

SOME HEDGE FUNDS DO HEDGE

It's time for more advisors to employ alternative strategies in asset allocation.

By Mark Purdy and Keith Tomlinson



We're thinking of changing our name: taking the "Hedge" out of Arrow Hedge Partners. After all, so much of the world hates hedge funds. Hedge funds have become a scapegoat for all the world's woes, from Greece's problems to the subprime mortgage crisis.

Or perhaps we should just keep it simple and add the letter "d," so Arrow Hedge Partners could become Arrow Hedged Partners. After all, investors may dislike hedge funds, but they all want hedge strategies. It's a given that any portfolio manager in his or her right mind would choose a long/short strategy over a long-only commitment. And "hedged" does in fact describe our portfolio. We do what hedge funds were invented to do: preserve wealth and grow capital.

So why all the animosity against hedge funds? The problem with investors' perception of the hedge fund industry can't be the performance. The returns for the industry in aggregate have been stellar. Let's get that out of the way right now.

The problem, as we see it, is one of classification. It seems that whenever something in the market goes wrong (and yes, things can go awry), the entire hedge fund industry gets tarred and feathered. At a recent conference that we attended, the moderator turned to the audience and asked its preference: gold, real estate, equities or hedge funds? Only a handful said hedge funds. Maybe they were the few who avoided Madoff, Amaranth or Norshield.

We found that exchange very strange, not so much for the answer but for the question. That's because we don't actually think of the hedge fund industry as an asset class. We see it as a strategy class. Comparing hedge funds to equities, real estate or gold is like comparing a

chef to chicken, mushrooms and garlic. The irony is that by dismissing hedge funds, these investors are implicitly saying they want to be the only cook in the kitchen, reducing their diversification and increasing their risk.

The only thing that hedge funds have in common is the freedom to choose. Unlike mutual funds, hedge funds can go short, employ leverage and trade multiple asset classes. Of course, their freedom of choice is limited to the investment parameters set out in their offering documents, but they have tremendous flexibility in setting their strategy. Two hedge funds can be as different in strategy as tomatoes and bananas; both are technically fruit, but that doesn't mean they go equally well with pancakes.

And that's where the real problem lies for hedge funds. Understanding the distinctions between hedge fund managers and their strategies is no easy task. It's much easier, if you are a financial advisor, to simply recommend the status quo when it comes to asset allocation.

But what happens when the status quo does not work for you any more? Global equity markets have treaded water now for 10 years, and so-called actively managed funds are proving not so active after all, when it comes to protecting investors from bear markets. Financial advisors' mainstay is mutual funds, a product that studies show to be inferior to passively managed funds. The public's awareness of this fact is growing, with investors increasingly turning away from mutual funds and the advisors who recommend only them. Hastened by the growth in ETFs, the passive market share is soaring. According to Morningstar, passive strategies now represent 22% of all fund assets, compared with just 11% in 2000.





Advisors' allegiance to mutual funds is a function of an asset allocation model that would be amusing if it were not so potentially harmful. This model has simplistically evaluated the past performance of equities and fixed income and determined that risk-tolerant investors should hold more equities, while conservative investors should hold more fixed income. The irony is that the model is completely reliant on historical data, while at the same time the investments themselves are plastered with warnings that past performance is no guarantee of future results.

Perhaps our asset allocation models should look at more than our own past experience when considering our future. Consider Japan, which has seen twenty years of zero interest rates and a stock market that's still 70% lower than its 1989 peak. Is it not worth even considering that the west might be headed into a similar deflationary spiral? Because if that is the case, is it really conservative for retirees to be placing the bulk of their assets in fixed income, let alone equities? It's hard to make ends meet with no investment income.

