



By Mark Purdy, CFA

ARROW CAPITAL
MANAGEMENT INC.

What do investors wish for in respect to their personal investments?

When the market goes up, they would likely hope to participate to a certain extent. And when the market goes down, they'd simply like to avoid losses. Consistent returns. Risk control.

While it may sound simple, not all investments practice with this conviction and we believe a more actively managed solution is needed to achieve this. This is because we have entered a period of much higher volatility and the traditional asset allocation "buy and hold" models are broken.

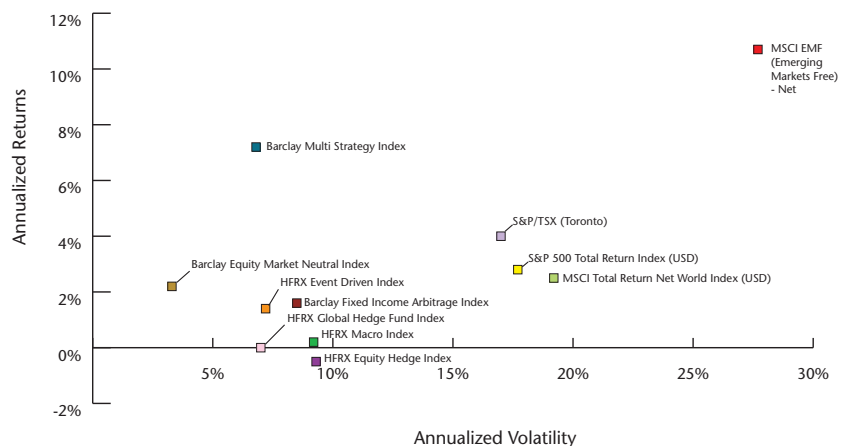
Consider the mutual fund industry, which is built on benchmarking where funds are typically required to stay fully invested. If their mandate does allow them this option, it's not generally in worth their while to do so since many are paid on management fee alone, with little regard to performance. So rarely do mutual funds stray from the benchmarks that the typical fund will have over 90% of the variance in its' returns explained by the movements in the market.

While mutual fund managers' ability to manage client risk is constrained, other impediments to preserving capital still exist. Despite the massive drawdowns of these funds only two short years ago, traditional, antiquated asset allocation models still place an enormous emphasis on long-only portfolios. Alternative, active solutions are gaining more acceptance in recommended asset mixes, but are still allocated at a much lower percentage than they should be overall, given the outperformance of so many alternative strategies over their long-only cousins.

Arrow was founded with the belief that true, active management would lead to superior investment results

CHART 1: LOWER VOLATILITY IN ALTERNATIVE STRATEGIES¹

March 2006 - March 2011



Source: Pertrac. Arrow Capital Management Inc.

through lower volatility investing, downside protection and solid, long-term growth. This is an approach that relies more on manager skill, than on market direction, to produce investment returns. With the team's own wealth primarily invested in Arrow's funds, the firm has been built on the foundation of mutual success. That foundation is your assurance that decisions made at the company and portfolio level are always in the best interests of investors.

Normally, bear markets create opportunities for reflection. We certainly did look back, implementing a proprietary trading system and quicker measures to deal with managers who do not live up to their targets. With momentum trading seemingly at the height of style, it would appear however that the market's meteoric rise since March 2009 has helped many investors forget the risks that are still close at hand. But all of this investment and risk-on trading necessitates the questions: do investors have the best players on the field? Do investors have

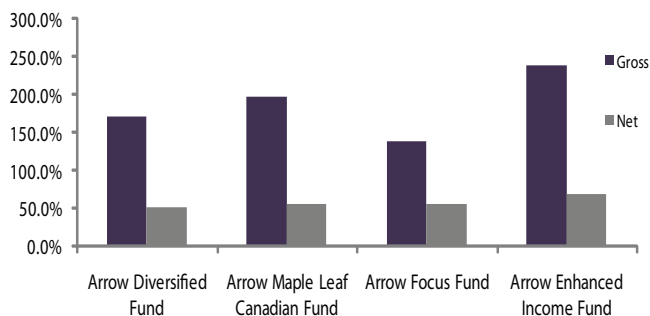


ARROW PORTFOLIO SERIES - FIRST QUARTER, 2011

the right combination of offense and defense? This is where asset allocation plays an important role. More on that later.

