

# The Arbitrage Fund

## Fourth Quarter Update as of December 31, 2007

### Portfolio Characteristics

Beta	0.22
Standard Deviation	3.24%
Correlation to S&P 500	0.56
Correlation to Lehman U.S. Aggregate Bond Index	-0.08
Weighted Average Market Cap	\$3.5 B

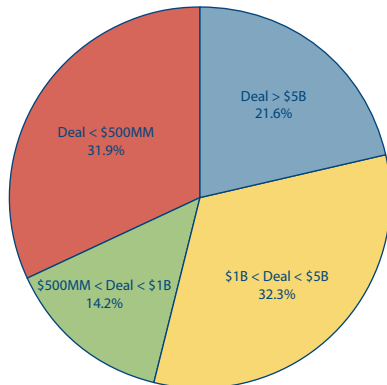
Standard Deviation measures the degree of variation of returns around the average return. Beta measures the overall risk of a financial security relative to the broader market. Risk measurements are trailing 3-year through quarter-end.

### Portfolio Composition

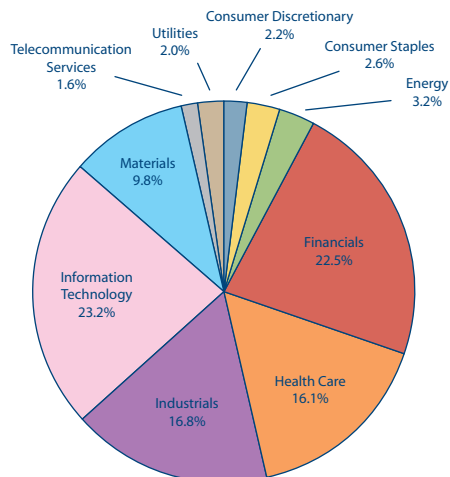
Total Fund Assets Under Management	\$171.8 MM
ARBFX (Retail Class) AUM	\$82.1 MM
ARBNX (Institutional Class) AUM	\$89.7 MM
Long Exposure	96.4%
Short Exposure	19.6%
Cash	3.6%

### Portfolio Diversification

#### Deal Market Cap Breakdown



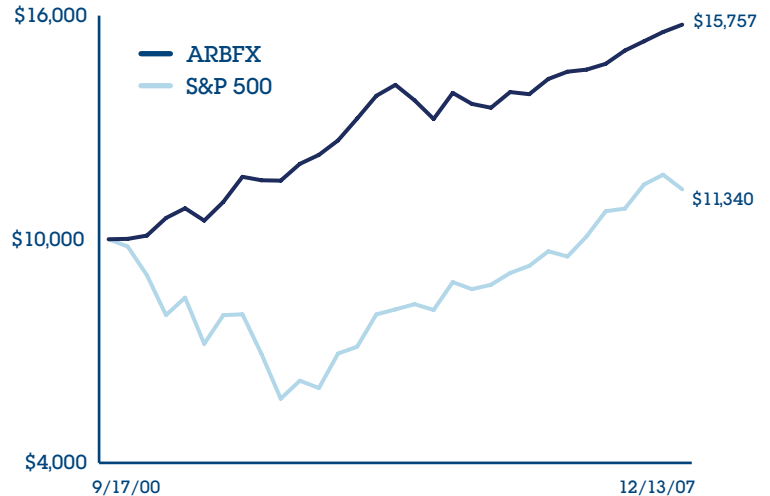
#### Deal Sector Breakdown



The pie charts above show a breakdown of the sectors and market capitalizations of the deals in which we are invested as a percentage of portfolio assets. Investing across the market cap spectrum and across industries aids in the diversification of the portfolio.

### Performance Comparison (ARBFX)

Change in value of a \$10,000 investment in The Arbitrage Fund versus the S&P 500, since inception (9/17/00).



Total returns for the period ending 12/31/07	3-Month	12-Month	5-Year Annualized	Annualized Since Inception (9/17/00)
The Arbitrage Fund (ARBFX)	1.27%	7.14%	5.56%	6.44%
The Arbitrage Fund (ARBFX)	1.33%	7.48%	--	4.02%
S&P 500	-3.33%	5.49%	12.82%	1.74%

The performance quoted represents past performance and does not guarantee future results. Investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than the original cost. Current performance may be lower or higher than the performance quoted. Performance data current to the most recent month end may be obtained by calling (800) 295-4485 or visiting our website at <http://www.thearbfund.com/>. Returns do not reflect a 2% redemption fee for shares that are redeemed from the fund within 90 days of purchase, which, if reflected, would reduce the performance quoted. Returns shown above include the reinvestment of all dividends and capital gains. Contractual fee waivers are currently in effect. Without such fee waivers, performance numbers would be reduced. The Total Annual Fund Operating Expenses for ARBFX and ARBNX are 2.14% and 1.89%, respectively. The Advisor has agreed to waive fees in excess of 1.88% and 1.63% for ARBFX and ARBNX, respectively, until at least August 31, 2012.

