ACT II LONG/SHORT FUND

Commentary - November 2011

Experience. Intelligent Investing.

Act II Long/Short Fund had a 2.7% decline in November, net of fees, compared to a 0.2%^ drop in the S&P 500 including dividends, and a 2.4%^ decline in the NASDAQ. As noted below, until the end of November the market retraced much of the 20% October rally, as the European crisis spread, negating the earlier optimism over the likelihood of a plan to deal with the issues. Another round of hopeful signals reversed the downtrend once again at the end of the month. Year-todate, we are down 6.0% net, compared to a 0.9%^ decline in the S&P 500 (up 1.1%^ including dividends), and a 1.2%^ drop in the NASDAQ. While we had outperformed the market all year through September, the month of October set us back substantially for reasons described in last month's letter—low exposure in the dramatic rally, and some individual stock issues.

Our performance in November was hurt by two stocks in particular that accounted for more than half the decline. Shares of Shutterfly, the online photo book company, dropped sharply from a series of events. The most important was mounting concern over a more competitive environment in the all important fourth quarter. While management has reiterated its strong growth guidance, it also acknowledged increased competitor promotions. There was also controversy over initial results from the acquisition of Tiny Prints on Shutterfly's third quarter call, and this was exacerbated by Tiny Prints' former owners selling shares. Negative articles from a research service focusing on short recommendations, and a bearish article in Barrons added to the pressures. Then Eastman Kodak announced it was considering selling its competing operation, which was taken as a risk that a bigger company would be the buyer, even though the most logical one would be Shutterfly, where it would be highly accretive. Finally, the company increased the borrowing capacity under a new undrawn revolver, perhaps for a bid on Kodak's operations, but for unspecified uses. We have done exhaustive work, including numerous conversations with management and believe that, while these issues have been more than discounted in the stock's performance, we recognize that the continued uncertainty until the Holiday season results are apparent will continue to weigh on the stock. As such we have continued to reduce our exposure to the stock.

The other problem stock was Echostar, the equipment and satellite operator which was spun off of DISH network. Echostar acquired Hughes Network Systems earlier this year, which is the leading satellite service provider to Enterprises and also offers satellite broadband to rural areas. The company sold its valuable wireless spectrum to DISH, building its substantial cash position to almost $2 billion. It also has substantial, less transparent hidden assets. Valuation is incredibly cheap at 2.7 times estimated 2012 EBITDA. Fundamentally, there were no particular developments, and we remain about breakeven in our investment. However, the complicated nature of the company, and the elusiveness of Chairman Charlie Ergen, took its toll in this very volatile market.

Shares of Apple, one of our largest holdings, also declined 5.5%, in part because of publicity over Amazon's lowpriced Kindle Fire, which is a competitor for the iPad, and from rumors from Asia about supply chain sources that indicated that iPad sales may be below estimates. We are highly confident that Apple will continue to report very strong numbers, including for the iPad, and note it's still below market valuation. Despite the overall decline, we had several strong performers for the month among our largest positions, including Century Link, Signet and Gameloft, and we also outperformed on the short side in November.

Turning to the market itself, it's all Europe all the time. It least it seems that way. While the market retraced half the October rally, falling 10% from the highs as the contagion spread from Greece to Italy to the stronger European countries, it snapped back in the final days of the month, as hopes rose once again for an overall plan to solve the crisis. In effect, the situation had to get so dire that the prospect of the long withheld support from the European Central Bank, along with an agreement to regulate Government spending on a centralized basis became inevitable. The market had similar hopes when the October rally began, but fizzled when piecemeal actions clearly weren't working and the crisis worsened. This was evidenced by rising Sovereign debt interest rates, which spread from one country to another, finally threatening the stability of the strongest nations as well as their banks. Not that we are out of the woods

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^ Indices are denoted in US dollars.

yet—the conservative forces at the ECB and in Germany still have to concede to the need for an emergency stimulus. A new ECB leader and concessions from Germany are raising hopes. Now the market is assuming whatever has to be done will be done, but there is still a risk of a repeat of the November slide if it doesn't.

On the domestic front, the outlook is much brighter, and there continue to be signs that the U.S. economy may be slowing, but will not have a double dip recession. Some of the indicators, like consumer confidence, manufacturing, and retail spending, have been surprisingly strong, while the more intractable ones, such as employment and housing, are getting slightly better.

From a valuation standpoint, consensus estimates for S&P 500 profits have been resilient, with little movement despite the economic uncertainties and deteriorating international outlook. Thompson Reuters consensus figures show average projected profits this year of $96.26 per share for the index, and $103 for 2012, down only slightly from earlier forecasts. This puts the S&P at 13 times the 2011 numbers, and 12 times the 2012 outlook. With interest rates low, this makes the market appear to be relatively cheap in the context of the 15 times historical average multiple. To the extent Europe stabilizes it probably is, although the continued volatility and global risk factors make it unlikely that the averages rebound to historic average multiples any time soon.

