ACT II LONG/SHORT FUND

Commentary - October 2011

Experience. Intelligent Investing.

	1 mo	3 mons	6 mons	YTD	1 yr*	3 yr*	Ann. ITD	Cum. ITD
Act II Long/Short Fund[1]	(1.3%)	(8.4%)	(9.9%)	(3.4%)	0.0%	3.3%	3.8%	15.4%
Nasdaq (CAD)	5.9%	1.4%	(2.2%)	1.1%	4.5%	8.3%	0.5%	1.7%

[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 Capital Management 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 Capital Management 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 had a net decline of 1.3% in October in spite of the market's booming recovery, as we kept exposure low too long. This reflected our concern about the broad uncertainties that have prevailed for months over a domino effect from the European debt crises, as well as weakening U.S. economic data. The S&P 500 was up 10.9%^ in October, including dividends, while the NASDAQ rose 11.1%^. The market's ascent was near linear and nearly uninterrupted. From the year's low, which was only hit on October 4th, to the rally top on October 27th (just 17 trading days), the S&P 500 rose 20%, the largest gain in 25 years. For the year-to-date, we are now down 1.6%^ net versus gains of 1.3%^ for the S&P (with dividends included) and 1.2%^ for the NASDAQ.

In addition to low exposure, we had a larger than usual number of stocks that reacted sharply against us to earnings deviations from expectations, both on the long side, and in some beaten down shorts whose results were less bad than forecast. The third factor in our underperformance was that we had shifted the composition of the portfolio to a more defensive mix and some of the less volatile positions, while up, trailed the market's advance. As part of our defensiveness, we had substantially lowered our gross exposure over the last couple of month, raising cash, which gave us less firepower in the rally.

The catalysts for the market rally were increased clarity on the European fix of Greece and other sovereign debt and bank issues, although there has subsequently been renewed turmoil in Greece and concern over Italian debt spreads. While not resolved, the doomsday scenario seems to have faded, while the various European banking agencies and Governments appear to have more resolve than the markets credited them with over the last several months. Concurrently, the U.S. picture also picked up a little, with better economic statistics than had been reported in previous periods. In fact, in an unusual development in the midst of the gloom, third quarter GDP showed an increase of 2.5% versus estimates that had been cut to 1.5-1.7% recently. For the full year, the Wall Street Journal economists' survey shows expected GDP growth of 1.5% this year and 2.3% for 2012. The Federal Reserve recently lowered its own forecast for 2011 to the 1.6-1.7% range from 2.7-2.9%, and for next year to 2.5-2.9% from 3.3-3.7%.

The hoped for rebound from the effects of the Japanese earthquake and lower oil prices appear to have materialized. Retail sales, while somewhat soft in October, have nevertheless been stronger than expected this past summer when consumer confidence readings were at their low point after the debt ceiling debate and U.S. credit rating cut. Capital good shipments and construction spending have been strong, indicating business confidence. Unemployment claims are declining slightly, as well.

While the odds of recession appear lower than the 40% we quoted as the consensus in our last letter, they haven't completely gone away. There is also the risk that the bi-partisan committee on tackling the deficit will revive the acrimony of August which could again depress consumer confidence. That's the latest issue here, while in Europe the focus shifts more to Italy with Greece still a major uncertainty, as well.

On a valuation basis, S&P earnings estimates remain around $95 for this year and $105 for 2012. Sixty-five percent of reporting companies beat third quarter estimates, although the number of guidance cuts has risen some. With the recent upward revision of third quarter GDP, and third quarter profit tallies, the range of profit expectations for next year has narrowed, with the $80 low end figure now considered unlikely. On $105 in S&P 500 earnings, the market closed October at just under 12 times forecasts. The historic average is over 15 times, and is normally higher when interest rates are low.

We have recently moved our exposure up, more because our view

^ Indices are denoted in US dollars.

that the bottom has been raised than because of optimism over a strong 2012. As has been the case since May, this has been one of the most difficult markets in years because so much depends on European policymakers, and stock correlations are much higher than usual, making individual stock selection more difficult. With a seasonal upward bias and some progress on the European policy making front, we are a bit more optimistic, but as we have seen even in the first week of November in reaction to the now aborted Greek referendum on that country's bailout, things can change swiftly.

SPOTLIGHT ON: Media and Recessions—2012 versus 2009

In recent weeks there has been a cascade of analyst and agency reports downgrading their forecasts for advertising in 2012 in view of the generally reduced outlook for the economy next year. In connection with third quarter earnings calls, several media companies suggested shorter term network ("scatter") business is slowing, which some investors have taken as an omen that 2012 results will be worse than expected. These fears have taken down the stock prices of many media companies because of their traditional cyclicality. The concern has probably been exacerbated by the not too distant memories of what happened in 2009. In that year, the drop in advertising was by far the steepest since the Depression and far worse than GDP or corporate profits. Of course, it was also the worst year for the overall economy since the Depression, and we are still trying to recover from it.

