

It appears that the market thinks the world is a safe place to freely invest again...we do not! We continue to be very concerned about debt levels in the developed world primarily in Japan, Europe and the US. Japan's economy is stagnant under a very heavy debt burden of greater than 200% of GDP and is growing at 7% a year. Europe is in a full blown sovereign debt crisis and we wait with baited breath to hear this week's latest policy solution from Europe. It is rumoured to include a change in the EU treaty to allow greater fiscal unity, ECB bond buying to reduce non-core bond yields and peripheral country debt service costs and loans from the IMF. Call me old fashioned but I thought the only way to reduce debt was to run a balance of payments surplus (ie. pay back the debt) or DEFAULT. So far I haven't heard of any discussion for the countries in question to run a surplus. All austerity measures so far have been to reduce deficits not create a surplus. Today's low or no growth economy is a very difficult environment to run a budget surplus. Europe has a consolidated debt to GDP ratio of more than 80% and growing at just under 4% in 2011 alone. If you remember back in the 80's when Canada had a debt to GDP ratio in the low 90's we were struggling to borrow money in foreign currency. Fortunately for Canada, we could access our domestic C\$ bond market, the global economy was soon to enter one of the highest growth periods since WWII and our politicians and Department of Finance were committed to reducing the debt.

In Europe no country has a domestic currency or bond market, I haven't heard any analysts suggesting that we are about to embark on anything but a low or negative growth environment over the next 3 years and the politicians have not been very impressive. The US debt to GDP ratio passed the 100% mark last week, coincidentally, for the first time since WWII. The 2012 deficit for the US is projected to grow by 6% after the mandated super committee cuts...assuming they happen?!

I really don't think the overall global debt story has a happy ending even if Europe has a bazooka-style approach to bond buying and financial subsidies for the peripheral countries. This debt is not going away without significant inflation. The only way to solve the problem is to reduce the levels of debt, which means significant deleveraging over a long period of time. Until debt levels start to go

down the market will continue to be incredibly volatile. November was a particularly volatile month driven by the bombardment of the news cycle/rumour mill out of Europe and the failure of the U.S. Super Committee on debt reduction. As a result the markets experienced many intra-session reversals and the East Coast Investment Grade Fund returned -0.50% for the month and is now down 2.45% year-to-date. What follows below is our summary of what happened during November, what we're now thinking, and how we will be positioning the portfolio going forward.

This has been a tumultuous year so far relative to global events beginning with the "Arab Spring" in January and continuing with the European sovereign debt crisis/slow moving train wreck. The result of this has been a very tough market to trade and one where we have been primarily focused on preserving capital. The leverage in the fund in November was modest at 1.89%. The average duration of the portfolio is relatively short, approximately four years and we have purchased a significant amount of portfolio protection in the form of put options, futures positions on the S&P index, and some commodity hedges. This protection served us well during the early part of the month when public equity markets started to deteriorate as credit spreads widened. At the low point of the month, equities were down 11% and we had been successful preserving capital in the fund to minimal losses.

However, on the last day of November the equity market recovered significantly with the expectation of good news coming out of the European discussions in early December and the Fed announcement that they are reducing the cost of US\$ funding for banks by 50 bp. They did this by reducing short dated FX swap lines and our protection lost some of its value. Normally this would have been offset by gains in the corporate bond portfolio but credit spreads have lagged this move preferring a "show me" approach with respect to the European meeting at the end of this week. Unfortunately this lag in credit spreads prevented the fund from rebounding on the last day of the month the same way as the equity markets did.

It is worth noting that the investment grade credit index (IG) traded out to its widest of the year (150 bp), after hitting a post crisis low in February in the low 60's. It is also worth noting that the high yield index has moved from the low 400's to the low 900's, so we have been in the least volatile sector of the market other than cold cash and government bonds. Our macro view is

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EAST COAST INVESTMENT GRADE FUND

that continued talk of stimulus will provide a wide and choppy trading range, but that we will not fall into a second recession in Canada and that the market will eventually improve as the global economy deleverages further in 2012 and beyond. If the market behaves as we expect, we will begin to add to the portfolio on a selective basis to take advantage of the wider spreads and the opportunity to earn higher returns going forward.

That written, the short-term volatility created from the European, U.S. and Japanese debt crises has the potential to push equity markets to new lows. If this happens we can see the IG index move out another 40 bp to 190 and the high yield index move above 1000 bp. This would most probably result in a loss on our books of about 3% to 4% and a hedge gain of about 2% to 3% and so a net loss in the range of 2% to 3%. This level of performance is at the negative end of our expectations. This we believe is a difficult scenario for the fund but one that we are prepared for. Our current returns are certainly not what we hoped for at this point, however, we don't think it's a disaster and although we are very concerned and cautious, we think there will be brighter days ahead for the fund.

Some additional thoughts:

1. Overall the risk in the fund has been low and we have weathered some very difficult market conditions with comparatively modest damage.

2. Credit spread widening since June has resulted in the running yield on the portfolio rising from about 4.25% to approximately 5.5% annually without any material increase in leverage.

3. We continue to believe that the European debt and banking crisis is not close to conclusion and that the US economic recovery carries risk and consequently we continue to carry high levels of portfolio protection.

4. Although Europe is not fixed, and neither is the US economy, we think the equity markets could very possibly trade down 950 to 1000 on the S&P. If this does happen it will cost the fund in the short term but will give the fund an unprecedented opportunity to earn double-digit returns annually over the next 2 to 3 years. We firmly believe in high quality Canadian credit securities.

In conclusion, we think our fund is performing the way we expect it to. Our glide path has been remarkably consistent as it relates to the unprecedented volatility we have experienced over the last three years. Although we have underperformed the DEX (fixed income index) as underlying interest rates have fallen dramatically, we have outperformed the equity markets. With interest rates at or near all-time lows, there is no return in long-only fixed income and the inevitability that interest rates will eventually rise will result in significant capital losses to long-only bond investors. We continue to believe that on a go-forward basis, we provide one of

very few credible options for fixed income investors.

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