



THE BENEFITS OF PROTECTION

By Mark Purdy, CFA



If you went snowboarding and escaped without injury, would you later regret purchasing a helmet? Perhaps. If you went snowboarding and suffered an injury, however slight, would you regret not purchasing one? Probably.

PC vs. Mac debate aside, most of us wouldn't think twice about installing a virus protection program on our home computer. Though we may navigate confidently through our favorite websites and Google searches, we are never completely in control; Trojan horses, worms and other file infectors could lie on any page, in any download, despite our very best judgment.

Even when you follow all of the recommended steps to prevent the flu, no amount of handwashing and healthy living can ensure that you avoid getting sick. But wouldn't the advance cost of medication, especially if you were travelling, seem miniscule in comparison to the time, enjoyment and dollars lost if you were not prepared with a surefire remedy?

The truth is, in a world where "buy and hold" is the consensus, protecting your portfolio can sometimes feel like throwing money away. While the rest of the world cheers QE2 and rising markets, you are the Grinch waiting in the breadlines to prove that your conservative stance is right. That's why we always tell potential investors that when they evaluate funds, they should consider them over an entire cycle: the good years and the bad. Even the very best can't escape from all possible downfalls, and so we protect ourselves, just in case. A well-protected portfolio is not meant to outperform in bull markets, but rather to deliver solid results across the entire cycle with far lower volatility than a pure buy-and-hold strategy.

To that end, we're pleased with the performance of our Portfolio Series funds, which in three of four cases outperformed the benchmarks, despite their insurance

against the downside. The one exception was the Arrow Maple Leaf Canadian Fund, which still delivered a 10.3% return, compared with a 14.4% return for the S&P/TSX. We'd argue that on a risk-adjusted basis, this Fund, too, has won. In the case of the Arrow Maple Leaf Canadian Fund, investors achieved 2/3 of the S&P/TSX's performance, with less than 1/5 of the volatility. After all, being protected in a rapidly rising market is like buying snow tires in what turns out to be an unseasonably warm winter: your driving – and wallet – is impeded, but wasn't the protection worth it?

TABLE 1: 2010 PORTFOLIO SERIES PERFORMANCE (%) ¹

Arrow Diversified Fund	6.6
MSCI Total Return Net World Index	5.9
Arrow Maple Leaf Canadian Fund	10.3
S&P/TSX Index	14.4
Arrow Focus Fund	15.8
MSCI Total Return Net World Index	5.9
Arrow Enhanced Income Fund	5.0
Barclays Aggregate Bond Index	1.0

Source: Pertrac, Arrow Hedge Partners Inc.

The cost of protection

Maintaining protection in a bull market is no picnic. Long-only mutual funds, especially those with higher betas, all benefit from the rising tide, while a conservative, more active fund manager is at a structural disadvantage. There's a cost to protecting, and in a bull market, that cost is performance.



ARROW PORTFOLIO SERIES - FOURTH QUARTER, 2010

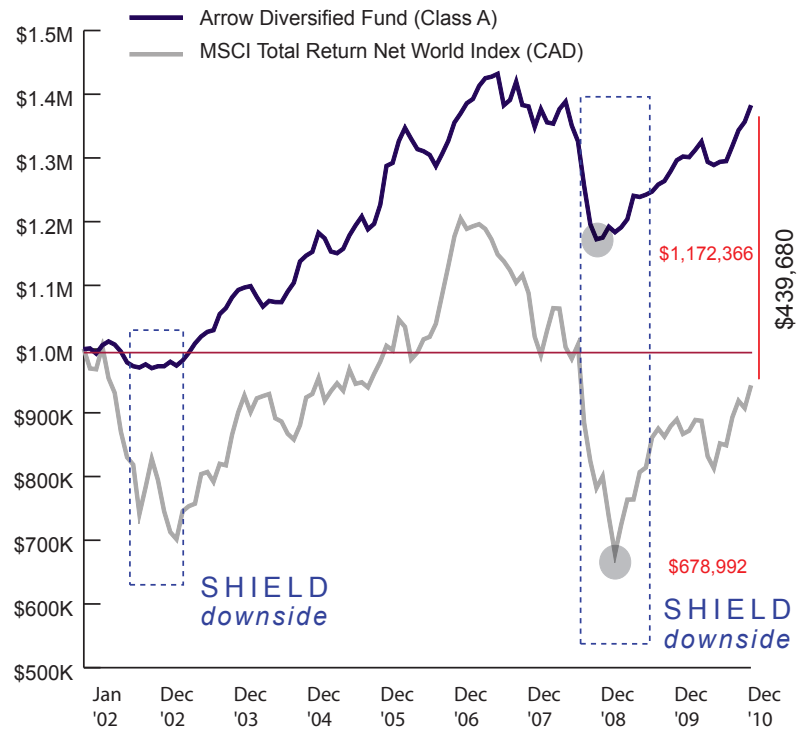
For example, consider a raging bull market, with stocks up 30%. The reality is that most stocks, good and bad, will rise. A mutual fund manager who simply shows up to work would see returns in that 30% range simply by mirroring the benchmark. Even if he were a lousy stock picker, selecting stocks that underperform the market by 5%, he'd still show an acceptable 25% performance. In contrast, an equity market-neutral fund manager, whose longs underperformed his shorts by that same 5% margin, would actually have a down year! He needs to work a lot harder to keep up, and in a surging market, he is unlikely ever to match the long fund.

