

ACT II NEW MEDIA FUND



Commentary - March 2011

Focus • Risk Management • Integrity

	1 mo	3 mons	6 mons	YTD	1 yr*	3 yr*	Ann. ITD	Cum. ITD
Act II New Media Fund ¹	1.3%	4.4%	10.8%	4.4%	8.7%	8.1%	7.0%	24.7%
Nasdaq (CAD)	(0.2%)	2.6%	11.3%	2.6%	11.2%	4.9%	1.0%	3.2%

¹ Unless otherwise stipulated returns are net of all fees, in Canadian dollars, reflect class "A" units and assume reinvestment of all distributions. This document is not to be construed as a public offering of securities in any jurisdiction in Canada. The offering of units of the Fund is made pursuant to the Offering Memorandum only to those investors in all jurisdictions of Canada who meet certain eligibility of minimum purchase requirements. Important information about Arrow Funds, including statement of each fund's fundamental investment objective, is contained in their respective offering memorandum, a copy of which may be obtained from Arrow Hedge Partners Inc. Please read the applicable offering memorandum carefully before investing. The information and materials in this document are for informational purposes only. They are not intended as investment, financial or other advice. The information included in this document is not an offer to sell. While the information and material in this document are believed to be accurate at the time they are prepared, Arrow Hedge Partners Inc. (and its affiliates, subsidiaries or sub-advisors) cannot give any assurance that they are accurate, complete or current at all times. Past returns are not necessarily indicative of future performance. Actual results will vary. This document is confidential and is intended solely for the information of the person to which it has been delivered.

* Returns are annualized.

Act II New Media Fund had a good month in March, especially given the market's big swings. For the month, we showed a net gain of 1.3% compared to basically a flat performance for the S&P 500 and a small decline for the NASDAQ. Year-to-date, we are up 4.4%, net of fees, while the S&P and the NASDAQ are up 5.9%[^] and 4.8%[^], respectively. Figures are depicted in the accompanying table.

The combination of global events, particularly the Japanese earthquake and the Libyan uprising, caused a 7% correction in mid-March, pulling the markets briefly into negative territory for the year, before rebounding most of the way back. A 28% rally from August preceded the dip and certainly aggravated the reaction, but it appears to be onward and upward again, as the continuing rebound in the U.S. economy has once again trumped the international news. The domestic recovery seems intact, despite some concerns over the price of oil and other commodities, with signs of continuing momentum on most fronts, excluding housing. Consumer confidence readings were set back some recently, but that appears to be mostly tied to the international news and gasoline prices, looking at the timing of the surveys.

There are still some worries out there, which are mostly international. They include concern over the debt situation in some European countries, the volatile Middle East and North Africa political situation, and the ramifications of the earthquake in Japan on production and supplies of vital components. Domestically, the approaching end of the Federal stimulus known as QE2 is an overhang, as is the status of the Federal budget. Jobs are recovering, but not at a fast pace. So far the increase in energy and food prices has not caused economists to meaningfully mark down GDP or profit forecasts, or to mark up inflation expectations, but those are risks as well.

Money continues to move from bonds into stocks, which is one of the major propellants of the market. Corporate balance sheets are

in excellent condition, with the highest cash balances in years, and debt that has been refinanced at record low rates, with maturities extended. Tech companies have 28% of their assets in cash. Apple and Google alone have a combined \$90 billion in the bank earning meager returns. With all that corporate liquidity we are seeing a pickup in share repurchases, dividend increases, and M&A, adding to the upward pressure on stock prices.

From a valuation standpoint, with S&P 500 earnings estimates still averaging about \$95 per share this year, and \$100 plus for 2012, the market's multiples remain at reasonable levels of 14 times, and a little over 13 times, respectively. This compares to historic averages of 15 times or better. The inability to predict with any confidence the outcome of the political situation in the Middle East and North Africa, and the still unclear ramifications of the earthquake in Japan will likely keep multiples down for a while, even though interest rates remain low and the domestic economy is chugging along. First quarter earnings will start getting reported in a couple of weeks, and that may be the push needed for stocks to break through again, assuming profits corroborate what the economic indicators are suggesting.