### Top Ten Deals (41.48% of portfolio as of 12/31/07)

Target	Acquirer
Aspreva Pharmaceuticals Corp	Galenica AG
Chittenden Corp	People's United Financial Inc
Cognos Inc	IBM
Genlyte Group Inc	Royal Philips
Huntsman Corp	Apollo Management LP
Imperial Chemical Industries Plc	Akzo Nobel AV
Respironics Inc	Royal Philips
TierOne Corp	CapitalSource Inc
UAP Holding Corp	Agrium Inc
Visual Sciences Inc	Omniture Inc

### Advisor

Water Island Capital, LLC	41 Madison Ave, Suite 2802	Phone: (800) 295-4485
	New York, NY 10010	

### For Additional Information:

An investor should consider the Fund's investment objectives, risks, and charges and expenses carefully before investing. The Fund's prospectus contains this and other important information. You may obtain a copy of the Fund's prospectus at [www.thearbfund.com](http://www.thearbfund.com) or by calling (800) 295-4485. Please read the prospectus carefully before you invest or send money.

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## Fourth Quarter Update as of December 31, 2007

### 2007 Review: The Best and Worst of Deals

For the year, The Arbitrage Fund returned 7.48% in its institutional share class (ARBNX) and 7.14% in its retail share class (ARBFX). The Fund experienced ten months with positive performance and two down months during the year. In terms of distribution of performance, the best monthly return came in August (+2.01% ARBNX/+1.95% ARBFX), with the worst month being July (-0.84% ARBNX/-0.85% ARBFX).

While the numbers indicate a relatively stable, solid year for the Fund, 2007 was anything but typical. It was a big year in many ways: the markets witnessed the largest transaction in history (ABN Amro: \$90+ billion), the largest LBO (TXU: \$40+ billion), a new record for transaction volume worldwide (\$4.5 trillion) and a record number of transactions (2000+), and the first year in which deal flow in Europe exceeded that of the U.S.

However, the year also brought with it some significant disruptions resulting from the seize-up in the credit markets mid-year, and with it, the largest deal collapse on record – the proposed purchase of SLM by private equity firm JC Flowers, valued at nearly \$25 billion. While the woes facing the credit market led to the unraveling of several other large high profile deals before the end of 2007, the forces of globalization remained strong throughout the year. The private equity shops and the LBOs gained the spotlight and the headlines during 2007, but the more important and significant story was the continued acceleration of strategic consolidation taking place around the globe.

#### The Speculative Froth for LBOs and Ominous Signs

The deal environment remained strong at the start of 2007, with healthy global economic growth coupled with a stable, but firming interest rate environment. The private equity funds were flush with cash, and corporate balance sheets were highly liquid. The new year was looking a lot like 2006, with some exceptions, however. The speculation around which large American company would be the next target of the buyout shops grew louder by the day. Rarely a day would pass without the financial press speculating on the next “takeout”, or whether or not one of the private equity shops would enter the bidding in competition with strategic buyers for already announced deals. No public company was “too big” to avoid the clutches of the private equity firms, whose number and size were growing day by day.

The early months of 2007 also found the investment community focusing on the deterioration in the mortgage market associated with the sub-prime lending sector. Banks were falling over each other to lend to the buyout firms, often without the typical protections and covenants attached to the bonds sold to finance these transactions. Deals were being struck at valuations well in excess of what we believed the underlying cash flows could support. Examples of this excess included such highly leveraged transactions as Finish Line’s purchase of Genesco (\$1.5 billion, almost entirely financed with debt), the SLM purchase by a group led by JC Flowers (\$25+ billion), the buyout of Harmon Industries by KKR and Goldman Sachs (\$8 billion), and British-based Sainsbury’s collapsed deal to be bought by a Qatar-based investment firm for close to \$20 billion. These highly leveraged deals were just a handful of the ill-fated transactions inked during a period of irrational risk-taking during 2007. Merger arbitrageurs were challenged to demonstrate their skills in managing risk and preserving capital in this environment. **This was our biggest challenge in 2007.** As spring rolled into summer, the turmoil in the credit markets accelerated as broader-based risk aversion spread from the subprime mortgage market to the rest of the credit markets.