As we wrote in our 2Q quarterly, *Some Hedge Funds Do Hedge*, the alternative industry is not so much an asset class as it is a strategy class; there are a wide variety of strategies with different risk/return goals. Our careful nature places us on the ultra-conservative side of the spectrum in respect to hedge funds. It limits aggregate gross exposure (long + short) to 200% of net asset value and net exposure (long-short) within a range of -25% to 100% of net asset value. To put these limits in perspective, consider this: If we were maximum bullish — with 100% net exposure — we would still have no more market exposure than a mutual fund. Moreover, we're not just buying equities; bonds, preferred shares and warrants are regularly used in our Portfolio Series to generate still-acceptable returns while significantly reducing risk.

CHART 2: GROSS/NET RISK EXPOSURE PORTFOLIO SERIES

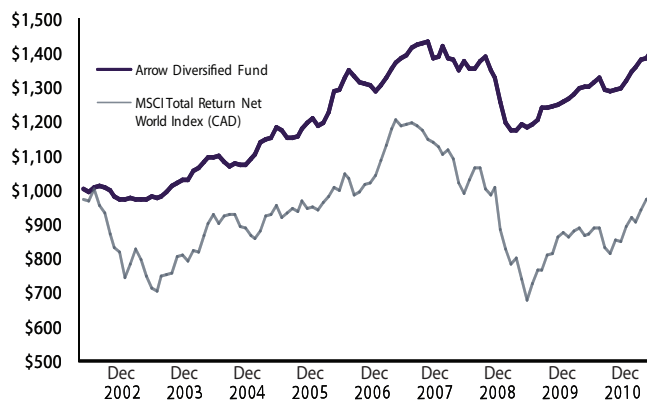


Source: Pertrac. Arrow Capital Management Inc.

The reality is that historically, even when we are bullish, our Portfolio Series Funds have maintained net exposure between 40 and 60%. Even now, with a fairly constructive view on markets, our net exposure at the Arrow Diversified Fund is only 46%, on the high side of history but less than half that of a mutual fund. This hasn't impeded its' performance – our managers know how to properly protect a fund and exploit dispersion, volatility and arbitrage in the marketplace.

In today's market environment, it is critical to not get carried away, especially when the market has already doubled in two years. Over the last few years, our Portfolio Series Funds have done well, recouping the bulk of the financial crisis losses (which are mild in comparison to the market) and outperforming the equity markets at large. There's an old saying that "markets climb a wall of worry," and there's certainly been plenty to worry about over the last two years. Despite our reservations, we've been unwilling to fight the Fed

CHART 3: DIVERSIFIED FUND GROWTH OF \$1000



Source: Pertrac. Arrow Capital Management Inc.

during this period, and have kept one foot on the gas pedal, prepared to take it off at any time. Within Arrow, there's still much debate as to market direction, although on balance, we're comfortable how we are positioned. Until sentiment changes, we'll stay net long with our finger always on the sell trigger. Meanwhile, our market neutral managers should benefit from dispersion and volatility returning to more normal levels, which should make them an important part of a well-diversified client portfolio.

What makes us optimistic?

Simply speaking, the U.S. crisis happened in 2008. The whole objective of government policies was to restore confidence and it has largely succeeded; the stock market has virtually doubled from pre-crisis lows, TARP has been repaid, corporate balance sheets have improved, job growth is picking up steam and consumer confidence is near a three-year high. Moreover, with U.S. housing prices already down 35%, and the currency so weak, the U.S. has arguably taken much of its medicine and is more competitive as a result. The big worry is that they have mortgaged the future with the amount of U.S. debt they are servicing.