At March 31, our top five holdings were Comcast, Signet, Manpower, Time Warner Inc. and Apple. Comcast has completed the acquisition of its half of the NBC Universal joint venture with GE, and the discount from that overhang is ending. NBC's results are also far ahead of what was projected when the deal was announced. Meanwhile reported numbers for the company and the cable industry are beating expectations. Signet, the most successful U.S. specialty jewelry store chain, is gaining market share at a time that consumers are moving further upscale after the long recession. Manpower continues to be a bet that the upturn in the use of temporary help is not just cyclical, but secular, as well. Time Warner remains relatively cheap among the entertainment conglomerates despite well above average growth in

[^] Indices are denoted in US dollars.

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earnings and cash flow, and with an aggressive return of capital to shareholders. We also continue to bet, as described below, that some of the “over the top” competitors will prove to be net contributors to profits rather than a negative, as the unquenchable demand for content and competitive bids by new entrants for what Time Warner and others have to offer, offset any significant threat to the cable network business. Finally, Apple continues to exceed expectations on nearly all fronts, yet it sells at a below market multiple when excluding its large cash hoard. Given its visibility and growth rate, compared to its valuation, we believe it should regain a premium, despite the uncertainty over the CEO’s health.

As one can see, our top holdings represent a variety of industries, which we attempt to balance in order to diversify our risk of unfavorable developments in any one sector. At the end of the quarter, our gross and net exposure was 160% and 65%, respectively. We continue to bet on the economic recovery and reasonable valuations.

We are pleased to announce the launch of our UCITS fund, the Act II Specialist Equities Fund, as of April 1st, with initial investments of approximately \$50 million. UCITS is a vehicle, primarily used by international investors, which has a regulatory structure that gives them more comfort and transparency when investing with U.S. hedge fund managers. The new fund will be run pari-passu with our U.S. and offshore funds. The UCITS structure will allow us to strengthen our international client base. The fund was launched in partnership with Luxembourg Financial Group, with shares available in British pound, euro and U.S. dollar share classes.

SPOTLIGHT ON: NETFLIX—THE BULLS VERSUS THE BEARS

There is probably no single stock that has drawn more attention and notoriety over the past year than Netflix, with both ardent supporters and committed detractors. In 2010, the stock more than tripled from \$55 to \$175 per share and was the biggest winner in the S&P for the year. In a rare display of point/counterpoint, the stock’s most prominent short seller, Whitney Tilson of T2 Partners, wrote a very long letter, which was published December 16, 2010, explaining his bearish rationale to the company’s CEO, Reed Hastings, with whom he shared an interest in a charitable trust. Mr. Hastings promptly wrote back an equally lengthy explanation of why he thought Mr. Tilson was wrong. Adding to the intrigue, the shares of Netflix jumped from \$178 per share, the day of the letter, to \$222 by February 11, when Mr. Tilson conceded defeat and covered his short. At that time, he wrote another letter explaining why he gave up. While the stock ran up to a new high of \$247 three days later, it then fell 24% from that level. However, in the last three weeks it has recouped most of that decline on the back of more content deals, as well as from short covering. Mr. Tilson continues to say that while he

wouldn’t short the stock, he wouldn’t buy it either.

We wouldn’t ordinarily write a piece about a single stock, especially one that we neither own nor are short, but this one is unique, because there are valid arguments on both sides of the equation. The answers have important ramifications to the whole media and entertainment infrastructure as well, an area in which we do have numerous holdings. We wrote in our September, 2010 letter that we thought the publicity about “over the top” competitors had gone too far in scaring cable and entertainment company investors. We felt that fears of cannibalization were grossly exaggerated, not because Netflix wasn’t a well run company with an impressive story, but because we believe that service is mostly complementary. The shortfall in cable industry units coincided with a high ticket Netflix deal to show first run movies from Epix, the new pay service from Paramount, MGM and Lion’s Gate. This caused both the run-up in Netflix shares and the decline in MSO/studio stocks. However, we believe the impact of the recession on lower tier subscribers, not cord cutting, was the reason for the cable slide. The announcement of its streaming only service for \$7.99 a month, in addition to the Epix deal and strong subscriber and financial numbers, were the main propellants of Netflix shares in 2010.