But the key thing to remember: an active manager isn't trying to match the markets. Whether it is running a short book, buying corporate bonds instead of common equity or buying put options to protect in the event of a "black swan" event, there's a big difference between underperforming because you're an inferior investor and underperforming because you're paying for protection. Protection costs money, and this often means money is left on the table.

Consider our recently launched Curvature Market Neutral Fund, which stays neutral by hedging each long position with a short one. It invests in North American securities, basing its investment decisions on game-changing turning points in share price determinants. The Fund was up 6.5% in 2010, while the S&P/TSX rose 14.4%. This certainly did not reflect inferior stock picking on Curvature's part; the Fund would have been up 33% if — like the S&P/TSX — it had no shorts. But then where would it be when the correction comes? Investors in market-neutral funds like Curvature know they're betting on someone's ability to generate alpha no matter what the market does, in good years or bad. In our view, comparing Curvature's stock picking to a long-only management strategy is like comparing Texas Hold'em to the slot machines.

In a bull market, investors' perceptions of risk become warped, and they're quick to dismiss the benefits of protection. The fear becomes not that of losing money but of missing the party altogether. The dramatic V-shape of the market rebound has helped investors forget that most mutual funds gladly rode the markets down in 2008 and will gladly ride them down again in the future. The irony is that conservative, less volatile funds like ours are still generally perceived as risky. The Arrow Diversified Fund, you'll recall, was down only 18% from peak to trough during the financial crisis, compared to equity markets, which plunged 44%.

CHART 1: ARROW DIVERSIFIED FUND GROWTH OF \$1M VS MSCI¹



Source: Pertrac, Arrow Hedge Partners Inc.

If markets go up, why bother with protecting your portfolio at all?

The main thesis behind buy-and-hold investing is that equity markets go up over time, and that it's simply too difficult to time corrections — so you better keep buying! We disagree. While stocks do go up over the long run, there are countless strategies and non-equity instruments available to make attractive returns while reducing the risk from a market correction. Moreover, stock markets may well deliver good returns over time, but the volatility along the way can be enormous.

For instance, why buy common equities if you can achieve double-digit returns through more conservative instruments? Arrow's Marret Resource Yield Fund, managed by Barry Allan, seeks to identify opportunities in the resource securities space. It often trades these opportunities through high-yielding debt. That way, if the macro environment collapses or the project underwhelms, at least their securities will be first in the pecking order, and you have the cushion of the high coupon. In other words, they've done their homework,

ARROW PORTFOLIO SERIES - FOURTH QUARTER, 2010

TABLE 2: FUND PROFILES

	SINGLE MANAGER FUNDS	TYPICAL MARKET EXPOSURE	ASSET ALLOCATION
Global Series	360 Global	Low Net	Long/Short Equity
	Enso Global	Long-Biased	Long/Short Equity
Income Series	Arrow High Yield	Variable Bias	High-Yield Bonds
	COR U.S. Equity Income	Long-Biased	High-Yield Equity
	East Coast Investment Grade	Variable Bias	Investment-Grade Bonds
	Marret Resource Yield	Long-Biased	High-Yield Bonds
North American Series	Act II New Media	Variable Bias	Long/Short Equity
	AFC Capital	Market Neutral	Equity Market-Neutral Pairs
	Burlington Capital	Low Net	Long/Short Equity
	Curvature Market Neutral	Market Neutral	Equity Market-Neutral
	Goodwood Value	Long-Biased	Long/Short Equity
	JC Clark Opportunities	Low Net	Long/Short Equity
	RCM Opportunities	Long-Biased	Special Situations
	SG U.S. Market Neutral	Market Neutral	Equity Market-Neutral

Source: Arrow Hedge Partners Inc.

and they know that there's stuff in the ground, but they want to be protected against the unpredictability of the commodity cycle. They may even protect themselves further by shorting the common equity of the same company.