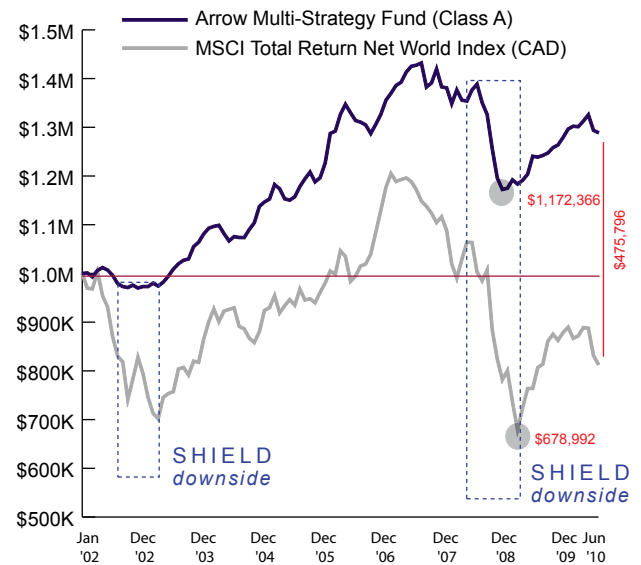
And that's where the other problem lies with traditional asset allocation models: they place far too much emphasis on long-only positions in equities and fixed income, and pay little attention to absolute drawdown risk. Alternative routes like hedge funds are rarely included in recommended asset mixes, and if so, only at the margin.

The data indicate that hedge funds are safer and generate higher risk-adjusted returns than equities. So why don't hedge funds make up a larger portion of the weightings? Perhaps it's complacency. Perhaps it's because hedge funds are not as readily accessible. Or perhaps it's simply because the advisory profession has evolved largely as a sales tool for long-only mutual funds. Whatever the reason, in Canada, the advisory profession is not well educated on hedge funds. Even the Certified Financial Planner certification — the self-described industry gold standard in financial planning — places virtually no emphasis on hedge funds in its curriculum.

We think that if you're going to sell investment advice, you'd better sell advice that works. Hedge funds are not just great bear market investments. To us, a good hedge fund manager is not the guy who's better at calling the market direction. Rather, it's the guy who can employ whichever tool in his toolbox the market most requires who will be able to generate decent returns and manage his risk.

Understanding the distinctions between hedge fund strategies is not easy work. We went to great length in our 2009 fourth-quarter report to explain our approach to hedge fund selection. Modesty aside, we'd place our funds of funds in the ultra-safe category, given our distaste for leverage and our stringent requirements for transparency and liquidity. To illustrate that claim, we thought we would introduce you to a few of the funds we hold in Arrow Multi-Strategy Fund.

CHART 2: ARROW MULTI-STRATEGY FUND GROWTH OF \$1M VS MSCI¹



Source: Pertrac. Arrow Hedge Partners Inc.

ARROW ACT II TMT FUND

Turn on BNN or CNBC and you'll inevitably see a mutual fund manager touting a sector fund, be it gold, financials or technology. But do you really want to invest with a long-only fund manager who has to be in a particular sector? Here's a person who might have years of experience telling him that his industry is about to crash, but because he's long only, he's got to buy. Talk about a misuse of talent.

Moreover, when investing in a stock, there are two issues to consider: the macro environment and the company's unique attributes. The reality is that too many stocks get their performance from the beta of the market, rather than the alpha inherent in the company itself. For instance, bank stocks tend to be driven by macro factors like interest rates and economic growth. Simplistically speaking, at the company level they're either conservative or aggressive: there's no great differentiation otherwise. In the absence of a crisis, share prices move as a group, and making money is more a function of getting the big picture right than of any great understanding of a company.

CHART 3: CANADA'S BIG THREE BANKS' PERFORMANCE



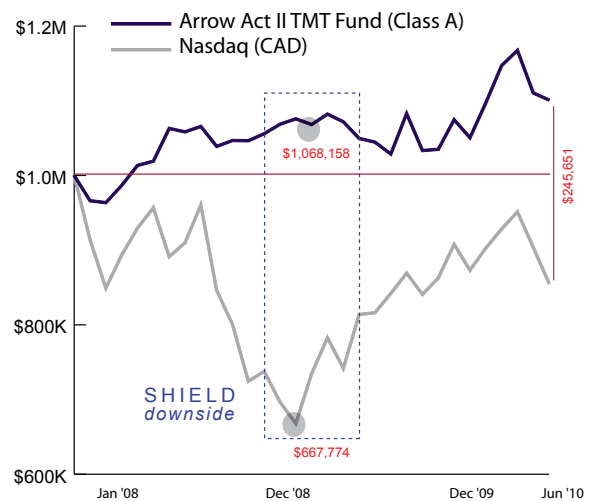
Source: Bloomberg

Technology and new media, on the other hand, is a complex and fast-changing area. The macro environment is important, but a company's own strategy can have an enormous impact — and even change the big picture altogether. A specialist hedge fund manager who understands the intricacies of the businesses and can go long or short can add a lot of alpha to the process. The difference in performance between two well-known mobile players like Apple and RIM makes that abundantly clear.