Since that time, there have been a number of developments that have raised some concerns over Netflix, while the cable and entertainment companies reported better than expected year end numbers, causing a rebound in the latter shares. The cable/entertainment stocks have outperformed this year. So have Netflix’s, and by even more, although they have been on a roller coaster ride, with that 24% fall in March on some competitive developments followed by a 26% rebound. Netflix shares continue to command a very high multiple, as well as a very high short interest, proving that the controversy has hardly died down.

The Bull Case

So what are the facts and arguments? We’ll start with the bulls. Netflix offers a very attractive service at a very affordable price, which is available on virtually all devices, and the company has the growing buying power to increase its competitive edge. Its enormous growth in subscribers will continue both domestically, and internationally where the company is at the tip of the iceberg in penetration. In the U.S., the company uses its hometown Bay Area as a proxy for its potential. Penetration there is 28%, or double Netflix’s 14% national average. In the fourth quarter of 2010, subscriber growth accelerated for the seventh quarter in a row to 63%, and first quarter guidance is for net gains of between 62% and 70%. In his year end shareholder letter, Mr. Hastings notes that at the beginning of last year, the company’s best estimate of subscriber net additions in 2010 was 3.6 million, and the actual increase was 7.7 million. For this reason, the

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company has ceased giving annual subscriber guidance.

The company also has pricing power in reserve which it will utilize once the shift from mail delivery of physical discs to streaming is further along, as well as the ability to raise ARPU via an extension of subscriptions from households to individuals using multiple devices. The company has a strong management team and balance sheet and the flexibility to redeploy excess margin into either marketing or content acquisition, enhancing its ability to accelerate its growing competitive advantage. In the fourth quarter of 2010, as an example, the earnings beat in part reflected a significant decline in marketing spend. This flexibility is among the reasons the bulls see margins expanding despite higher content acquisition costs and lower ARPU. Netflix is getting large enough, in fact, that it could possibly negotiate directly with the studios in competition with the traditional pay networks. Its 20 million subscriber base already exceeds that of Showtime and Starz, and the projected 30 million by year-end 2011 will match HBO's. Meanwhile, apart from movies, the company's focus in acquiring new content is on previous seasons of popular television series, which is a very attractive niche because of their "stickiness," due to the satisfaction levels these often have with subscribers. The latest negotiation for prior seasons of AMC's *Mad Men*, which is owned by Lion's Gate, is particularly interesting because the estimated \$1 million per episode price is competitive with, and probably reduces, the show's value in the traditional syndication market.

On the product quality issue, the arguments are basically that the company's rate of growth can absorb the increase in program costs needed to maintain the appeal of what it offers, and that Netflix customers do not care if the content is limited and/or old, because for \$7.99 a month it's a great value regardless of how much is current. That argument will be critical in the negotiations over the early 2012 expiration of the company's contract with Liberty Starz, which handles digital rights to first run movies from Disney and Sony Pictures, as we will discuss later. Meanwhile, Netflix continues its breakneck pace of acquisitions with a recent agreement with Epix member Paramount (Viacom) for first run movies on its Canadian service, and an enlarged portfolio of shows from News Corporation's Fox. Netflix is also reportedly negotiating for the large library held by Miramax and the Lion's Gate deal for *Mad Men*.

While ARPUs are declining because of the deliberate attempt to shift subscribers to the streaming only service, Netflix has the ability to raise prices for that tier, once it is comfortable that a majority of its customers have done whatever downshifting to that level of service it expects them to do. A \$1 price increase on what may be 30 million plus subscribers at the end of this year is \$300 million which would add significantly to the current program acquisition kitty of slightly over \$1 billion. Further, Netflix has been considering family plans, to exploit its broadening connected devices subscriber base. Like cell

phone companies or Sirius/XM, an additional fee would be charged for the right of family members to view Netflix content at the same time on different devices. This would be a virtually no cost way to raise prices. Meanwhile, the margins on streaming are substantially higher than on disc delivery, given the absence of postage, paper, and related costs. This is offsetting the impact of the declining ARPU from the trade-down to the digital-only service. Last year, Netflix spent almost as much on delivery of physical DVDs as it did on content acquisition. Since the company only initiated the \$7.99 service streaming in November, the cost benefits of the switch from mail delivery are mostly yet to be realized.