Another active strategy that provides income while protecting against interest rate risk and market risk is the newly launched East Coast Investment Grade Fund, managed by Mike MacBain and John Schumacher, both of whom have extensive experience in markets (having been president of TD Securities and co-CEO of Scotia Capital, respectively, among other senior executive capital market roles at other major Canadian banks). Through the 2008 crisis, bonds helped offset losses by being the only asset class that was negatively correlated. By investing at the highest point in the capital structure in investment-grade names and protecting against downside scenarios, this Fund aims to protect your wealth from volatile markets over both the short and long terms.

In our second-quarter report, *Some Hedge Funds Do Hedge*, we discussed the tendency of investors to lump all hedge funds into one category, despite there being enormous differences in their risk profiles. There are so many different strategies: some use leverage on big directional bets, while others use no leverage and are strictly equity market-neutral. As a firm, we would place ourselves on the

more conservative side of the risk spectrum. Our Portfolio Series funds make use of many tools to reduce market exposure and volatility. While our Global, Income and North American Series funds vary in respect to strategy and net market exposure, what they all share is our conservative requirements for low leverage, high transparency and high liquidity.

Outlook for 2011

We believe 2011 will be a good year for our funds, with both volatility and dispersion expected to increase. We also believe markets are due for a sharp correction, most likely in the second half. Our goal is to aid in your asset allocation process by providing a platform of funds with different risk/return profiles that will complement each other in a portfolio throughout various market conditions. Fundamentally speaking, we are cautiously optimistic about the markets, and in the face of heavy government intervention, our foot is 2/3 down on the gas pedal, ready to ease off at any time. We'd rather give up some upside while markets continue to rise, and be prepared to swiftly hit the brakes should the warning lights start flashing.

This concern about the market is shaped by our view that the lingering effects of the global banking crisis have only been papered

over by the massive stimulus efforts, and that the fundamental issues remain unresolved. After all, if things were as great as the market suggests, then why are interest rates still at emergency levels? QE1 has led to QE2, but rising treasury yields and a recent pickup in dispersion among securities suggest the market will not be receptive to the printing presses for much longer. Moreover, the “Santa Claus rally” was premised on a U.S. recovery that, to date, remains uncertain, while valuations are no longer arguably cheap. This increases the likelihood of a sharp correction. Geographically, Asia remains the bright spot, as it’s always better to be in the position of trying to tame inflation than trying to create it. Nevertheless, its efforts to tighten in the face of U.S. easy money could create some economic shocks along the way, particularly in respect to commodities.

Some other themes we expect to play out in 2011 include increased M&A, greater dispersion among stocks, higher volatility and excellent macro trading opportunities in sovereign debt and commodities.

As we wrote in our last quarterly, *Growing Your Wealth in a Shrinking World*, there is a massive deleveraging taking place in western economies, one that is likely to continue for several years. Low interest rates, non-excessive valuations and record amounts of cash on corporate balance sheets all mean M&A is picking up – all good signs for the event-driven crowd.

We also expect dispersion of security performance in 2011. One of the great difficulties for hedge funds in 2010 was the high correlation between stocks, which made shorting very difficult. With government intervention, stock picking, the name of the game, hardly mattered. This was particularly hard on relative-value funds like our own AFC Capital Fund and Curvature Market Neutral Fund, which don’t ride free beta and run more balanced portfolios.

The good news is that markets seem to be getting more selective. Dispersion can be observed through the CBOE SPX Implied Correlation Index, which measures correlation via the options of the 50 biggest stocks in the S&P 500. Correlation spiked during the financial crisis, jumping from a pre-crisis level of 45 to 100, as macro issues outweighed stock specifics. With the printing presses in full gear, correlation surged again in 2010, peaking in September at 70. It’s since come off sharply. In our view, it’s not a coincidence that the index peaked just after Bernanke’s Jackson Hole speech, when he signalled QE2. This suggests that investors are becoming more dubious about the effectiveness of Fed policy. Already, AFC and Curvature are seeing improved results, with fourth-quarter gains of 2.8% and 6.2%, respectively.

Going hand in hand with a market correction would be an increase in market volatility. Equity volatility, as measured by the VIX index, has been in a steady decline since late 2008, when it peaked at 80. It

currently stands around 16 – which is on the low side of history – and reflects complacency among market participants. When markets correct or become more volatile, the VIX will increase.

We are positioning our Portfolio Series funds for that possibility. Investors will recall that in late 2009, we launched an overlay for all of our Portfolio Series funds. The overlay – some 5% of the portfolios – is managed directly by Arrow, and it enables us to act swiftly, positioning the portfolios based on breaking market information or neutralizing any unnecessary risks at the portfolio level. In recent months, we have used that overlay to buy protection against a market decline and/or a rise in the VIX.