There are some major differences this time, however, including the fact that the dourest economic forecasts are not as severe as what happened last time, short of a domino effect from a European debt related collapse. Beyond that there are some other major reasons why a recession, if there is one, wouldn't cause the same impact on media companies as last time.

For one thing, the drop in auto advertising alone represented one third of the overall ad decline in 2009, and this time that sector may be among the strongest. With better capitalized companies, no shutdowns or bankruptcies like occurred in 2009, and a rebound from Japanese companies who cut back as a result of the earthquake there, auto advertising is likely to increase in 2012 under most circumstances. There are already indications that spending is accelerating since September on the local dealer front, as the Japanese OEMs are coming back. Auto advertising has historically been fairly steady in both directions on a per unit spending basis. Most forecasts expect at least a moderate increase in auto sales in 2012, and the industry is still well below prior peak levels of production with the age of the existing universe of cars approaching historic replacement levels. Auto advertising is particularly important to television and radio stations, accounting for as much as 25% of local television receipts.

Secondly, next year is a political year, and also includes the Olympics. In 2009, results were hurt by comparisons with the 2008 Presidential year and Olympics spending. Since then, the amount of spending on issues advertising has also increased substantially, partly as a result of court rulings allowing it. The impact of all this is not only more money, but a squeeze on available advertising inventory.

A third factor on the television station side is the growth of non advertising revenues, chiefly retransmission fees, which were just starting in 2008. This is particularly beneficial to the network parent companies. CBS is expecting a minimum of $250 million in such revenues next year, a 100% jump, and less than halfway to its ultimate estimates. NBC is just starting to ask for such fees, a process that was on hold during the pendency of the Comcast acquisition. The networks eventually expect to recapture about half the fees their affiliates get. Thus, stations may begin to lose some retransmission revenues to their networks as affiliation agreements come up for renewal, although for the time being there's probably more growth in what's coming in than losses from what's going out.

In addition, the network and entertainment companies that produce television programming have significant content libraries, and they are finding new buyers from over the top competitors, such as Netflix, Hulu and Amazon. CBS has signed deals worth hundreds of millions of dollars with the new players, which will be an increasing buffer to any softness in network revenues. Time Warner, the biggest television producer, has hardly touched its library in terms of sales to new markets, and it has the biggest library. Both retransmission fees and library sales are very high margin revenue sources.

Like much of corporate America, U.S. media company balance sheets are in far better shape than they were in 2008-2009. Debt has been reduced, maturities stretched out, and interest rates lowered. This means that advertisers are less likely to hold or cut back media plans because of their own credit and leverage situations. In many cases, media company share counts have been reduced by repurchase programs and/or dividends have been initiated or increased from excess free cash flow. Reduced leverage and returns of capital are allowing modest revenue gains to translate into double digit increases in earnings and free cash flow per share.

The present picture is also better than at this time in 2008. The upfront network selling season was strong with CPM (cost per thousand) price increases in low double digits, especially for cable networks. Scatter, or short term prices, are still above the upfront although slowing, and cancellations for first quarter are still minimal. The upfront market was up moderately at this time in 2008 for the 2008-2009 season, so things can change quickly. The networks' earnings declines in 2009 came largely from the next upfront, for 2009-2010, which was being negotiated in the depths of the recession in the spring of 2009. That could happen again, of course. However, short of a recession, the situation next spring does not look likely to be anywhere near as bad as it was in 2009.

Most analysts' estimates for 2012 at the broadcast and cable network companies are for revenues to grow in the low to mid-single digits on an organic basis, which implies that scatter pricing will be less than upfront. But a higher percentage of network inventory, close to 80%, was sold upfront this year, a reaction to sharp scatter price increases in 2010, which is what current short term business will have to compare to. However, the tight inventory situation works against too big a drop, and until scatter falls below upfront, there is a risk of a squeeze to advertisers who pull out of their upfront commitments. This arbitrage between upfront and scatter happens nearly every year depending on the relative strength of upfront versus scatter the prior season. While on the margin pricing may decline as the season progresses, overall revenues are still expected to rise modestly, unless there is a major recession next year. And, as noted, the network companies have much more of a buffer this time from political, Olympics, and non traditional sources.

Advertising generally follows the course of nominal GDP, which is a good proxy for corporate sales, with fluctuations in the relationship largely a result of profit and margin trends. In recent years, the ratio of advertising to nominal GDP has declined some, even adjusting for political/Olympics years. We believe part of that is the downward pressure on rates from the shift to the new media, particularly the Internet, which has unending supply, and away from the old media, like newspapers, which are relatively expensive on a cost per thousand basis.

Estimates for total U.S. advertising next year are generally in the 1-3% area for core growth, before the contribution of political and Olympics, and 3-4% including those items. This compares to estimates that 2011 domestic advertising spending will have risen about 3%. The negative bias in ad/GDP secular trends in recent years means the lower end of estimates of core growth are generally below the macro economic forecasts of 2.3-2.9% growth quoted earlier even though the opposite is true so far this year.

