ARROW FUND OF FUNDS

Arrow Hedge Partners Inc.

2009 – A YEAR IN REVIEW

What's NEXT?

What do you do when the price of an asset is lower than the sum of its parts?
Normally, you buy that asset. But what do you do when a banking system then breaks down?

By Mark Purdy and Keith Tomlinson

We thought we would try something a little different with this quarterly letter, what with the extreme volatility in markets over the last two years and the perception — at least for this moment — that what was supposed to be the next great depression is now over, before it really started.

As for all investors, it has been a challenging period for us at Arrow. We made some mistakes, and our funds did not hit their performance targets, even though we did outperform our peers and the equity markets. At its worst, our flagship Multi-Strategy Fund was down 18%[1] from peak to trough, compared with equity markets, which fell 44%. We've recovered a good part of that loss, and the Fund is currently down just 9%[1] from its peak. In the meantime, equity markets still have a long way to go to recover from 2008.

We did see redemptions during this period, and our assets under management fell. But we fared better than most hedge funds. Through the crisis, according to HFR Global Hedge Fund, assets fell from an estimated US$1.9 trillion to US$1.4 trillion, recovering to US$1.6trillion. Many hedge funds closed or suspended redemptions. We can't help but think that since we were one of the few hedge funds that did not restrict redemptions, investors treated us as their ATM of choice. Or perhaps, after the failures of Portus, Norshield, Tremont, Abria and others, they were afraid we would be next.

But there is another factor, which we hear again and again from our sales channel: "You weren't supposed to lose in a bear market," they tell us. "You were supposed to give us positive returns in good years and in bad. That is why we placed our clients in your fund. You were supposed to protect them."

We hear you. It would be easy to say that, faced with an almost complete collapse of the banking system, and a game in which the rules kept changing (e.g., the short-selling ban), no one could realistically expect funds of funds to make money in 2008. We must also try to give you a better idea of just what went wrong, and more importantly, what we have learned through the process — and why we now believe that we are even better positioned than before to deliver on our objectives.

> *"We're now better positioned than ever to deliver on our objectives — even if "once in a lifetime" events happen more than once in our lifetime."* Mark Purdy, CIO

HEDGE FUNDS VS. MUTUAL FUNDS

First, a few notes on mutual funds.

Over time, stock markets usually go up. That simply reflects the fact that productivity and economic growth tend to increase over time, which increases earnings. In a rising market, most stocks — good and bad — tend to go up. Long-only mutual funds benefit from that trend, as they are required to be fully invested. At the same time, a true long/short hedge fund manager will always be at a structural disadvantage when stocks are only rising.

CELEBRATING 10 YEARS
ESTABLISHED 1999

Mutual funds might seem to have an edge. But do you really want to ride a bus when the driver must always keep his foot on the gas pedal?

The dramatic rebound in markets has helped investors forget that most mutual funds gladly rode the markets down between 2008 and the first quarter of 2009, and they will gladly ride them down in future, should the recent strength in markets prove short-lived. While markets have a tendency to rise over time, there can be multi-decade periods in which there is little or no increase. U.S. markets traded in a narrow range between 1966 and 1982, and Japan is still a long way down from its 1989 peak. Even in Canada, markets are still only now at 2000 levels. At Arrow, we believe that financial markets are in for a very challenging period over the next five years as the massive excess of a generation of spending is unwound.

The popular perception is that hedge funds are riskier than mutual funds, but in fact, they can be much safer. We stress the word "can," because a proper hedge fund can be safer. It all depends on the fund, recognizing you are taking on different risks. Unless the stock market goes to zero, a long-only mutual fund is never going to blow up. Where the hedge fund industry gets a bad rap is from managers who take on too much leverage or too much concentration, or who simply don't hedge themselves at all. When they collapse, the whole industry gets painted with the same brush. Large-scale frauds (like Madoff and Petters) have also done a lot of damage to our industry. At Arrow, we carefully avoid managers where we see undue investment risk or operational risk. We also put our money where our mouth is: our employees currently have $35 million in our funds.

THE SELECTION PROCESS

If we look at what went wrong for us during the crisis, it was certainly not our manager vetting process. While many of our peers choked on Madoff's web of deceit, we avoided that mess altogether. Modesty aside, this was not luck. To say our vetting process is restrictive is an understatement. Virtually half of all the prospective managers we investigate fail to make the grade. Over the years, our conservative approach has even limited our performance upside — and we think it's worth it. The likes of Madoff and Amaranth Advisers never get past page one of our checklist.

