

ABSOLUTE CONVERTIBLE ARBITRAGE FUND

PORTFOLIO COMMENTARY - ARBIX

Q3 2018



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PORTFOLIO COMMENTARY :

The Absolute Convertible Arbitrage Fund was slightly positive in the third quarter despite conditions that pressured valuations and made short term trading difficult for arbitrageurs. Credit markets remained firm, but interest rates continued to rise and equity volatility declined precipitously. Notably, the VIX (CBOE Volatility Index) dropped from 16.1 to 12.1 while the 100 day historical volatility for the Russell 2000 Index fell from 15.8 to almost a decade low of 10.5 (Calculated using the past 100 day Russell 2000 closing prices). Heavy convertible issuance also kept a lid on valuations.

The pace of convertible new issuance has already surpassed all of 2017 with 105 deals priced raising \$41 billion in proceeds year-to-date. We could end the year with new issuance up +30-40% from last year. A busy new issue calendar is vital to keeping the convert market replenished for the next few years. Convertibles are hybrid securities with finite expected lives which help to limit interest rate risk. However, as existing convertibles get redeemed or converted, dedicated convertible buyers, like us, need new securities in order to replenish portfolios with attractively priced arbitrage trades. Fortunately, greater supply naturally increases choice which leads to a higher likelihood of finding undervalued securities that fit our portfolio.

Most importantly for us, the type of convertible debt coming to market continues to be right in our wheel house as 97 of the 105 deals thus far are non-rated and 82% from small and mid-cap companies. We closely examine the credit profile of each new issue that comes to market. We continue to see new issues with stronger credit metrics which should keep convertible default rates at extremely low levels for the foreseeable future.

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We purposely ended the quarter with excess cash as we gradually became more cautious about valuations. We are especially concerned with the increased exposure of unhedged, long only funds to in-the-money tech convertibles. Technology companies have been the dominant issuers of convertibles this year. Most of these underlying tech stocks have performed extremely well creating a highly equity sensitive convertible marketplace exposing long only funds to more downside risk than usual.

If momentum in the tech sector reverses, long only funds may rush for the exits which could exacerbate a selloff as market makers need to hedge convertibles by shorting the same underlying stocks. Our portfolio is well diversified in terms of industry exposures, but we do have a number of positions in technology convertibles with strong credit profiles. Unlike long only funds, each one of our positions is already hedged by shorting the underlying equity of the same company. As always, our equity hedges are meant to keep our equity beta risk close to zero. In the very short term, long only funds may compress convertible valuations in a selloff as they seek liquidity to reduce long exposure, but we remain ready for a buying opportunity if the markets become tumultuous.

- Eric Hage, Chief Investment Officer, Mohican Financial Management
Portfolio Manager of the Absolute Convertible Arbitrage Fund

DEFINITIONS: The Volatility Index, or VIX, is an index created by the Chicago Board Options Exchange (CBOE), which shows the market's expectation of 30-day volatility. It is constructed using the implied volatilities on S&P 500 index options. The Russell 2000 is a market cap weighted index that includes the smallest 2,000 companies covered in the Russell 3000 universe of United States-based listed equities. The Russell is by far the most common benchmark for mutual funds that identify themselves as "small-cap." It is not possible to invest directly in an index. Beta is the measure of a fund's relative volatility as compared to the S&P 500 Index which by definition is 1.00. Accordingly, a fund with a 1.10 beta is expected to perform 10% better than the Index in up markets and 10% worse in down markets. Russell 2000 volatility is calculated using the past 100 day closing prices for the Russell 2000 in Bloomberg's "HVG" function, which graphs historical price or yield volatility for a selected security, more accurately price options and warrants.

HEDGE FUND CONVERSION - In August 2017, a hedge fund managed by Mohican Financial Management LLC reorganized into the Fund. The Fund's performance for periods prior to the commencement of operations is that of the hedge fund and is based on calculations that are different from the standardized method of calculations adopted by the SEC. The performance of the hedge fund was calculated net of the hedge fund's fees and expenses. The performance of the hedge fund is not the performance of the Fund, has not been restated to reflect the fees, estimated expenses and fee waivers and/or expense limitations of the Fund, and is not necessarily indicative of the Fund's future performance. If the performance of the hedge fund had been restated to reflect the applicable fees and expenses of the Fund, the performance may have been lower. The hedge fund was not registered under the Investment Company Act of 1940 ("1940 Act") and was not subject to certain investment limitations, diversification requirements and other restrictions imposed by the 1940 Act and the Internal Revenue Code of 1986, which, if applicable, may have adversely affected its performance.

Past performance does not guarantee future results. The Fund's net asset value and investment return will fluctuate based upon changes in the value of its portfolio securities. There is no assurance that the Fund will achieve its investment objective, and an investment in the Fund is not by itself a complete or balanced investment program. For a complete description of the Fund's principal investment risks please refer to the prospectus.

Asset allocation decisions may not always be correct and may adversely affect Fund performance. The value of a convertible security is influenced by changes in interest rates, with investment value declining as interest rates increase and increasing as interest rates decline. The credit standing of the issuer and other factors also may have an effect on a convertible security's investment value. Debt securities have interest rate, inflation and credit risks and are subject to prepayment and default risk. High yield and junk securities involve greater risk and tend to be more sensitive to economic conditions and credit risk. Short sales may be considered speculative and it may be difficult to purchase securities to meet delivery obligations. The Fund may leverage transactions which include selling securities short as well as borrowing for other than temporary or emergency purposes. Leverage creates the risk of magnified capital losses. Diversification does not prevent loss or enhance returns. Foreign investments present additional risk due to currency fluctuations, economic and political factors, govern-

ment regulations, differences in accounting standards and other factors. Investments in emerging markets involve even greater risks. Small, mid and large cap stocks are subject to substantial risks such as market, business, size volatility, management experience, product diversification, financial resource, competitive strength, liquidity, and potential to fall out of favor that may cause their prices to fluctuate over time, sometimes rapidly and unpredictably. The Fund is actively managed and may experience high turnover. This may cause higher fees, expenses and taxes, which could detract from Fund performance.

These views are subject to change at any time based on market and other conditions, and Absolute Investment Advisers disclaims any responsibility to update such views. No forecasts can be guaranteed. These views may not be relied upon as investment advice or as an indication of trading intent on behalf of any Absolute Investment Advised investment product.

Investors should carefully consider the Fund's investments objectives, risks, charges and expenses before investing. This and other information is in the prospectus, a copy of which may be obtained by calling (888) 992-2765 or visiting the Fund's web site: www.absoluteadvisers.com. Please read the prospectus carefully before you invest.

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