Like your computer’s anti-virus program, your snowboarding helmet and your flu medication, fund protection should be a core component of your portfolio. And right now, it’s a great value: without going into the complexities of option pricing, the simple fact is that the lower the VIX, the cheaper the cost of protection. You want to buy “hurricane” insurance before the storm: it’s too expensive after the fact! To the extent that we are long on the markets, using options might be the cheapest type of insurance and the best use of capital. And if we’re wrong, well, that’s exactly the cost of protection: fewer gains during the upswing, but at least you can sleep at night.

SECTOR EXPOSURE

ARROW DIVERSIFIED FUND (CLASS A)¹

SECTOR EXPOSURE (%) AS AT DECEMBER 31, 2010				
	Long	Short	Net	Gross
Consumer Discretionary	11.1	(3.9)	7.2	14.9
Consumer Staples	2.3	(1.0)	1.3	3.3
Energy	15.2	(4.3)	10.9	19.5
Financials	11.7	(4.8)	6.9	16.5
Government	2.1	(5.2)	(3.1)	7.3
Health Care	4.2	(0.7)	3.5	4.9
Indices	2.8	(5.7)	(3.0)	8.5
Industrials	9.5	(5.5)	4.0	15.1
Information Technology	8.3	(2.8)	5.6	11.1
Materials	21.5	(11.7)	9.8	33.3
Telecommunication Services	3.5	(1.3)	2.3	4.8
Utilities	1.0	(0.4)	0.5	1.4
TOTAL	93.3	(47.3)	45.9	140.6

ARROW FOCUS FUND (CLASS A)¹

SECTOR EXPOSURE (%) AS AT DECEMBER 31, 2010				
	Long	Short	Net	Gross
Consumer Discretionary	13.7	(5.3)	8.4	19.0
Consumer Staples	0.7	(1.1)	(0.4)	1.8
Energy	23.0	(4.5)	18.5	27.5
Financials	3.6	(2.8)	0.7	6.4
Government	0.6	(3.0)	(2.4)	3.6
Health Care	7.4	(0.9)	6.4	8.3
Indices	3.6	(7.2)	(3.6)	10.8
Industrials	7.8	(4.3)	3.5	12.2
Information Technology	10.5	(3.3)	7.2	13.8
Materials	22.3	(11.0)	11.3	33.4
Telecommunication Services	3.8	(1.7)	2.2	5.5
Utilities	1.0	(0.9)	0.1	2.0
TOTAL	97.9	(46.1)	51.8	144.1

ARROW MAPLE LEAF CANADIAN FUND (CLASS A)¹

SECTOR EXPOSURE (%) AS AT DECEMBER 31, 2010				
	Long	Short	Net	Gross
Consumer Discretionary	8.8	(4.0)	4.9	12.8
Consumer Staples	1.5	(1.2)	0.3	2.7
Energy	18.0	(6.7)	11.3	24.7
Financials	16.6	(5.9)	10.7	22.5
Government	0.9	(10.9)	(10.0)	11.8
Health Care	2.3	(0.9)	1.4	3.2
Indices	1.2	(4.8)	(3.6)	6.0
Industrials	8.6	(5.4)	3.2	14.0
Information Technology	11.4	(3.3)	8.1	14.7
Materials	26.1	(15.3)	10.8	41.4
Telecommunication Services	4.4	(1.0)	3.4	5.5
Utilities	1.3	(0.7)	0.6	2.1
TOTAL	101.2	(60.1)	41.1	161.3

ARROW ENHANCED INCOME FUND (CLASS A)¹

SECTOR EXPOSURE (%) AS AT DECEMBER 31, 2010				
	Long	Short	Net	Gross
Consumer Discretionary	10.2	(2.3)	7.9	12.5
Consumer Staples	2.7	(0.9)	1.9	3.6
Energy	20.2	(3.8)	16.4	24.0
Financials	26.3	(8.5)	17.7	34.8
Government	3.6	(18.4)	(14.8)	22.0
Health Care	7.1	(1.7)	5.4	8.8
Indices	3.6	(6.0)	(2.4)	9.6
Industrials	11.7	(4.9)	6.7	16.6
Information Technology	10.7	(2.4)	8.4	13.1
Materials	17.1	(10.2)	6.9	27.4
Telecommunication Services	7.4	(0.5)	6.8	7.9
Utilities	1.7	(0.3)	1.4	2.0
TOTAL	122.3	(60.1)	62.3	182.4

¹ 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 Diversified 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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