In addition, the circular logic between stock market performance and the economy bodes well for further upside. Take an economy that is in a slump and add a stock market rally. At first, bears scream dead-cat bounce. But if the rally holds (as this one has), then rising share prices will create rising wealth, which ultimately means higher spending, sales and profits, propelling the next leg of the bull market. Increased retail confidence in the sustainability of this bull market can be seen in U.S. equity mutual fund flows, which have turned positive in recent months. This, in tandem with still-acceptable valuations, suggests that the U.S. market has more room to run.

The Fed has been increasingly signaling that QE2 may come to an



ARROW PORTFOLIO SERIES - FIRST QUARTER, 2011

end, but even when that occurs, the market might surprise on the upside; after all the end of emergency low rates will signify that the recovery has traction. Moreover, until the recovery is truly established, rates won't rise beyond "normal" levels with the government kicking in stimulative measures if necessary. Our preferred markets are the U.S. and select emerging markets, whereas Europe (outside of Germany) seems stuck in a hole, unwilling to take the pain.

What makes us nervous?

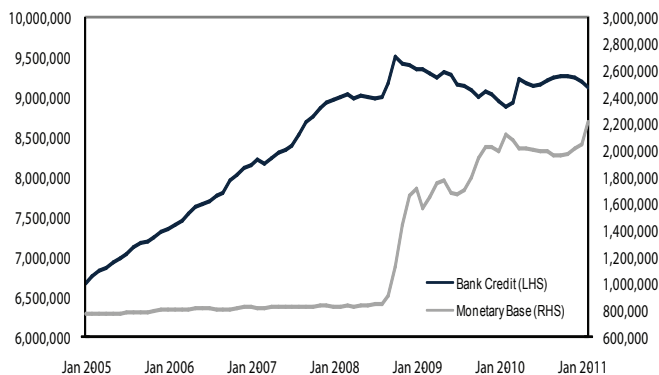
There are still many factors to fret about: a China slowdown, too-high oil prices and inflation, metals prices continuing to reach new highs, all of which are well documented in the press. Our biggest concern is one that does not get a lot of press and which we wrote about in a previous quarterly, *Growing Your Wealth in a Shrinking World*. In a nutshell, for all of the talk of out-of-control printing presses, the simple truth is that the Fed's efforts are still having no impact on money supply. The Fed may be printing paper, but banks aren't lending it out. Ultimately, a sustained economic recovery is dependent on banks doing just that.

would that say about the economy — and ultimately share prices? Just look to Japan for perspective on that issue.

In this type of market environment, and luckily for seniors, actively managed funds are well-positioned to capture alpha and protect against these types of risks. Arrow offers a series of income funds including high yield, investment grade and U.S. income that should provide this additional yield while protecting their principal.

To summarize, a final word on asset allocation. The key is to set up a proper investment policy asset mix that we strongly believe should include stocks, bonds, and alternatives. Once the asset mix is properly defined, it is then important to rebalance that portfolio on a quarterly basis or as needed. Over time, we would recommend up to 25% of a properly diversified portfolio into select alternative investments. This will give you a smoother ride towards your retirement date, and beyond.

CHART 4: MONETARY BASE VS BANK CREDIT



Source: Federal Reserve

We feel this discussion wouldn't be complete without examining the impact of low interest rates on retirees' income streams. While many are forced to tighten their belts, work longer, or get a part-time job, even more worrisome is anecdotal evidence of an increasing risk profile among those who chase riskier assets to make up yield.

There's reason to be concerned when the popular media is comfortable endorsing the accumulation of dividend-paying stocks to make up for lost interest income. It's true that an additional 100-200 basis points in annual income over current 5-year GIC rates can be generated from high-dividend stocks. But is the increase in duration risk or potential for capital loss worth it? After all, rates can't likely stay at emergency lows for that much longer, otherwise what



