The Arbitrage Funds
ADVISED BY WATER ISLAND CAPITAL

# WATER ISLAND CREDIT OPPORTUNITIES FUND

## Q3 2021 COMMENTARY

### PORTFOLIO REVIEW

Water Island Credit Opportunities Fund (ACFIX) returned 0.30% for the third quarter of 2021 and 2.35% for the year-to-date period. The Bloomberg US Aggregate Bond index returned 0.05% and -1.55%, while the ICE Bank of America US High Yield index returned 0.94% and 4.67%, for the same periods, respectively.

At quarter-end, the effective duration of the portfolio was 1.1 years, with a duration to event (our internal measure of the duration of the portfolio based on expected timing to completion of a catalyst) of 0.3 years.

### MANAGER COMMENTARY

Equities produced modest gains during Q3, while the US 10-Year Treasury Bond fluctuated from 1.2% in July to 1.5% at quarter-end. The market's tone was mixed, with optimism over economic growth combatting inflation concerns, supply chain bottlenecks, government shutdown fears, and regulatory pressure on large technology firms. Fixed income investors continued to focus on finding yield and income in a market where treasuries and spreads remain near all-time lows.

While the overall market experienced muted returns, event-driven managers saw significant volatility during the quarter. High profile mergers such as the Willis Towers Watson/Aon tie-up were challenged by regulators, causing the deal to be withdrawn and leading other deals to trade lower on the news. Transactions which required foreign regulatory approval were also delayed, as political issues between the US and China dampened near-term optimism for deal closures. The market for special purpose acquisition companies (SPACs) – a recently popular asset class for event-driven investors – was also challenged during Q3. SPAC transactions faced setbacks from government agencies questioning the fairness of many deal structures for retail investors. In addition, selling continued in the space as other investors needed to see more definitive financial and operating progress following the close of many SPAC transactions.

Although Water Island Credit Opportunities Fund operates in the event-driven market, we experienced little volatility during the quarter compared to traditional event-driven investors. One reason for this is not every equity-based deal has a debt component that is available or attractive for our purposes. Secondly, our debt positions typically have a fraction of the downside compared to equity-based approaches, and downside that does exist can often be further mitigated through prudent hedging.

During the quarter, we experienced significant turnover in the portfolio as deals were completed and bonds were redeemed. We replaced these investments with a combination of merger-related situations and yield-to-call bonds that we believe offer attractive yield, short duration, and minimal downside. In the merger space, we added new positions to the portfolio such as the second-lien bonds of Blackboard Inc, a leader in online educational activity, which agreed to be acquired by Anthology Corp. We also added the bonds of Kraton Corp, a leader in titanium dioxide production, which is being acquired by South Korea's DL Holdings Co Ltd, and the term loans of Neustar Inc, which is being acquired by TransUnion to enhance the company's digital marketing and consumer protection segments.

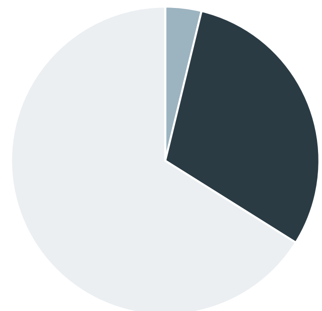
As we begin the fourth quarter, COVID is no longer the market's primary focus. Instead, growth, inflation, energy prices, central bank actions, and supply chain delays have replaced the pandemic as the key risks occupying investor mindshare. Washington politics will also attract our attention as officials play games of brinksmanship over the debt ceiling limit and other important issues. On the investment side, fixed income investors will continue looking for shorter duration investments with both yield and less sensitivity to rising rates.

In this environment, we anticipate a continuation in the record-setting pace of mergers and acquisitions announcements, along with further refinancing activity. Significant capital remains untapped among private equity funds and access to capital remains open for corporations looking for strategic alternatives. We have also seen recent opportunities in the convertible bond market, including announced merger transactions and investments that can provide both yield and optionality. We expect to see more of these opportunities – particularly if market volatility emerges – but we are motivated to seek those investments that can offer moderate returns coupled with short duration and little sensitivity to rising interest rates.

| **TRAILING RETURNS (ACFIX)** AS OF 9/30/21 | |
|---|---|
| 1-Year | 4.82% |
| 5-Year | 3.71% |
| Since Inception (10/1/12) | 3.17% |