> *"There are numerous high quality hedge funds in Asia that are undercapitalized, by focusing on these undercapitalized managers we feel this is one area that can potentially add a lot of value for our investors."* Keith Tomlinson, Director of Research

At Arrow, we have two distinct teams engaged in the manager selection process: an investment committee and a risk committee. Prospective managers typically must pass two comprehensive on-site visits from these teams to make it to the approved list. We get our prospects from a variety of sources: prime brokers, investors, managers, databases and industry conferences. If something grabs our attention, our investment team will meet with the fund and assess whether the investment style, strategy, track record, size and, most importantly, manager temperament look good. If they like it, they'll write an initial report and table it at the next investment meeting, where it will be debated internally. If the fund's fundamentals stand up to scrutiny, a senior member of the team will typically meet with the manager. Thereafter, if it's still a go, the risk committee will go to work, assessing both operational and investment risk. Are the funds doing what they're saying they're doing? Can we trust the numbers? Do they have the manpower? What would this fund do to the correlation of the entire portfolio? If the fund passes that last test, then, subject to capital constraints, we'll look to invest. As of now, we have 34 managers on our fund of funds approved list of hedge fund managers, and 211 at some stage of the investigation process.

There are three red flags that would immediately prohibit investment in a particular manager: poor transparency, low liquidity (privates, etc.) and high leverage. The value of our process was proven during the financial crisis.

TRANSPARENCY

We demand full transparency in every hedge fund we invest in. What that means, in practical terms, is that the manager must either hold our portfolio in a managed account in which we are the manager or provide independent third-party confirmation of its positions via a prime broker or administrator. If we are relying on third-party information, we pay close attention to their valuation methodology, particularly where the fund in question holds non–exchange-traded assets. At a minimum, we get disclosure on a monthly basis. All this information, coupled with e-mail and verbal communication, helps us manage our aggregate risk. Equally important, this makes it extremely difficult to perpetrate a fraud.

LIQUIDITY

When it comes to liquidity, we need to be able to redeem on agreed terms, so that you can get your money out. We want to be sure our managers have properly matched the liquidity of their funds with that of their investors. It's important to us that our managers invest in liquid instruments so they can redeem our investments, if need be, upon short notice. Our liquidity model was proven during the crisis. While gates and restrictions were being imposed by hedge funds all around the world, we honoured every single redemption request (once a month with 10 business days' notice). This was no small feat, considering that hundreds of global hedge funds restricted redemptions, and many are still locked up today. At the worst of the period, just 7% of our managers had gated, and only one is still gated as of today.

Providing liquidity helped keep our reputation intact through the crisis. Unfortunately, being one of the hedge funds that was actually honouring redemption requests may have amplified the outflow. Our fund of fund assets shrank from $250 million before the crisis to $150 million. That said, $70 million of that reduction reflected the actions of one institution, reducing their exposure as part of their "hedging" activities or "de-leveraging process."

LEVERAGE

It is very easy – and tempting — to use leverage to enhance returns. And it easy to get away with: excess use of leverage is not captured in risk statistics like the Sharpe Ratio, especially when markets are trading in a consistent pattern for an extended period of time. Complacency sets in, and the Sharpe Ratio looks great — until it looks terrible, and by then it's too late.

We've never liked leverage. Leverage kills hedge funds. That is why we have no leverage at the top level, and we limit our aggregate gross (long + short) exposure to 200% of net asset value. We also limit our net (long – short) exposure to a range of -25% to 100% of net asset value. We generally hold our individual fund managers to the same restrictions.

FEES

A word on fees: there is often criticism in the press that the funds of fund model is flawed, in that the investor pays fees twice, once to the manager, and once to the underlying funds. In our case, this is not true. Between our different classes of funds, we currently average "all in out" at about 2.5% and 20% (2.5% annual management fees and 20% performance fees). But we don't keep it all. We pay the fees for the underlying fund managers, as well as 1% trailer fees for financial advisors. We can also usually negotiate a fee reduction with the underlying managers. "Net-net," Arrow earns about 50 basis points per year on our fund of funds. So ultimately, you're not paying much more than if you had been able to replicate our portfolio on your own.