A new development is the recent revelation that the company has licensed 26 episodes of a new show, "House of Cards," directed by Social Network director David Fincher and actor Kevin Spacey, based on a former hit British television series. Netflix's commitment was made without a pilot and is believed to entail at least a \$100 million investment given the cost of prime time programming and the number of episodes. While this is a daring move in one sense, given the failure rate of television shows, its success could change the perception of the service, assuming more such shows are acquired. HBO, Showtime, AMC and other cable networks depend heavily on brand awareness from the relatively few hours of original programming they broadcast, rather than just the movie deals that make up most of their broadcast hours. Starz, too, has seen a lift in subscribers with only a couple of original series. With Netflix's ability to promote its original content, the image of the service as consisting of only old content with some newer films thrown in could change. The company has the ability to widely promote the new show not only through advertising, but via its powerful recommendation engine.

Competitively, Netflix is more broadly distributed on non-television Internet connected devices than any other service, including a prominent placement on Apple's products. The remotes for several Blu Ray Players and Internet connected televisions will soon have separate buttons with the red Netflix logo which will make it even easier to access and promote the service.

Netflix entered its first non-U.S. market—Canada—late last year, with a streaming only service, and results have exceeded expectations, with 8% penetration after only a few months. The company is expected to broaden its international footprint soon, which will open the prospect of replicating its formula in many other countries, giving it the visibility of many more years of rapid growth. Netflix expects to open a second market this year, and budgets \$50 million in international start-up losses in the second half. In a recent report, Credit Suisse sees an international addressable market of 167 million versus the 267 million potential in the U.S. and Canada, as a result of which it projects a 16% compound rate of growth in subscribers to 69 million in five years, from an estimated 33 million by

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year end 2011. Amazon's acquisition of Love Films, a similar service in Europe, appeared to set back Netflix prospects there, while at the same time raising concerns about Amazon as a competitor. There has been speculation that Netflix's second international market will be Brazil instead, one of the fastest growing economies.

From a financial standpoint, the company also noted in its year-end press release that historically it has used free cash flow to repurchase stock, and that, after a break to "reassess our cash needs" in the fourth quarter, it intended to return to the market in the first quarter. While the company does not want to leverage itself, it appears intent on continuing to use free cash flow for share repurchases and states that "we are neither price sensitive nor market timers."

The Bear Case

As to the bears, the primary arguments are rising competition, escalating program costs, and valuation. Contributing to the March pullback were announcements by Amazon and Facebook, among others, that they would compete in this space. Additionally, new deals, including a two-year one for an estimated \$200 million for old CBS content whose economic value had already exhausted in the syndication market, raised questions on the cost side. Most importantly, Netflix's previously mentioned contract with Liberty Starz, which expires in the first quarter of next year, is likely to escalate by multiples of the original cost of \$25-30 million a year, and under more restrictive conditions. New films from both Disney and Sony Pictures via the Starz deal probably represent a quarter to one-third of Netflix subscribers' viewing time, so it would be difficult not to have them, whatever the cost. The company will, however, now have product from the Epix group, although it is a weaker group of studios.

Meanwhile, the sellers of content are waking up to the threat of Netflix to their traditional business models, and being more careful of what, and under what terms, they sell to the company. In effect, they are restructuring their windows by pushing back the timing of the availability of content to Netflix while trying to get their more traditional clients to pay more for priority access. This follows the 28-day windows imposed last year on both Netflix and Coinstar's Red Box kiosks after the initial DVD window, while allowing day and date broadcast on cable/DBS/telco video-on-demand channels, in an attempt to protect the declining DVD sales market.

The studios are also promoting the so-called TV Everywhere concept whereby their cable, satellite and telco video affiliates would permit subscribers free access to content outside the home television set as long as they were authenticated pay television subscribers. This effort might dampen consumer desire to pay extra for Netflix. While Netflix has been busy acquiring content, it still has rights to only 30,000 titles for streaming, or about one-fifth what it has for DVDs, and its growth is limited by the number of Internet connected devices. Additionally,

bears point out that some of Netflix's growth has come from the demise of the bricks and mortar video store, with the bankruptcies of both Blockbuster and Hollywood Video, which won't provide the market share gains it has in the past.