Having moved up our exposure over the last month, we are making the bet that Europe will have to come up with a credible plan to stabilize the financial markets, as the U.S. did in 2008-2009. The recent rally in the midst of escalating crises, while seemingly counterintuitive, is basically a judgment that drastic action must be done, and that that day is near. Seasonal factors should also be favorable for stocks as the year-end nears.

SPOTLIGHT ON: BROADBAND— CABLE'S NEW CORE PRODUCT

There has been much publicity lately about competitors to cable's traditional video service. Articles citing Google and Sony's separate considerations of entering the business in competition with the pay television networks are the newest stories, following the spate of publicity about over-the-top competition from Netflix especially, but Amazon and Hulu, and most recently Verizon, as well. Less publicized, however, is how data and other non-video services are taking over as the industry's lead products, sometimes literally as some MSOs offer standalone broadband service. Given that the margins on incremental data service subscriptions are double that of video, the nature of where the industry makes its money is changing. When one adds in the commercial aspect of the industry's broadband offerings, along with wireless backhaul, voice services, and advertising, one sees a changing picture.

In an October 31st article, Multichannel News, taking Street and company estimates, projects that video revenues will fall below the halfway mark by 2013 in the case of Charter and by 2015 for number one MSO, Comcast, where it is already down to 53%. Data will be the largest component of the other half, with voice and commercial services making up most of the balance. Interestingly, all these non-video services have higher profit margins than video. Video margins are inherently lower because of the cost of programming and have also been squeezed in recent years by pressure from retransmission fees. The shift to non-video sources means that cable operator profits from broadband and related services will shortly exceed income from the original video service.

Broadband penetration today is about 65% of all households, and thus has more room to grow than video, which is close to 90%. Some believe that, like wireless, it will eventually get to 100%. Furthermore, cable's incremental share of broadband additions is rising because of the superior performance of its DOCSIS 3.0 technology. While cable has a 55% share of the market, it is taking over 70% of incremental business, mostly at the expense of telco company DSL offers. As the buildouts of AT&T's Uverse and Verizon's FIOS broadband systems are nearly complete, there is reason to believe cable's share could rise further as DSL continues to decline. FIOS and U Verse video systems cover 40% of the country, so DSL is the product in the other 60%. Thus, cable has a growing market share of a growing marketplace.

In various articles, Alliance Bernstein's Craig Moffett argues that as video consumption increases on the Internet, cable operators will move to a usage based pricing model, much like the wireless operators already have. "The adoption of usage based pricing would be transformational to the debate for Cable operators, inasmuch as it would essentially indemnify them against all potential outcomes." Time Warner Cable got flak for an attempt to do this a while ago, but it was poorly conceived and did not offer a low-end tier. The reason for ultimately adopting usage based pricing is the rapid growth in bandwidth consumption of Internet video. However, UBP also offers the opportunity to grow the market, by offering lower end tiers that will enable the cable industry to penetrate some of the one-third of households who don't presently take broadband for economic reasons. Another side benefit might be the impact it could have on over the top competitors, if it costs a lot more to consume lots of video on the Internet.

Also, note that in conjunction with the lawsuit against Comcast that led to the FCC"s "net neutrality" rules, that agency made clear that usage based pricing was acceptable as long as it wasn't discriminatory. Today's various charges for different download speeds are conceptually similar to the idea of usage based pricing. An increasing percentage of users are already paying a premium for faster delivery. Comcast placed a 250 gigabyte cap on broadband users, which is far in excess of typical consumption today, but that usage will rise dramatically with video. In Canada, cable operators have imposed caps as low as 25 gigabytes per month, which has caused Netflix to lower the resolution of its transmissions there.

The fastest growth segment at the cable operators is the commercial business. Comcast's commercial services revenues have grown at a compounded rate of almost 50%. The advent of DOCSIS 3.0, as well as competitive voice products, and to a lesser extent traditional video, has triggered this rise. Operators, starting with the smaller end of what is known as SME (small and medium sized enterprises) are moving up the scale to the medium sized businesses. These are huge markets in terms of current spending by such businesses. In conjunction with their commercial efforts, the MSOs are also entering the wireless backhaul business. With plant near cell phone towers, it is relatively cheap for them to offer connection between cell sites to the carriers, and their fiber product is superior and often cheaper than the T-1 lines that have historically been used by the wireless industry.

Cable operators are also taking share of voice, primarily as part of their triple play bundles. Offsetting this trend, however, fixed line voice subscriptions as an industry are declining because of wireless substitution. While cable voice customer counts won't be what were originally hoped for, they will still be incremental, and they are another example of a high margin product. Plus cable penetration of voice is still less than 20% for most operators, which allows plenty of upside from market share trends despite the headwinds from wireless substitution. Cablevision, the most successful, has 40% voice penetration. A decline in voice subscribers at Time Warner Cable in the third quarter spooked investors, but the company attributed it to a shift in marketing to double play from triple play subscriptions, and says it is showing voice subscriber gains in the current period. All other MSOs have had steady gains in voice subscriptions. Because of the very low incremental cost, voice pricing can be heavily discounted as an inducement to taking triple play bundles.