Founded in 2002, Arrow ACT II TMT Fund (ACT II) is a New York-based fund focusing on TMT: consumer technology, media and telecommunication stocks (including Internet and consumer products and services). It's a typical long/short hedge fund in

structure, but not at all typical in skill set. The fund is headed by Dennis Leibowitz, an investment veteran with 35 years of experience. His eight-man team has tremendous expertise and contacts, and its extensive industry knowledge is endorsed by the fact that many of the Fund's investors are former media executives.

CHART 4: ACT II GROWTH OF \$1M SINCE INCEPTION²



Source: Pertrac. Arrow Hedge Partners Inc.

Nor is ACT II typical in its performance, which has been nothing short of stellar, having made money in both 2008 and 2009. We know that, officially, we're never supposed to say the past can predict the future. But with hedge funds, it's hard to ignore the past, particularly after periods of unprecedented volatility. If you're a mutual fund, you would have simply risen with the recent 2009 rebound, but in the hedge fund community, to make money in both years takes a special kind of talent. The cream has clearly risen to the top in ACT II's case, with a maximum drawdown since inception of -9%, compared with -51% for the S&P 500 Total Return Index. Moreover, the Fund's volatility has been considerably lower than that of the market.

ACT II's approach is very much fundamentally driven. Trades are generated either by distinct themes or by one-off alpha-creating ideas; the Fund team's knowledge of every level of the industry fosters idea generation and gives it a "first move" advantage. Some of the themes ACT II is currently trading on the long side are a rebound in advertising, cable television growth and cloud computing. The Fund uses little leverage (less than one times) and engages it to minimize market risk through its short book. The Fund is typically long, with 30% to 70% net long and short exposure. There are approximately 350 stocks on its coverage list, mainly in the U.S.

AFC CAPITAL FUND

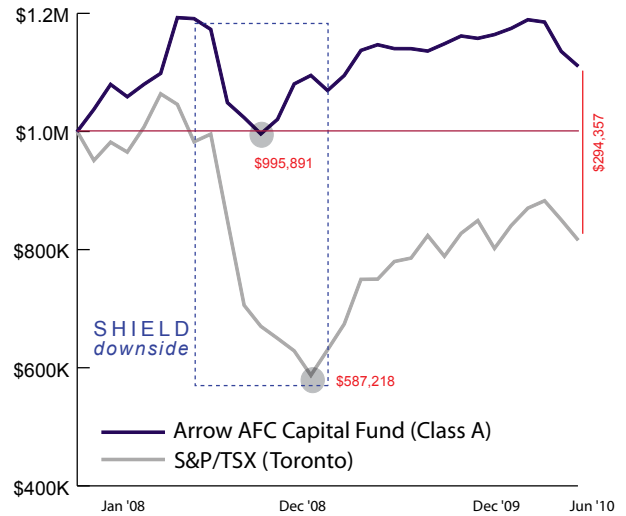
Launched in 2005, Montreal-based AFC Capital Fund (AFC) is a fundamentally driven market-neutral fund that ties itself to one key corporate event: the quarterly earnings release. Its managers look for situations in which companies will beat or miss consensus earnings expectations and trade them accordingly. The Fund minimizes market and sector risk by only pairing longs with shorts in the same industry. It actively trades the pairs, which are typically held for only three months.

The Fund has three fund managers, each with an area of specialty: technology and telecom, industrial products and basic materials. All three have worked in the industries they cover and have considerable investment experience to boot — enough to believe that their own view on earnings outlook is superior to that of the consensus. Investment decisions are based on clear catalysts and timelines and pairs are only initiated when AFC’s earnings estimates significantly vary from the consensus.

Markets normally spend more time rising than falling. Accordingly, it can be difficult to make money in a fundamentally driven market-neutral fund, since you’re removing the beta. Mutual fund managers who are bearish and wrong still make money when the market goes up — simply because they are forced to be long. A market-neutral fund manager, on the other hand, has to be right at least half the time, just to break even. If you invest in this sort of strategy, then you are investing in the belief that these seasoned managers are better than the street at forecasting earnings in companies that they know inside and out. AFC’s performance and distribution of returns indicate a skill level far higher than chance would dictate.