ARPU has been coming down because of the ability to receive streaming only for \$7.99 a month or streaming and one DVD for \$9.99. Formerly, the price for one to four discs out at a time ranged from \$8.99 to \$23.99 a month. The new streaming only plan went into effect in November at which time the low end one disc out plan, which includes streaming, went up to the \$9.99 price point. For 2009, ARPU per paying subscriber (initially there is a free trial period) was \$13.30. It dropped to \$11.64 in last year's fourth quarter but averaged \$12.19 for the year. ARPU so far has been down less than some expected, but the bearish view is that this is because of inaction or ignorance by those paying the higher price, and that it will pick up steam as customers realize the opportunity to cut their bills.

On the international front, not only has Amazon potentially preempted a near-term European move, but in Canada the cable companies have imposed usage based pricing, which has prompted substantial compression of the Netflix video signal in that country. The company, however, states that the subscribers' experience continues to be satisfactory. In the United States, AT&T recently became the first multichannel video operator to impose caps on the wireline side, and the cable companies and Verizon are seen as likely to follow. Video is the most bandwidth consuming product on the Internet, and Netflix is the number one video provider.

On the programming front, as already noted, there is growing evidence that program suppliers are being more careful about what they sell to Netflix and other on-line distributors and when. The lion's share of post theatrical profits comes from sales of DVDs, which are declining, and then deals with cable networks and broadcasters, in the DVD, first run, or syndication windows. In the case of cable networks, almost half their income is from subscriber fees paid by cable operators, and the other half from advertising. Advertising revenues in particular could be jeopardized if ratings declined because the same shows were available at the same time on a \$7.99 monthly streaming service from Netflix as on an expensive cable tier.

The same situation would be true of the prices broadcast stations and cable networks are willing to pay for syndication rights to off network or cable original shows. Stations and cable networks could begin demanding exclusivity for such rights against competitors like Netflix. Since syndication product is normally licensed over several cycles, the availability of such programming could be tied up for years before Netflix and similar distributors got it. Lion's Gate obviously concluded it was worth the risk.

Notwithstanding that deal, while Netflix may have the money to

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spend on more and better content, it doesn't mean the product will be available. Both Disney and CBS have indicated that Netflix was willing to buy more of their library than either was willing to sell them. And there is a lot more left to sell. CBS has said its Netflix deal accounted for only 7% of its content. The network appears to be holding back additional shows Netflix wanted, in order to see if it can attract competitive bids, probably from Amazon. Most importantly, HBO, which controls digital rights for parent Time Warner's Warner Bros., as well as News Corporation's Fox and Comcast's Universal Studios, will not sell digital rights to Netflix at all. HBO rights encompass half the output of Hollywood and have several years to run.

In addition to withholding product, suppliers are delaying the availability of content to Netflix. Specifically, CBS's Showtime pulled past seasons of some of its current television series from the Netflix streaming service, although it is keeping those that are no longer on the air available. Newer series will be offered on Showtime's own Anytime service (a TV Everywhere model). Starz also recently imposed a new 90-day delay on its original content to Netflix just as a new original show, Camelot, was set to debut. Starz also promises to delay the release of first-run movies from Disney and Sony to Netflix, which the latter contends the current agreement does not allow. This will obviously be a point of contention in upcoming negotiations. Additionally, Disney recently pushed back the availability of Disney Channel and ABC Television shows to Netflix until after their respective seasons end. Increasingly it appears that what the studios and pay services are trying to do is make content available first on authenticated devices to their primary clients, while holding back the availability of product to Netflix to some later date. This was not the case until recently when the content suppliers began to recognize both the potential revenue source Netflix represented, but also the threat they perceived it could be.

The big showdown will be the upcoming Starz deal. It is widely acknowledged that the pay network made a terrible mistake in giving Netflix streaming rights it controlled from its two major studio partners for a reported \$25 to \$30 million a year, or \$0.15 a month compared to the \$2.00 to \$4.00 a month that cable and satellite operators pay for the Starz premium channel. The value of streaming was underappreciated at the time, which is the reason Netflix got a bargain, and perhaps why Starz later changed management. The price for a new deal is expected to jump to \$150 to \$200 million annually. This is similar to the \$200 million annual fee the company is estimated to have paid Epix for product from a lesser group of studios. That deal is exclusive for digital streaming, but titles are only available on a delayed basis in the pay television window.