These projections do not presume a recession, but a slowdown. Even with a mild recession advertising would likely be down only modestly judging by the historic economic reversals other than 2009. However, since the industry is digging itself out of the greatest hole ever (advertising was down an unprecedented 16% in 2009), and given the differences we cited earlier, especially auto advertising (down 20% in 2009), we believe that any deviation from historic pattern is more likely to be on the upside than the reverse. Also on the plus side is the fact that profit margins are rising, and that condition historically leverages advertising swings positively.

Note that advertising in the first half of this year is up around 5-6%, which well exceeds GDP. Third quarter earnings reports so far have been strong, with double digit increases being reported. In the advertising agency group, there has actually been an acceleration in organic growth in the third quarter (part of which is from emerging markets). That is not to say things couldn't change quickly, despite the lack of much current evidence. Advertisers are certainly in a cautious mood given what they, like everyone else, are reading about and seeing from consumers.

On the network scatter issue, the high upfront sellout ratio this year probably explains some of the slowing scatter markets, as advertisers, having already made large commitments, are cautious while they are flushing out their remaining 2011 budgets, in view of the economic uncertainties. However, so far cancellations of upfront network commitments for the first quarter of 2012 are still minimal. Another data point on year end caution came from National Cinemedia, which sharply lowered its fourth quarter guidance recently, claiming advertiser commitments to the television network upfront market cut out money they expected. Cinema advertising is a newer medium, and more discretionary. NCMI is also dependent on a handful of industries so results can be skewed.

Magazine pages have deteriorated as well, and they tend to retreat earlier than most media, as they did in the last recession, beginning with the first quarter of 2008. Promotional spending, as indicated by Valassis and News Corporation's free-standing coupon business is going into decline. Meredith noted that contrary to normal years, fourth quarter special projects spending was on hold because of economic uncertainty.

On the local front, judging by recent earnings calls, things have actually strengthened a little since September, perhaps in accord with overall economic results. Local television core growth, ex political, is still up low single digits and strengthening some as Japanese auto advertisers come back. Lamar reports some pickup in outdoor spending, and radio is flattish. While newspaper print numbers deteriorated over the summer, the companies are reporting slightly slower declines since September, in part because comparisons ease.

Nevertheless, as has been the case since the recession, national advertising, representing big corporations which need to continue to promote brands, and which are in better financial condition than local businesses, is likely to remain stronger than local spending if there is a recession. Local television and radio stations, will however benefit from political and Olympics dollars this time.

On the secular front, trends continue to favor digital, cable networks and television, with print in particular exhibiting further declines and/or market share losses. Directories, newspapers, magazines, and couponing are declining or losing share, while Internet search and display, cable and broadcast networks, and newer media like mobile, social and digital video are ramping quickly. The other traditional media like outdoor and radio are somewhere in the middle with flat to slightly positive trends. In 2009, compared to the unprecedented 16% drop in total advertising, national television (broadcast and cable) was down only 5%, and Internet advertising less than that, while newspaper advertising dropped 25%.

From a valuation standpoint, most media and entertainment shares are at the low end of historic multiple ranges, and with a few exceptions, they are trading below the market's overall P/E. Historically they trade at a modest premium. The difference would seem to imply concern over the industry's cyclicality and memories of 2009. Since we believe the risk is far less than that, not to mention the uncertainty over whether there will even be a recession, we believe the group is attractive overall. That attraction is amplified by the accelerated return of capital programs at virtually all the entertainment and cable companies. Increasingly measures such as EPS and free cash flow per share valuations will back up traditional EBITDA multiples. If one looks at likely EPS growth rates compared to P/E multiples, the group is clearly cheap.

Our investments have been in such big cap entertainment companies as Time Warner, Viacom, and CBS, which are all big broadcast and/or cable network owners, and in the advertising agencies, where our primary play is Interpublic. We also have positions in Comcast, the new owner of NBC, and DirecTV, which, like the rest of the pay television industry, has a growing advertising business, but more importantly still derives the majority of income from its subscription business and faster growing Latin American operations. Also, to the extent the big entertainment companies are dominated by their cable network business, about 40% of revenues do not come from advertising but cable operator fees, which are not cyclical, and are growing. Even the cyclicality of the broadcasters, specifically CBS, are much less than historically, because of the rise of retransmission fees and library sales, which really only became meaningful since the 2008-09 recession.

Given the percentage of advertising to total revenues and profits at most of the above noted companies, their national versus local orientation, and the likelihood that any decline will be modest, we believe the sector is attractive, especially at today's levels. The more dour forecasts assume a recession. On anything short of that, these companies will have higher earnings next year and several could withstand a mild recession and still have increased per share results. While the market may be myopic on any data points hinting of slower growth, as it has been on recent earnings calls, we believe at this point there is more opportunity than risk.

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

Regards,
Dennis H. Leibowitz