The sea change in the market’s re-pricing of risk was not entirely unexpected, although the magnitude and severity of the disruption in the credit markets proved more disruptive to deal flow than anticipated. Our portfolio investment team had become cautious on the private equity takeouts in early 2006, when leverage ratios on many deals were stretched, and we believed that LBO deals were being priced to perfection. From

### Risks and Disclosure

The Fund uses investment techniques that are different from the risks ordinarily associated with equity investments. Such techniques and strategies include merger arbitrage risks, high portfolio turnover risks, options risks, borrowing risks, short sale risks, and foreign investment risks, which may increase volatility and may increase costs and lower performance. Past performance is not a guarantee of future results. Fee waivers and reimbursement of fund expenses by the Advisor, which capped the Fund’s expense ratio at 1.88%, positively impacted the Fund’s total return.

Material represents the manager’s opinion and should not be regarded as investment advice or a recommendation of any security or strategy. Contractual fee waivers which expire in 2012 are currently in effect; without such fee waivers, performance would be less than that shown above. The Arbitrage Fund is distributed by SEI Investments Distribution Co.

2006 into 2007, we continued to position our portfolio away from leveraged transactions towards strategic deals involving industry players. The concern then, as it continues to be today, is that a transaction dependent on attractive financing and involving financial engineering rarely offers strategic value to either party to the deal. During the 18 months up to mid 2007, transactions involving the purchase of public companies by private equity shops with cheap loans were, in our opinion, not offering arbitrageurs an adequate return relative to the risks involved; the primary risk: obtaining the financing to get the deal done. But when the cheap funding disappears, as it did this past summer, the risks of capital loss are significant for those investors not paying attention to the risks of leverage. This is a key factor in deal selection for our investment team.

The disruptions to deals caused by the credit market turmoil did spill over to the deal market. During periods of market stress, across-the-board selling of deal stocks, strategic or not, takes place as leveraged investors are forced to liquidate positions in order to raise cash. This indiscriminate selling can present opportunities for investors positioned to capitalize on the market turmoil. August 2007 was one of those times, giving our Fund an opportunity to add to positions at extremely attractive rates of return. Positioned without leverage, with a well-diversified portfolio of primarily strategic deals, the Fund was able to profit from the dislocation taking place. As highlighted at the start of this note, August turned out to be the Fund’s best performing month in 2007.

#### A New Environment for Dealmaking

Since the summer’s credit market turmoil, there is a new environment facing arbitrageurs that is worth mentioning. First, spreads within our universe of investable deals have finally begun to reflect the risks for those transactions reliant on the debt markets for financing. Second, the LBOs – particularly the mega-billion deals – have largely fallen silent after comprising as much as 35% of deal transactions during mid 2007. Those leveraged transactions that have been announced since the summer of 2007 are typically smaller and less leveraged, meaning the buyers are putting more of their own cash into the deal. And third, strategic buyers, having been pushed aside or preempted by the private equity shops for most of the year, are back and moving forward with transactions. Many strategic operators tell us that acquisition prices are more reasonable, to a great extent because of the absence of financial buyers from many auctions.

#### A Successful Year for 2007 and the Outlook for 2008

2007 was a challenging year for merger arbitrageurs, mainly due to issues related to credit market concerns. Our team performed well by maintaining our discipline with regards to valuation methodologies around deal metrics and acceptable risk tolerance. Ultimately, it boils down to our focus on capital preservation.

Our underlying approach to merger arbitrage did not change during 2007, and remains the same today. **We follow an unleveraged, diversified approach with a focus on strategic deals. Our asset size allows us to be a nimble investor, with exposure to deals across the market cap spectrum.** Now, more than ever, with the disappearance of the large mega-billion LBO and our desire to remain fully invested within the framework of a vibrant deal environment, asset size plays to our advantage. It did during 2007 and we expect that it will in 2008 as well.

A turning point was reached in the credit markets directly impacting deal flow, deal size and structure, and of course, the participants. Deal flow remains strong, but strategic buyers are front and center in today’s merger field. Transaction flow or values in 2008 are not expected to match 2007, but remain healthy nonetheless. We expect that even with much lower levels of deal flow compared to 2007, the Arbitrage Fund will remain fully invested.