ARENA
INVESTORS LP

To: Investors and Interested Parties

From: Arena Investor Relations

Date: January 24, 2018

Re: Fourth Quarter 2017 Update
Arena Special Opportunities Fund, LP

A Message from Our Founder

It is our view that the majority of tradeable fixed income asset classes including corporate, ABS, mortgages and EM are grossly overvalued compared to expectations of their ultimate post-loss expected returns. Similarly, investments linked to those securities (e.g. leveraged loans, CLOs, middle market corporate private loans, etc.) appear to largely share the lofty valuations of the credit products to which their pricing is linked.

Furthermore, "second derivative" investments, the valuations of which could not possibly make sense without relying on the above instruments for leverage, could also be argued to share the same or sometimes greater levels of over-valuation. Examples include corporate and real estate private equity, as well as the overall stock market when viewed on a dividend yield basis versus the yield available in the bond markets.

I continue to assert that the investments we pursue at Arena allow us to avoid this over-valuation because they have some sort of process-driven "wrinkle" such that we are able to avoid being price takers and, therefore, we are able to mitigate our exposure to the above-mentioned mispriced asset types.

In a recent *Wall Street Journal* article, "Pension Funds' Dilemma: What to Buy When Nothing is Cheap," the author notes that Wilshire Consulting is predicting a 6.25% compound return over the next decade for equities, a potentially aggressive number given last year's 25%+ return, and particularly meager given their implied long-term duration and the fact that equities are by definition at the bottom of every capital structure. At the same time, Wilshire predicts 3.5% for core bonds at a time of historically profligate capital structures.

When we compare this to our portfolio with weighted average LTV attachment points of 4%, asset-heavy security, and an average duration of less than two years, we continue to like what we own. We believe the compound return of such a portfolio over time compares favorably with the majority of what institutional allocators have now come to expect in this difficult return environment for conventional assets.

When discussing with investors my views on value, I frequently hear, "Well, if you think tradeable credit markets are going to implode, what do you think will be the trigger?" In response, I start by quoting John Maynard Keynes, who said, "Markets can remain irrational longer than you can remain solvent." In other words, we are not going to put ourselves into a position — even in times like these — to be directionally short credit and, thus, will not speculate on the timing of the trigger for a material downturn in the credit markets.

However, we can point to many potential places where the "fire" could start. At the end of each calendar year, I always enjoy Byron Wien's “List of Ten Surprises.” In most instances, these surprises are unlikely yet conceivable macro-oriented occurrences, any one of which could materially affect the overall market. In light of my admiration for Wien's annual list, and with this investor question in mind, I thought I might lay out my list of top ten occurrences which could precipitate a blow-up in the markets. Note that they are in no particular order, have some overlap with Wien’s list, and that any of them could be argued to have a very low probability of happening.

1. Jeremy Corbyn is elected prime minister of the United Kingdom, bringing with him a series of far left commercially destructive Socialist policies, the likes of which have not been seen since the U.K.'s previous dalliance with such views in the 1960s and 1970s.

2. There is an aggressive move by those challenged by Saudi Arabia's ambitious young reformer, Mohammed Bin Salman, that precipitates an internal struggle that then brings Islamic extremists into a conflict that further destabilizes the Middle East.

3. North Korea and the current U.S. administration. Not much more needs to be said.

4. A material fraud is detected in a large non-bank financial institution, drawing attention to areas not covered by bank regulators and "too big to fail" legislation.

5. An ETF referencing underlying fixed income instruments has a "break the buck" event, along the lines of what happened with certain money market funds in 2008, and the market wakes up to the fact that ETFs are asset-liability mismatched derivatives which at times have little or no underlying access to liquidity—particularly when they need it.

6. The current U.S. administration decides to attempt to nullify the majority or entirety of the general obligation debt of Puerto Rico (perhaps using the prior administration's misuse of the federal bankruptcy code in the Chrysler restructuring as a precedent).

7. The Chinese government attempts to deal with its enormous non-performing loan problem in conjunction with materially increased attempts to limit the export of Chinese capital and further anti-capital markets activity along the lines of the brazen and wholly unexplained abductions of Chinese public company CEOs.

8. A data breach that dwarfs this year's Equifax fiasco occurs (perhaps in a much larger and more sensitive pool of data like that of the IRS or NSA) and precipitates a decline in consumers' seemingly bottomless appetite for exposing themselves and their personal data and habits (that's right, I mean you, Alexa) and thereby creates strategic and corporate issues for the "do no wrong" FAANGs and other high growth/high valuation growth stocks.

9. A circumstance similar to the July 2016 situation where several of the large UK property owning real estate funds experience a "run on the bank" and suspend redemptions. This then highlights the fact that since the 2008 crisis, hundreds of billions of dollars of open-ended mutual funds and trusts that provide daily liquidity and in which both institutional and retail investors have substantial exposure are invested in assets that cannot possibly be liquidated in a day—or even, in the event of a hiccup in the markets, several months or longer.

10. The largest quant funds, many of which are an order of magnitude larger than they were ten years ago, experience a simultaneous meltdown similar to that which occurred during August 2007. This is then exacerbated by the increase in both the absolute and relative amount of the equity markets that are invested on a passive basis, thereby highlighting for the market that when a large number of market participants are using similar computer models, bad things can happen.

While we certainly hope that none of the above happens during 2018, at Arena we continue to make investments and size those investments in our portfolio so that we do not require "hope" as part of our strategy.

All the best,

Dan Zwirn