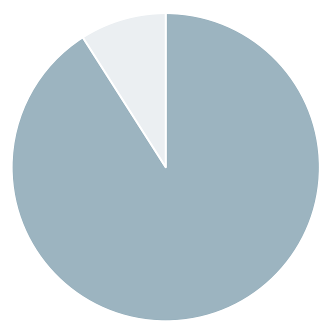
*Performance greater than one year is annualized.*

**CREDIT QUALITY** AS OF 9/30/21




*Subject to change. Reflects long exposure as percent of net assets.*

**GEOGRAPHIC EXPOSURE** AS OF 9/30/21




*Subject to change. Reflects long exposure as percent of net assets.*

**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 lower or higher than the performance quoted. For performance data current to the most recent month end, visit http://arbitragefunds.com or call (800) 295-4485. Returns shown above include the reinvestment of all dividends and capital gains. Total Annual Fund Operating Expense for ACFIX is 1.52%. The adviser has contractually agreed to waive fees in excess of 0.98% for ACFIX until September 30, 2022, excluding the effects of taxes, interest, dividends on short positions, brokerage commissions, acquired fund fees and expenses, and other costs incurred in connection with the purchase or sale of portfolio securities. Without such fee waivers, performance numbers would have been reduced.**

**TOP CONTRIBUTORS**

*Altice France SA* — Altice France is part of Altice Europe, a leading provider of cable and telecommunications services throughout the world. We initiated a position in Altice France first lien bonds earlier in the year as the company continued to de-lever its balance sheet. We were attracted to the investment opportunity based on the bonds' seniority in the capital structure, attractive yield, and likely short duration due to the company's ongoing redemptions of this large issue. In September, the company called our bonds for redemption and in October this successful investment will close.

*Werner FinCo LP* — Werner Co is a global manufacturer of ladders, access equipment, secure storage, and light duty construction products, with a portfolio of more than a dozen leading brands worldwide. Our thesis for this investment was based on an attractive yield that was compelling for a company with respected brands, adequate liquidity, a track record of growth, 5.0x net leverage, and a motivated sponsor who has contributed over $450 million into the equity.

*Kaleyra Inc* — Kaleyra offers cloud communications platforms for building SMS, voice, and messaging applications. During February, the company announced a transformative acquisition to expand its American footprint by purchasing privately held Mgage LLC for approximately $220 million. As part of this transaction, we joined a group of investors to help fund this deal via a convertible bond offering. The investment was attractive not only from a valuation standpoint, but also due to the potential of the pro-forma company, and the multiple catalysts related to the company being under-covered by the research community (which we believe will change over time). This position led to gains during Q3, and the bonds continue to offer attractive yields along with strong optionality as the company progresses on expanding its geographic and customer bases.

**TOP DETRACTORS**

*LABL Inc* — In July, Clayton Dubilier & Rice announced a definitive agreement under which it would acquire and combine Multi-Color Corporation and Fort Dearborn, to create the world's largest label solutions company. Clayton Dubilier is acquiring Multi-Color and Fort Dearborn from private equity investors Advent International and Platinum Equity. We initiated a position in both 2026 and 2027 Multi-Color bonds, as we anticipated the company's debt would be retired upon the close of this deal and we were encouraged by the de-levering aspect of the transaction. Market prices for the bonds reflected the high probability of a near-term redemption, but Clayton Dubilier ultimately elected to keep Multi-Color's debt outstanding. The company's 10.5% bonds due 2027 consequently moved back to pre-deal levels, but we believe these bonds will be retired during 2022 as that coupon is massive for the company today. The company's 2026 bonds moved less, as they are secured.

*UpHealth Inc (GigCapital2 Inc)* — UpHealth is a company recently formed through the roll-up of several businesses related to digital health services and taken public via a SPAC named GigCapital2. As part of this investment, we purchased convertible bonds of the company which aided in the initial funding of the SPAC transaction. Despite losses in the bonds during the quarter, we believe the company is poised to capitalize on its digital health platform which will provide services to patients worldwide. While the company's integration takes place, we feel we are compensated for the risk with an attractive yield and ability to participate in the upside via the convertible bond's optionality. During Q3, the company's stock was caught in the small-cap and post-SPAC sell-off, and those declines and loss of market value contributed to declines in the company's bonds. Management communication and execution will be among those factors we will be watching closely.