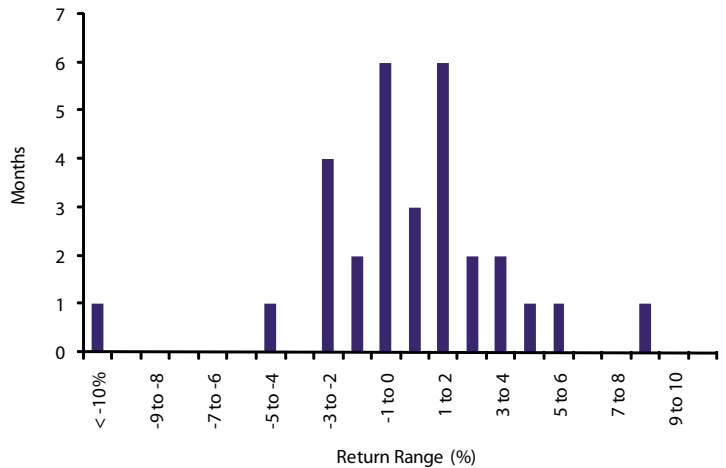
Like all the funds we invest in, AFC uses modest leverage with gross (long plus short) exposure typically at 150–200% of NAV. The main risk to their strategy is that at times of market flux, shorts can rise more than the longs. Moreover, because this Fund typically holds only 30–40 names, there is meaningful concentration risk, if things go wrong. On the other hand, it is this courage of conviction that we seek when we put our trust in an alpha-generating fund like AFC.

CHART 5: GROWTH OF \$1M AND DISTRIBUTION OF RETURNS³



Source: Pertrac. Arrow Hedge Partners Inc.

CHART 6: DISTRIBUTION OF RETURNS³



Source: Pertrac. Arrow Hedge Partners Inc.

ARROW MARRET RESOURCE YIELD FUND

Canada's investment mainstay is the resource sector. For senior resource stocks, getting the big picture right — gold prices, energy prices and metal prices — is the primary concern, and no easy task. For junior companies, understanding project dynamics plays a greater part, as all too often, assets yield a lot less than one would have hoped.

Marret Resource Yield Fund (RYF) seeks to identify opportunities in the resource securities space and take advantage of high-yielding senior securities in a firm's capital structure. That way, if the macro environment collapses or the project underwhelms, at least these securities will be first in the pecking order. The beauty of this strategy is that the higher yields in this fixed-income space can often achieve equity-like returns with the lower risk of a debt holder, especially when warrants are provided with the debt financing.

When it comes to resource companies in Canada, there are many of them, but obtaining financing can be tricky. Banks prefer hard security. Project financing where the security revolves around the success of the project is not a business banks like to engage in. RYF's manager, Barry Allan, has 25 years of experience as a high-yield investor. His team of fixed-income and resource experts know how to structure these sorts of deals to protect an investment. Moreover, they understand these types of businesses: the Fund originates many of its own deals.

Typically, an RYF deal will revolve around a short-dated senior secured note with coupons ranging from 12% to 15%, strong asset coverage, strong project economics and long-dated warrants that provide a nice kicker if the common stock goes up.

As an investment in resources, RYF gives a smoother ride than common stocks, while reducing cyclicality. Typically, 50–60% of the Fund's assets are in secured and senior debt in the resource space, with the rest largely in high-yielding common equity and trusts. Over 80% of the companies the Fund invests in have a market capitalization greater than one billion dollars. The Fund also seeks to arbitrage valuation differentials between various securities in corporate structures. Leverage is limited, with total gross (long plus short) exposure not to exceed 200%. It currently pays out a distribution of \$0.05 a month.

Barry assumed managing the Fund — which was formerly called Arrow Canadian Income Fund and employed a different strategy — in November 2008. We know Barry well, because he has been successfully managing Arrow High Yield Fund for us since August 2004.