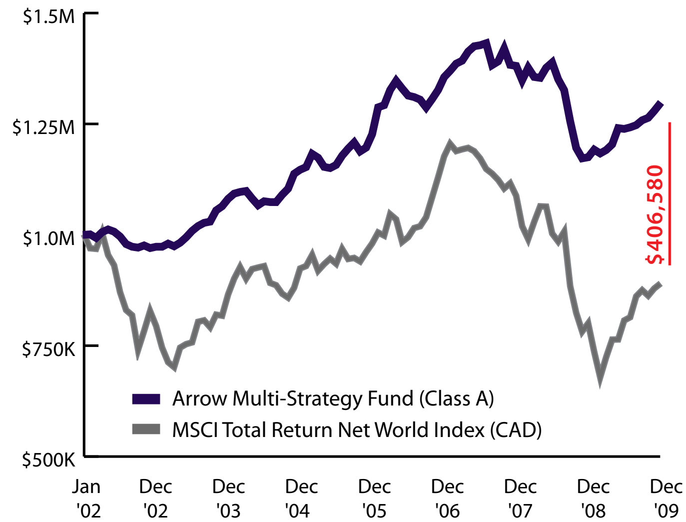
THE FINANCIAL CRISIS

The 2008–2009 financial crisis is the second bear market Arrow has faced since our funds of funds started operations in early 2002. Our Multi-Strategy Fund did brilliantly during that first bear market. In fact, things seemed to be on track for a good 2008 as well, after we skated by the Bear Stearns bailout in March; we were up 5.4%[1] at the end of June 2008.

> *"We're still positive on credit for 2010, but looking to take less outright directional risk; we think we would rather invest with managers who can be tactical in their approach to risk."*
>
> *Mark Purdy, CIO*

If it had been a normal cyclical bear market, we would have been all right. But it all turned very wrong for us in September 2008, when Lehman Brothers failed and short sales were banned in many markets.

CHART 1: GROWTH OF $1M FOR ARROW MULTI-STRATEGY FUND[1] - AS OF DECEMBER 31, 2009



Source: Pertrac. Arrow Hege Partners Inc.

What do you do when the price of an asset is lower than the sum of its parts? Normally, you buy that asset. But what do you do when a banking system then breaks down? When redemptions and the collapse of your bankers force you to sell that asset too, you must inevitably take your losses.

We did not have any direct exposure to Lehman, but its failure and the short-selling ban created huge distortions in financial asset pricing. Hedging was virtually impossible. It was a perfect storm as leveraged market participants were unwound. Our long/short and event-driven managers were whipsawed. One fund that specialized in master limited partnerships fell 60% due to Lehman's bankruptcy-forced selling of those instruments. On the positive side, diversification by asset class helped.

WHAT COULD WE HAVE DONE DIFFERENTLY?

It would be easy to explain that the financial crisis was a "once in a lifetime" type of event — an event that impaired the way we normally make money, an event that we could not really prepare for. But that would not be helpful. The real question is what have we learned, and what can we do differently?

The reality is that you try to manage risk: investment risk, market risk and operational risk. The only way you can hedge for the unknown is to keep leverage down, keep liquidity up and be nimble. We think we scored two out of three in that respect, given our low leverage and ability to meet redemptions.

Where we think we could have done a better job is to have been more nimble. When it comes to our managers, we should have been a little more disciplined and a little less loyal. If there's one thing we've learned through the crisis, it's to act more quickly. When hedge fund managers draw down, see a key member leave or experience other business problems, it's best to redeem quickly. In some cases, we deferred the decision — and not from any lack of information: we had the transparency. It's harder to cut a relationship than a stock, but in every case, we regretted the decision not to.

Being nimble also means being able to take action where action is needed. In the past, we have limited our top-down strategic views to the selection process. We chose good managers that reflected our views on markets, sectors and instruments, and then we monitored them closely. But what we saw in this recent financial crisis was that our portfolio did not always work the way we thought it would, as several managers did the opposite of what we thought they would.

OVERLAY IMPLEMENTED

This led to the decision last year to put in place a mechanism to ensure that the portfolio accurately expresses the macro views of the investment team. After all, even if you want to replace managers, it cannot be done overnight. To that effect, we established an overlay for all of our funds of funds. The overlay — some 5% of the portfolio — is managed directly by Arrow, and it will enable us to act swiftly to position the portfolios based on breaking market information or to neutralize any unnecessary risks at the portfolio level.

LOOKING AHEAD

Our business is actually getting easier. For one thing, the financial crisis was the first real test in a long time for the hedge fund industry. There is a wealth of talent out there, and that talent is now more easily identifiable. If you're a mutual fund, you would have simply risen with the recent rebound, but in the hedge fund community, the cream has clearly risen to the top. The crisis washed out a lot of good managers, and there are many orphan funds that did a great job but today have no money. For example, there are numerous high-quality hedge funds in Asia that are undercapitalized. We think that focusing on these undercapitalized managers could potentially add a lot of value for our investors. There are also funds that did poorly in 2008, but still recovered nicely. They may look bad on paper, but we think that by going in and seeing what they've learned from the experience, we'll uncover some real gems.