*Five9 Inc* — In July 2021, Zoom Video Communications, the well-known provider of cloud-based video conferencing services, agreed to acquire Five9 in a stock-for-stock merger. Although the transaction was expected to enhance Zoom's contact center platform, skepticism surrounding the deal's merits combined with a poor quarterly earnings report from Zoom led investors to sell Zoom shares lower, thus decreasing the deal value for Five9 holders. Ultimately the lower deal value contributed to the companies terminating the transaction, after Five9 shareholders voted down the deal. We invested in the situation via Five9's convertible bonds along with an equity hedge designed to mitigate downside in the event of a deal break, but also provide upside if a higher bid emerged. Although the position experienced a small mark-to-market loss during the quarter, we are confident that continued volatility in the stock will enhance the value of our bonds.

GLOSSARY: *Duration* is an approximate measure of a bond's price sensitivity to changes in interest rates, with each year of duration roughly equating to a 1% change in price inverse to a 1% change in yield. *High yield* refers to a bond with a credit rating lower than investment grade. A *special purpose acquisition company (SPAC)* is a holding company that raises money through an IPO for the sole purpose of acquiring a privately held entity, as a means of taking its target public without going through a traditional IPO process of its own. A *credit spread* is the difference in yield between a US Treasury bond and a debt security with the same maturity but of lesser quality. A *convertible bond* is a bond that the holder can convert into a specified number of shares of common stock in the issuing company or cash of equal value. *Yield-to-call* is the yield of a bond that is called prior to maturity. *First lien* bonds are debt that is first in line to be paid back before all other creditors. *Second lien* bonds are lower priority debt that can only be repaid after more senior debt. *Mark-to-market* is a measure of value using the most recent market price.

**IMPORTANT INFORMATION**

**Investors should carefully consider the fund's investment objectives, risks, and charges and expenses before investing. To obtain a prospectus containing this and other important information, visit http://arbitragefunds.com or call (800) 295-4485. Read the prospectus carefully before investing.**

***RISKS: Investments are subject to risk, including possible loss of principal. There can be no assurance that the fund will achieve its investment objectives. The fund uses investment techniques and strategies with risks that are different from the risks ordinarily associated with credit investments. Such risks include event-driven risk; merger arbitrage risk (in that the proposed reorganizations in which the fund invests may be renegotiated or terminated, in which case the fund may realize losses); credit risk; convertible security risk; liquidity risk; market risk; sector risk; interest rate risk; short sale risk (in that the fund will suffer a loss if it sells a security short and the value of the security rises rather than falls); hedging transaction risk; large shareholder transaction risk; leverage risk; high portfolio turnover risk (which may increase the fund's brokerage costs, which would reduce performance); counterparty risk; swap risk; options risk; preferred security risk; investment company and ETF risk; derivatives risk; LIBOR rate risk; currency risk; foreign securities risk (in that the securities of foreign issuers may be less liquid and more volatile than securities of comparable US issuers, and may be subject to political uncertainty and currency fluctuations); active management risk; and temporary investment/cash management risk. Risks may increase volatility and may increase costs and lower performance.***

Water Island Credit Opportunities Fund top ten holdings as of September 30, 2021: Altice France SA/France 7.375% 5/1/2026; Blackboard Inc 10.375% 11/15/2024; Five9 Inc 0.5% 6/1/2025; Fresh Market Inc/The 9.75% 5/1/2023; Hill-Rom Holdings Inc 4.375% 9/15/2027; Medallia Inc 0.125% 9/15/2025; Meredith Corp 6.875% 2/1/2026; Modulaire Global Finance Plc 8% 2/15/2023; NeuStar Inc FR 8/8/2024; Tronox Inc 6.5% 5/1/2025. Top ten holdings represent 36.5% of the portfolio. Holdings are subject to change. Current and future holdings are subject to risk.

Bloomberg US Aggregate Bond Index is a broad index of domestic investment grade fixed income securities. ICE Bank of America US High Yield Index is a broad index of high yield corporate bonds. Indexes are unmanaged and one cannot invest directly in an index. Indexes are shown for informational purposes only.

Commentary represents the manager's opinion and contains certain forward-looking statements which may be different than actual future results, is subject to change, and is under no obligation to be updated. Commentary should not be regarded as investment advice or a recommendation of any security or strategy.

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