The question is not only how much more Netflix will have to pay Starz, but under what terms they will get access to Disney and Sony Pictures' first run product. The amount and timing of such releases may be

more limited than they are now. Some have speculated that those studios will demand that Starz limit their full output only to higher tiers than the \$7.99 streaming service. Payments may also be variable with subscriber growth this time, rather than the attractive flat fee structure Netflix has with Starz now. The 90-day delayed window just imposed in the current deal is likely to be replicated in the new one, as the content providers favor TV Everywhere authentication for the first window, in a political nod to their current major revenue providers. As other deals come up for renewal, there is the certainty that prices will escalate because of Netflix's growing subscriber base and pocketbook, and there may also begin to be competitive bidders like Amazon, Apple, Google or Hulu.

From a financial standpoint, it all boils down to whether Netflix revenues will grow faster than its costs. The bulls think so, but the bears point out that just a Starz deal alone at an incremental \$175 million a year would raise programming costs by one-third what the company paid out for all content last year. That percentage would drop to under 20% of this year's budget, however, which may be a more relevant base since the deal will not be renewed until 2012. Add that to the recent deals with CBS, Disney, Fox and Lion's Gate, however, and one can see the risk of margin compression at anything less than, or as a tradeoff for continued rapid subscriber growth.

Including Starz, these five deals might aggregate to a figure equal to consensus expected EBITDA of \$515 million this year. Looking at it from another perspective, content acquisition costs are likely to rise by \$700 million this year to about \$1.3 billion. Gross margins are expected to decline this year, but the shift to streaming and a drop in marketing costs as a percentage of revenues accounts for a predicted increase in overall operating margins as per company guidance. The escalation in content purchased last year caused a decline in the conversion rate of Netflix's EBITDA to free cash flow, another aspect of the same issue. We would caution that it is difficult to match the timing of cash payments with the amortization of product costs. Mr. Hastings believes this will even out over time, and that free cash flow will grow in line with profits.

On the competitive front, on February 22, 2011, Amazon followed its European acquisition by announcing a free video streaming service to its Prime subscribers who pay \$79 a year to get free shipping services. Comparing the cost of Netflix streaming to the \$79 minimum to qualify for Prime status puts the latter at a slightly lower price (\$6.58 a month versus \$7.99), although at this point Amazon has not acquired streaming rights to nearly as much catalog as Netflix (5,000 titles versus 30,000). However, Amazon certainly has the buying power to go much further in the acquisition of content if it chooses to.

Prior to this, Netflix's competition has largely been among offerings

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like Apple TV or Amazon's video on demand platform, rather than from a subscription service. The major exception is studio owned Hulu Plus, which began a paid service for first run films and earlier windows for television series last November. This supplements its ad supported free site for streaming of current television shows. Hulu Plus is priced similarly to Netflix at \$7.99 a month, but has earlier availability of television and movie content. The latest competitive twist has been a new Warner Bros. deal with Facebook. The studio announced on March 8th that some of its movies will be available for a two-day rental for \$3.00 using Facebook credits. This announcement was one of the biggest factors behind the stock pullback last month, following the impact of the Amazon Prime report. The Facebook deal with Warner Bros. is still a test, however, and it is still a la carte.

A more speculative question is whether the pay television operators themselves would try to compete with Netflix, by offering a similar product on a subscription basis. Cable and satellite companies already have rights to substantial library material, which they generally offer on a free video-on-demand tier. Interestingly, at an analysts meeting in February, when asked which competitor he would fear the most, Mr. Hastings said it wasn't Amazon, Apple, Google, Red Box, or Hulu. It was Comcast.

It would not be a stretch to see Comcast, adding to those rights additional catalog similar to what Netflix has acquired, spending a couple hundred million dollars. This could comprise the basis for a competitive service, yet still not be a budget stretcher in the context of Comcast overall. If it was primarily a library service, Comcast could offer it cheaply as a package, or even for free, as it does with much of its video-on-demand product. That would not cannibalize the company's existing revenue generating video on demand service. With authentication rights and the cooperation of others on the content end, Comcast might even be able to take it a step further and offer a superior service to Netflix, with both equal or better library material and new movies the latter doesn't have, perhaps as part of an industry consortium. Comcast owns Universal Pictures now, and that studio's contract with HBO expires at about the same time the Starz deal does with Disney.

