve capital growth.

Holdings and portfolio exposure are subject to change.

**Performance through 12/31/14 for Arbitrage Event-Driven Fund: AEDFX (R class), -1.69% (one year), 1.79% (three year), 2.42% (since inception 10/1/10); AEDNX (I class), -1.54% (one year), 2.00% (three year), 2.65% (since inception 10/1/10); AEFCX (C class), -2.41% (one year), 1.33% (since inception 5/31/12); AGEAX (A class), -1.80% (one year), 1.40% (since inception 5/31/13).** Performance through 12/31/14 for Barclays US Aggregate Index: 5.97% (one year), 2.66% (three year), 3.38% (since Arbitrage Event-Driven inception 10/1/10). 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. Total Annual Fund Operating Expenses for AEDFX, AEDNX, AEFCX, and AGEAX (excluding sales charge) are 2.36%, 2.11%, 3.11%, and 2.36% 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 August 31, 2016. Class A shares have a maximum front-end sales charge of **3.25%**.*

**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 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 commentary contains certain forward-looking statements. We use words such as "expects", "anticipates", "believes", "estimates", "forecasts", and similar expressions to identify forward-looking statements. Such forward-looking statements involve known and unknown risks, uncertainties and other factors, which may cause the actual results to differ materially, and/or substantially from any future results, performance or achievements expressed or implied by those projected in the forward-looking statements for any reason.

Top ten holdings as of 12/31/14: TriQuint Semiconductor Inc; Allergan Inc., Covidien PLC, Tokyo Electron Ltd; DIRECTV; Protective Life Corp., Safeway Inc., American Realty Capital Healthcare Trust Inc; Family Dollar Stores Inc., Covance Inc. Top ten holdings represent 32.0% of the portfolio. Holdings are subject to change. Current and future holdings are subject to risk.

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. Indexes are unmanaged and one cannot invest directly in an index.

Material represents the author's opinion and should not be regarded as investment advice or a recommendation of any security or strategy.

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