Turning to the video side, subscribers at the cable operators peaked in 2003 at 66.1 million, and had fallen 10% to about 60 million by last year end. Cable's share of multichannel video customers has decreased from 52% to 48% of the 101.2 million overall pay television universe, which in turn represents about 87% of all U.S. households. However, over the same period MSO video revenues rose 37% through a combination of price increases, and extra charges for digital tiers, HD, DVR, VOD and whole home services. Broadband customers more than tripled in the same time span, while cable voice subscribers rose sevenfold after a later start.

The maturation of new video products does not necessarily mean video revenues will decline, but growth in such revenues will probably decelerate or flatten out. Newer video services like video-on-demand and advertising offer some incremental revenues, although price increases are becoming more difficult given the economy, and competition from alternate sources of entertainment. Thus the industry is more dependent on non-video sources to make up the difference.

The decline in cable video subscribers is attributable to a number of factors. They include competition, the economy, and the decline in household formations and, to a small degree, the growth in alternative video sources like Netflix. Video subscriber declines have actually lessened so far this year. Both third quarter and year-to-date video losses by the cable operators were less than in comparable 2010 periods. Part of this is attributable to a narrowing share loss. From a competitive standpoint, the satellite operators showed marginal and diminishing additions as DirecTV is growing, but mostly at the expense of DISH. The video operations of the telephone companies showed the best gains, but they are nearing a full buildout of their planned expansions, although their penetrations are still rising.

Since 2009, the overall multichannel universe has grown, with satellite and telco adds more than offsetting cable losses, meaning there has been a net increase in pay television subscribers. Surprisingly, there has even been a net increase in the more discretionary premium network subscribers, i.e., the total of HBO, Showtime and Starz. This is interesting in view of the economic and over the top arguments.

Opinion is almost universal, backed by company evidence, that the impact of cord cutting is imperceptible so far, with not only more premium subscribers, but the fact that churn remains low. In a recent report, however, Credit- Suisse argues that it will become more of a threat because of demographic changes. The report suggests the problem will be gross connections, which are lower for younger, newer households, rather than churn which has not shown any particular spike despite the economy. Nevertheless, the firm is overweight the group because of prospects for cable's non-video services. Keep in mind that over-the-top services require broadband connections, and cable is taking the lion's share of them.

The economy is the most important factor in subscriber losses, in our opinion, and this is corroborated by the fact that they are almost entirely from customers taking the lowest tiers, including basic-only. There has been some attempt by the industry to introduce lower priced packages that would strip out costly channels, particularly in the sports category. Because of the program cost savings, this is not necessarily a negative despite lower ARPU. The best example is Time Warner Cable's TV Essentials, which has a $29.95 introductory price for a year for 47 basic and 42 cable channels (including USA, CNN, Nickelodeon, and TBS, but not ESPN) and Comcast's new My Choice package for $24.95 with $10 theme-based add-on tiers. Interestingly, Time Warner Cable has also introduced a high-end valet-like tier at a much higher than average price, and it seems to be garnering more subscribers than TV Essentials.

In a surprising development, Spectrum Co., a consortium of Comcast, Time Warner and Bright House agreed to sell valuable idle wireless spectrum to Verizon at a substantial profit in a $3.6 billion transaction. In connection with the sale, which eliminates the threat of MSOs spending large sums to build a wireless network, the cable consortium and Verizon agreed to a cross-selling deal, where the operators can market Verizon Wireless in their franchise territories, while the Verizon stores will co-market cable services, even in FIOS territory. The biggest potential here would be the ability to market the video services to Verizon customers in non-FIOS territories.

One of the most interesting questions about cable video subscriber prospects is whether trends could actually reverse if the economically induced very low level of household formations picks up again. The key is occupied housing, not starts or sales. Because of the recession, vacancy rates and the number of persons per occupied household have both gone up. New household formations have slowed to 0.5% in the last couple of years from a peak of 2% a year and occupied homes were up only 0.1% in the first nine months of 2011. An increase in household formations could offset or even more than compensate for a continued decline in pay television penetration.

The slowdown in video revenues may limit overall revenue gains to mid single digits for the cable operators, but it doesn't suggest a decline. In fact, the nature of the gains is such that EBITDA margins will rise. Leveraging this further, capital expenditures are falling as a percent of revenues and in some cases absolutely. Consequently, free cash flow is often growing by double digits.

The icing on the cake, in our view of the stocks, is that virtually all the cable operators are accelerating their return of capital programs through both share repurchases and dividends at a time when valuations are near their historic lows. In fact, capital returns are now exceeding the majority of free cash flow. Yet valuations are lower than telephone companies which have less growth and higher capital expenditures. In part this is because of higher dividend yields in the latter case. We think the valuation of cable stocks is in the process of shifting from merely EBITDA (on which they are nevertheless historically cheap) to free cash flow and EPS.

In summary, while the constant publicity about cable video subscriber losses, margin pressures and competitive developments dominate the headlines, cable industry growth prospects look strong, especially on a free cash flow basis, as broadband and other services more than take up the slack. Thus, we are bullish on the stocks. Our largest investment in this area is Comcast, which we believe is exceeding the performance of the industry in cable, and has substantial upside potential from NBC.

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

Regards,
Dennis H. Leibowitz