ARROW DIVERSIFIED FUND (CLASS A)¹

SECTOR EXPOSURE (%) AS AT MARCH 31, 2011				
	Long	Short	Net	Gross
Consumer Discretionary	10.5	(2.9)	7.5	13.4
Consumer Staples	2.6	(1.5)	1.1	4.0
Energy	20.6	(5.2)	15.4	25.8
Financials	16.2	(4.6)	11.5	20.8
Government	4.6	(15.6)	(11.0)	20.1
Health Care	3.7	(1.5)	2.2	5.2
Indices	5.6	(9.8)	(4.1)	15.4
Industrials	10.1	(4.1)	6.0	14.2
Information Technology	8.8	(2.6)	6.3	11.4
Materials	23.3	(10.5)	12.8	33.8
Telecommunication Services	4.2	(1.1)	3.1	5.2
Utilities	2.0	(0.9)	1.2	2.9
TOTAL	112.2	(60.1)	52.1	172.4

ARROW MAPLE LEAF CANADIAN FUND (CLASS A)¹

SECTOR EXPOSURE (%) AS AT MARCH 31, 2011				
	Long	Short	Net	Gross
Consumer Discretionary	7.4	(3.9)	3.5	11.3
Consumer Staples	3.0	(0.5)	2.5	3.5
Energy	26.7	(8.5)	18.3	35.2
Financials	16.7	(4.9)	11.8	21.6
Government	6.2	(18.6)	(12.4)	24.9
Health Care	1.6	(1.0)	0.6	2.7
Indices	7.4	(10.4)	(2.9)	17.8
Industrials	7.1	(3.6)	3.5	10.7
Information Technology	9.4	(2.3)	7.1	11.7
Materials	35.6	(15.7)	19.8	51.3
Telecommunication Services	4.0	(1.1)	2.8	5.1
Utilities	2.5	(0.2)	2.4	2.7
TOTAL	127.8	(70.8)	56.9	198.6

ARROW FOCUS FUND (CLASS A)¹

SECTOR EXPOSURE (%) AS AT MARCH 31, 2011				
	Long	Short	Net	Gross
Consumer Discretionary	11.3	(3.3)	8.0	14.6
Consumer Staples	0.5	(0.9)	(0.4)	1.5
Energy	25.0	(5.7)	19.3	30.8
Financials	4.5	(2.9)	1.5	7.4
Government	0.2	(2.0)	(1.9)	2.2
Health Care	6.5	(2.8)	3.7	9.3
Indices	1.5	(8.8)	(7.4)	10.3
Industrials	8.4	(2.6)	5.9	11.0
Information Technology	9.5	(2.0)	7.5	11.4
Materials	26.1	(9.5)	16.7	35.6
Telecommunication Services	3.5	(1.0)	2.5	4.4
Utilities	0.2	(0.2)	0.0	0.4
TOTAL	97.2	(41.8)	55.5	139.0

ARROW ENHANCED INCOME FUND (CLASS A)¹

SECTOR EXPOSURE (%) AS AT MARCH 31, 2011				
	Long	Short	Net	Gross
Consumer Discretionary	8.7	(2.6)	6.2	11.3
Consumer Staples	4.3	(2.7)	1.6	7.1
Energy	29.4	(9.3)	20.1	38.7
Financials	30.5	(8.9)	21.7	39.4
Government	7.7	(24.9)	(17.2)	32.6
Health Care	8.3	(3.5)	4.8	11.8
Indices	7.7	(12.2)	(4.6)	19.9
Industrials	12.2	(3.9)	8.2	16.1
Information Technology	9.8	(1.2)	8.6	11.0
Materials	21.7	(9.5)	12.2	31.2
Telecommunication Services	5.5	(0.3)	5.2	5.8
Utilities	3.5	(0.2)	3.4	3.7
TOTAL	149.4	(79.3)	70.1	228.7

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.

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 Capital Management Inc. Please read the applicable offering memorandum carefully before investing. Past returns are not necessarily indicative of future performance. 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 or a solicitation to buy any security nor does it constitute an offer by Arrow Capital Management Inc. to provide its investment advisory services in any jurisdiction in which, or to any person to whom, such would not be permitted under applicable law. While the information and material in this document are believed to be accurate at the time they are prepared, Arrow Hedge Partners Inc. cannot give any assurance that they are accurate, complete or current at all times.