DirecTV, the second largest pay network, with 20 million subscribers, is another potential bidder for library material, and it has been acquiring content and promoting the availability of 6000 titles in the pitch for its new Internet connected video-on-demand service. Other possibilities include the expansion of the HBO Go service beyond the TV Everywhere concept to a standalone offering, or a stepped up pay offering by Hulu Plus, which will probably continue to be favored with newer seasons of television series than Netflix in upcoming negotiations, given its ownership.

Conclusion

Netflix is a unique story. It has created a powerful and enormously successful ecosystem that is becoming a virtuous cycle of subscriber growth funding ever better content, leading to even more subscriber growth. It has also been farsighted in prompting streaming, which was inevitable and competitive, at the expense of its much more proprietary DVD by mail system. Obviously, there are a number of scenarios one could envision that could disrupt the Netflix business model. At the other extreme is the idea of someone buying Netflix, which is not out of the question either, especially if the far sighted Mr. Hastings sees a slowdown coming from competitive forces. The most logical partner is clearly Amazon, a competitor which has not only the motive and the money, but the only one that also has the multiple.

From the standpoint of the studios and broadcast networks all this is good news, as long as it doesn't jeopardize their traditional income streams. The suppliers are trying to make one and one equal more than two through windowing. A Morgan Stanley report estimates that rental revenue to Hollywood from Netflix will jump 50% this year in line with the company's growth, both offsetting and overtaking income from the declining bricks and mortar store business. Netflix will represent 30% of the video rental dollar marketplace this year, according to that report.

Despite that, shares of the entertainment conglomerates initially reacted negatively when the Epix deal was announced, because the parent companies—Time Warner, Disney, News Corporation (Fox) and Viacom (Paramount)—are more dependent on their cable networks than on their film and television production operations. One of the reasons those stocks have rebounded substantially since is the growing recognition that Netflix and other "over the top" competitors are more likely to represent a new window and source of funds, net of any disintermediation of their existing business models, especially if newer players begin competing with each other for content.

The fear that Netflix's growing buying power will hurt the pay television networks and distributors by outbidding them for content is exaggerated, in our opinion, because that does not square with Netflix's own business model, and the company doesn't really need to take on the conventional markets to succeed. To quote Mr. Hastings, in his response to Mr. Tilson's letter, "we have no intention of overspending relative to our margin structure, and there is no specific content that we must have at nearly any cost!". . . "So if content costs rose faster than we expected, then in practice we'd have less content than otherwise, rather than less margin." While admitting this could crimp subscriber growth over what it could be, he went on to conclude that "Management at Netflix largely controls margins, but not growth."

As to the shares of Netflix, one of the reasons that Mr. Tilson folded his bearish bet is that he conceded Mr. Hastings' point that you don't short a stock when the company is still in the early stages of the "S Curve." That is probably the best argument for not shorting it now. Interestingly,

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several of Mr. Hastings' rebuttal points focused only on the next year. Near-term guidance is very strong and likely to be exceeded once again. Taking the \$4.50 consensus EPS forecast for 2011, a 50% increase from 2010, shares are at 53 times those expectations, although that multiple drops to 37 times the \$6.50 midpoint of analysts' numbers for 2012. Obviously these are significant premiums to a market at 14 and 13 times 2011 and 2012 estimates, respectively, requiring the kind of growth rate the bulls see, and for more than just the next year or so. Forecasts for 40% plus subscriber, revenue and profit growth this year place the multiple in context, and one could argue the premium to growth is not excessive. Netflix is in rarefied company with other stocks one dare not have shorted recently, like Amazon and Open Table, within our universe. The answer to the question of whether subscriber growth can accommodate escalating program costs and increased competition may not be knowable for the near or even the medium term future. In our opinion, the risk is probably more the competitive one than the margin issue. At this point, we would not bet against the stock, especially with a likely very strong first quarter about to be reported, but like Mr. Tilson, at the current valuation, we would hesitate to be buyers either despite the impressive fundamentals. With another 24% pullback, however, who knows?

Thank you for your continued interest in the Fund. For further information, please contact your regional Arrow Hedge representative.