TABLE 1: ARROW MULTI-STRATEGY FUND TOP 10 HOLDINGS (%) - MAY 31, 2010¹

Strategy Allocation	ALLOCATION	MARKET EXPOSURE			
		LONG	SHORT	NET	GROSS
Arrow RG Fund Class 'X' Units	5.8	47.2	-29.3	17.9	76.5
Arrow MMCAP Risk Arbitrage Fund Class 'X' Units	5.3	113.6	-52.8	60.8	166.4
Arrow Marret Resources/High Yield Fund Class 'X' Units	5.0	80.8 [^]	-7.2 [^]	73.6 [^]	88.0 [^]
Arrow R Fixed Income Fund Class 'X' Units	4.4	89.4	-46.2	43.2	135.6
Arrow LH Asian Fund Class 'X' Units	4.4	153.1	-47.8	105.4	200.9
Arrow Act II Fund Class 'X' Units	4.0	87.6	-41.5	46.1	129.1
Arrow Risk Arbitrage Fund Class 'X' Units	3.9	98.1	-28.2	69.9	126.3
Arrow AFC Capital Fund Class 'X' Units	3.9	88.8	-84.3	4.6	173.1
Arrow 360 Global Long/Short Fund Class 'X' Units	3.9	73.9	-15.8	58.1	89.7
Arrow Enso Global Fund Class 'X' Units	3.8	98.6	-6.6	92.0	105.2

¹ From January 2002, the returns are for Arrow Multi-Strategy Fund (Class A) net of all fees in Canadian dollars.

² From January 2008, returns are for the Arrow Act II TMT Fund (Class A) net of all fees and in Canadian dollars.

³ From January 2008, returns are for the Arrow AFC Capital Fund (Class A), net of all fees and in Canadian dollars. Exposure to the US dollar is generally hedged, but from January to March 2008 it was not hedged.

[^] Market Exposures are for the Arrow Marret Resource Yield Fund. Allocation percentage is for both the Arrow Marret Resources and Arrow High Yield Funds, which are managed by Barry Allen of Marret Asset Management.

ARROW MAPLE LEAF CANADIAN FUND (CLASS A)⁴

Security Exposure (%) as at May 31, 2010			
	Long	Short	Net
Equities	60.5	-45.4	15.1
Corporate	15.4	0.0	15.4
Warrants/Other	1.6	-2.2	-0.6
TOTAL	77.5	-47.5	29.9

Strategy Exposure (%) as at May 31, 2010	
Global Long / Short	21.6
Relative Value	21.9
Event Driven	36.0
Macro	19.0
Cash & Working Capital	1.5
TOTAL	100.0

ARROW MULTI-STRATEGY FUND (CLASS A)⁴

Security Exposure (%) as at May 31, 2010			
	Long	Short	Net
Equities	47.6	-24.9	22.6
Corporate	22.9	-4.8	18.1
Warrants/Other	1.2	0.0	1.2
TOTAL	71.7	-29.8	41.9

Strategy Exposure (%) as at May 31, 2010	
Global Long / Short	28.7
Relative Value	21.9
Event Driven	27.1
Macro	14.4
Cash & Working Capital	7.9
TOTAL	100.0

ARROW FOCUS FUND (CLASS A)⁴

Security Exposure (%) as at May 31, 2010			
	Long	Short	Net
Equities	68.8	-32.1	36.7
Corporate	19.7	-6.4	13.4
Warrants/Other	1.5	-0.2	1.3
TOTAL	90.0	-38.6	51.4

Strategy Exposure (%) as at May 31, 2010	
Global Long / Short	29.9
Relative Value	20.0
Event Driven	20.3
Macro	22.1
Cash & Working Capital	7.7
TOTAL	100.0

ARROW ENHANCED INCOME FUND (CLASS A)⁴

Security Exposure (%) as at May 31, 2010			
	Long	Short	Net
Equities	35.5	-29.0	6.5
Corporate	56.5	-10.5	46.0
Warrants/Other	1.3	-0.1	1.2
TOTAL	93.4	-39.6	53.8

Strategy Exposure (%) as at May 31, 2010	
Global Long / Short	6.9
Relative Value	30.0
Event Driven	36.9
Macro	22.4
Cash & Working Capital	3.9
TOTAL	100.0

⁴ From January 1, 2010 the returns are for Arrow Maple Leaf Canadian Fund (Class A), from July 2001, returns are for Arrow Focus Fund (Class A), from January 2002, the returns are for Arrow Multi-Strategy Fund (Class A) and from January 2005, returns are for Arrow Enhanced Income Fund (Class A). All returns are net of all fees in Canadian dollars.

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