Another positive is that it is getting easier to find funds that will accommodate our stringent investment criteria. Before the crisis, we had a lot of difficulty getting funds to meet our need for transparency. The financial crisis has changed that, with more of our competitors now demanding similar transparency.

In respect of our current positioning and market outlook, the main thrust of our long-term view is that we are in a primary bear market and have been since 2000. In the short term, we think we have reached an inflection point. We are positioned 44% net long, with most of that long exposure in corporate debt. At 135% gross assets to net asset value, our leverage is very modest, and we remain flexible, given our overlay.

OPPORTUNITIES FOR 2010: TOP STRATEGY CALLS

Over the next few years, we see selective upside in equities (good environment for long/short), and think government bonds could also prove risky.

Last year, our focus was mainly on credit, which proved to work to our advantage, as credit spreads fell fast from their crisis levels. We're still positive on credit for 2010, but looking to take less outright directional risk; we think we would rather invest with managers who can be tactical in their approach to risk. Maintaining liquid portfolios, with the ability to move out of positions quickly, is something we believe will add quite a bit of value as volatility returns to the markets. Capital structure arbitrage is also a very interesting source of returns in that space. With recent increased levels of volatility, trading opportunities abound.

We believe there are some interesting opportunities in the equity long/short space. We're looking at managers with reasonable gross exposure who managed their balance sheets well during 2008. We also favour managers with tighter net exposures (-20%/+20%) that can benefit from increased dispersion in their short and long books without having to take on too much market risk at any one given time. Because of this increased dispersion, we also like some of the relative value macro themes some hedge fund managers are implementing in their books for 2010.

In the short term, equity market volatility is increasing, so short selling should be easier this year. In what looks like a slow economic recovery, the business climate for restructurings, as well as mergers and acquisitions, is an excellent one for event-driven trades. In the emerging markets sector, we should start seeing greater variation between sovereign credits as the risks of default materialize.

All in all, we are optimistic. We opened the Multi-Strategy Fund in January 2002 in the middle of a bear market. Between that bear market and the more recent crisis, we still managed to deliver a 29.6%[1] cumulative return (through December 31, 2009), outperforming both the markets and many of our hedge fund peers. We have learned a tremendous amount through these cycles, and we have done it as a team. We're now better positioned than ever to deliver on our objectives — even if "once in a lifetime" events happen more than once in our lifetime.

ARROW MULTI-STRATEGY FUND (CLASS A)[1]

Security Exposure as at December 31, 2009

	Long	Short	Net
Equities	47.4%	-41.6%	5.8%
Corporate	36.6%	-3.7%	32.8%
Warrants/Other	5.7%	0.0%	5.7%
TOTAL	89.6%	-45.3%	44.3%

Strategy Exposure as at December 31, 2009	
Global Long / Short	27.0%
Relative Value	24.5%
Event Driven	19.7%
Macro	13.4%
Cash & Working Capital	15.4%
TOTAL	100.0%

ARROW FOCUS FUND (CLASS A)[1]

Security Exposure as at December 31, 2009

	Long	Short	Net
Equities	48.6%	-35.2%	13.4%
Corporate	37.2%	-4.7%	32.9%
Warrants/Other	6.7%	0.0%	6.7%
TOTAL	92.5%	-39.9%	52.6%

Strategy Exposure as at December 31, 2009	
Global Long / Short	26.0%
Relative Value	15.6%
Event Driven	30.0%
Macro	19.8%
Cash & Working Capital	8.6%
TOTAL	100.0%

ARROW ENHANCED INCOME FUND (CLASS A)[1]

Security Exposure as at December 31, 2009

	Long	Short	Net
Equities	37.6%	-51.1%	-13.5%
Corporate	70.9%	-7.5%	63.5%
Warrants/Other	7.0%	0.0%	7.0%
TOTAL	115.5%	-58.5%	57.0%

Strategy Exposure as at December 31, 2009	
Global Long / Short	7.2%
Relative Value	27.4%
Event Driven	32.7%
Macro	19.8%
Cash & Working Capital	12.8%
TOTAL	100.0%

[1] From July 2001, returns are for Arrow Focus Fund (Class A), net of all fees in Canadian dollars. From January 2002, the returns are for Arrow Multi-Strategy Fund (Class A), net of all fees in Canadian dollars. From January 2005, returns are for Arrow Enhanced Income Fund (Class A), 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 Hedge Partners 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 Hedge Partners 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.