

## SG US Market Neutral Fund

Commentary - December 2011

*Experience. Intelligent Investing.*

2011 was a roller coaster ride, but at the end of the year Small Cap stocks were down for the 28th time since 1926 (85 years). The daily market volatility and uncertain macro environment were key themes throughout the year, likely driving investors to take off the risk trade and focus on the larger, less volatile names. As a result, the DJIA was up 5.53% for the year, making it the only major equity index that was positive while most other major markets around the world suffered double digit declines. The S&P 500 was flat, the Russell 2000 lost 4.18% and the average equity mutual fund was down 2.57%. Though these returns are uninspiring, it was still quite a bit better from early October, when most major stock markets were in bear market territory and down close to 20% for the year. From a sector standpoint, utilities were the clear winner ending the year up 14.5% (safety and dividends mattered) while bank stocks were the poorest performing area down 17%.

Dealing with the market's volatility was one of the greatest challenges all investors faced this past year. Forces like the Arab Spring Revolt, the PIGS crisis, the Japanese Tsunami, floods in Thailand, US unemployment of 9%, the US debt downgrade by S&P, and Congressional dysfunction were all factors that helped increase volatility. To recap, the markets advanced early in the year, reversed direction during the summer, plunged into bear market territory during the fall only to reverse once again in the fourth quarter and erase most of the year's losses. Volatility was a daily phenomenon. Of the 251 trading days in 2011, the market moved greater than 1% on 136 days (55%), while 63 days (25%) had moves greater than 2%. Virtually half of those volatile days were split between negative and positive moves. We at SG Capital Management are pleased that we were able to manage volatility well and report positive returns net of all expenses in each of our Strategies for 2011. Similar to 2008 and early 2009, our risk management disciplines served us well in a challenging market environment.

Most believe that the biggest risk for 2012 will continue to be the Eurozone. The European Central Bank introduced liquidity by extending 489 Billion Euro in low interest loans. This move is merely a band aid on a crisis that could linger for years to come. It is almost certain that we will be dealt incessant doses of negative news coming out of Europe, which could extend 2011's market volatility into 2012. Europe's problems will likely result in lower economic

growth in that region, but the major question at hand is how severe will the slowdown be. If there is only a mild recession in Europe, than most other major economies could escape unscathed. However, should the recession turnout to be something worse, contagion will inevitably spread with a more dramatic negative impact on world economies. The US equity markets have bounced roughly 20% from the lows in early October, and there appears to be growing optimism that the US will be able to continue to recover despite any potential issues in Europe. As always, we think it will be critical to monitor investment expectations given what appears to be an increasing confidence in an economic recovery in the US. Other global issues that could impact our markets include the continued health of the Chinese economy as well as the political instability in North Korea and the Middle East. If 2012 turns out to be a year of continued volatility, we believe our risk management approach will continue to help us achieve our goal of producing positive absolute returns regardless of market conditions.

While there seems to be significant risks in just about every corner of the globe, the data in the US is pointing to a more optimistic story. Several months ago it looked like we were headed for a double dip recession, but now expectations appear to imply slow to moderate growth in economic activity. The Federal Reserve seems to be stuck in a low rate strategy for the foreseeable future and there are some signs this strategy is beginning to take hold. Recent data from November showed positive signs on the housing front, a better than expected advance in the leading indicators, a more sizeable increase in durable goods orders, and robust Christmas sales. The US consumer has remained resilient and it will be interesting to see if this trend continues.

While consumers are doing their part to drive economic recovery, the biggest risk to the US economic recovery might actually be in Washington. We are not sure what the requirements are to get elected to office in this country, but we are certain it's not common sense. Forget about political persuasion, the members of Congress as a group appear to have little grasp on the realities facing main street Americans. The political bickering that goes on in our hallowed halls of Congress has had little to do with anything that matters and more about political posturing. Our guess is this will only get worse as we enter a Presidential election year in 2012.

<sup>1</sup> The Fund was originally advised by Tetra Capital Management until the advisor was replaced in December 2010 by SG Capital Management. The Fund was formerly called the Tetra U.S. Long/Short Fund. 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.

^ Indices are denoted in US dollars.

As we evaluate the stock market we note that by all valuation metrics, stocks are attractively priced on an absolute basis. In 2000, forward P/E's on average were 25 times compared with only 12 times now. Corporate balance sheets are strong with little debt and large cash balances. The uncertainty about global macroeconomics, government regulations, tax policy and health care have made stock buy backs and dividend increases a more attractive alternative to reinvesting back in businesses. If businesses are reluctant to reinvest, this in itself perpetuates slower macroeconomic growth and could keep valuation multiples at low levels.

Martin Conrad of C.I.G. had an enlightening piece in Barron's recently on the Psychology of Investing. He notes that most successful investors have a tendency to be defensive. They avoid extreme positions and keep mistakes small. Conrad also explains how stress is prevalent when a great deal is at stake which can impair rational decision making. Emotion overtakes reason and gets magnified during volatile environments. Hopes and wishes rather than rational and disciplined analysis will destroy the pocket book of any investor. He believes to be successful, one must be a Contrarian, or go against the crowd, and exhibit discipline when correct or incorrect. We at SG Capital Management have a similar philosophy which is incorporated in our investment strategy. We are typically long companies that the Street hates and short companies that others love. We require a near term catalyst which helps us manage the risk of big blow ups by forcing us to liquidate mistakes quickly and by allowing us to place tighter hedges around earnings events.

Our biggest winners in 2011 were indeed contrarian ideas. Ceradyne, Jabil Circuit, Amcol and Quanta Services were all long names that worked very well for us. Each one of them had negative sentiment, poor stock performance and cheap valuations when we went long into their earnings event. Fortunately, we were correct in our fundamental view and in each case, a positive earnings report resulted in strong stock price performance over the short term. On the short side, Interactive Intelligence, IIVI Inc and Neogen were our best names for the year. Again, these were names that the street loved with high expectations and valuations. We entered these short positions prior to disappointing earnings news and were able to profit as the stocks sold off. As we enter 2012, we have several ideas, both long and short, that fit our style. We hope these names will drive performance as they report earnings over the next three to six weeks.

From a firm perspective, we have made several investments in technology and people over the last year. Our business is growing and we are confident that the new additions will provide positive contributions to performance, risk management, operations and client service. We look forward to another strong year.

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

Sincerely,

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Partner, Portfolio Manager

Glen Schneider, CFA  
Partner, Portfolio Manager

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