

THE MERGER FUND®

July 18, 2007

Dear Fellow Shareholder:

June was a rocky month for both the stock and bond markets, but The Merger Fund® managed to eke out a small gain, representing the 20th consecutive month in which the Fund was profitable. For the second quarter as a whole, the Fund's NAV rose from \$16.05 to \$16.37, a gain of 2.0%. For the first half of 2007, we were up 4.8%, roughly in the middle of our rate-of-return targets. With private-equity groups showing a seemingly insatiable appetite for deals and strategic buyers nearly as aggressive, worldwide M&A activity ran at record levels in the second quarter. Reflecting credit-market jitters, arbitrage spreads—the per-share profit to be made if the deal goes through—widened significantly in June, which weighed on the Fund's end-of-quarter performance but also presented us with a larger number of attractive investment opportunities. We had no broken deals in the three months ended June and benefited from several takeovers in which the buyers eventually paid more than the original deal price. Overall, 20 of the Fund's arbitrage holdings showed meaningful gains, while just two posted material losses.

Private Equity Blinks

Shareholder approval of proposed mergers and acquisitions can usually be taken for granted. In most cases, the target company's shareholders are happy to receive a 20%-40% takeover premium, while arbitrageurs like us, who may collectively control 20% or more of the target's stock by the time the transaction is put to a vote, usually have a vested interest in seeing the deal go through. And in stock-for-stock mergers that also require approval by the buyer's shareholders, management is routinely given the benefit of the doubt; for the most part, only transformative, "bet-the-company" acquisitions are at risk of a negative vote. Recently, however, the shareholders of many target companies have been taking a more skeptical view of what they're being offered, especially in going-private transactions.

Leveraged-buyout firms increasingly are facing push-back from holders who believe that the prices paid in these deals are less than compelling when compared with the potential profits to be made by the LBO groups when the companies they acquire are subsequently sold or taken public, often within a relatively short period of time. In recent years many of these "round-trip" transactions have resulted in extraordinary—and well-publicized—windfalls for both the private-equity firms and the company executives who are invited to co-invest with them. Profits of this magnitude obviously contribute to the perception that shareholders could have done much better. Investor activism is also working against rubber-stamp approval of the terms offered in going-private deals. Instead of working quietly behind the scenes or simply selling their shares in response to what they regard as an inadequate price, a growing number of fund managers are waging high-profile campaigns to force acquirers to improve their offers. These efforts appear to be working.

Among the Fund's most profitable investments last quarter were three going-private transactions in which the buyers were forced to raise their offers at the 11th hour in order to win shareholder approval. Our best-performing holding was Biomet, a manufacturer of artificial hips and other reconstructive devices used in orthopedic surgery, which last December agreed to be acquired by Blackstone Group, TPG, Kohlberg Kravis Roberts and Goldman Capital Partners for \$44 a share in cash. Proxy material circulated in advance of the special meeting of Biomet's shareholders disclosed that the company had turned down a higher offer from a strategic buyer, apparently over concerns that the combination could run afoul of antitrust regulators. Investor disappointment over the company's decision not to sell to the highest bidder was compounded by the fact that in the months since the deal with the private-equity consortium had been announced, the shares of Biomet's medical-device peers had appreciated almost 20%, making the buyout price look even less attractive.

Institutional Shareholder Services, an influential proxy-advisory firm, recommended that Biomet's holders reject the \$44 offer, and as the June 8 vote approached, it wasn't looking good for the buyers. The day before the shareholder meeting, the consortium raised its bid to \$46 a share, to be paid in a tender offer commencing the following week. Our guess is that the extra \$2 a share won't have a material impact on the buyers' eventual profit on this transaction, but it was decidedly meaningful to The Merger Fund.®

Another winner for us last quarter was Clear Channel Communications, a major radio and outdoor advertising company, whose private-equity buyers, Thomas H. Lee Partners and Bain Capital Partners, also managed to find a little extra money for shareholders when it became clear that the deal was about to be voted down. The Clear Channel buyout, announced in November 2006, called for holders to receive \$37.60 a share in cash. But as soon as the deal terms were made public, several big institutions began to lobby against the transaction. One, Highfields Capital Management, a well-regarded hedge-fund manager, went public with its opposition to the deal, arguing that better management coupled with a more leveraged capital structure would create more shareholder value over time. In March both ISS and Glass, Lewis & Co., another proxy-advisory firm, called the buyout terms inadequate and recommended a "no" vote. With approval of the transaction requiring a two-thirds vote—greater than the typical 50% threshold—Thomas Lee and Bain faced an uphill struggle.

Clear Channel, whose management continued to support the deal on the table, decided to postpone the vote by a month. On April 18, the day before the rescheduled shareholder meeting, the buyout group raised its offer to \$39. Although the deal took a few twists and turns thereafter, the takeout consideration was eventually sweetened to \$39.20 a share, with holders also given the option of receiving some equity in the privatized company. After having vowed earlier in the process that they wouldn't pay "another penny" for Clear Channel, Thomas Lee and Bain ended up agreeing to pay almost \$800 million more to seal the deal, which still awaits FCC approval.

The recently completed buyout of Laureate Education, operator of both traditional and Internet-based colleges and universities, by a 10-member consortium of private-equity firms also saw recalcitrant shareholders force an improvement in deal terms. In late February, approximately a month after the transaction was announced, Select Equity Group, a 7% holder, complained to Laureate's board of directors that the sale process had been flawed and that the transaction price—\$60.50 a share—was inadequate. Less than a week later, T. Rowe Price, a large mutual-fund complex with an 8% stake in Laureate, also told the board that the buyout terms seriously undervalued the company. Not much happened in public over the next couple of months, but in early June Laureate accepted a sweetened \$62-a-share bid from the consortium. Again facing the loss of a deal, private equity elected to pay up.

Risk Gets Repriced

At one point in the June quarter, the spread between yields on non-investment-grade, or "junk," bonds and risk-free Treasury securities fell to the lowest level on record. And not only were investors in low-grade bonds willing to accept relatively skimpy interest rates, but they also showed little reluctance to accept other borrower-friendly credit terms, including provisions that give debtors the option of issuing additional bonds in lieu of paying interest in cash. Yield-hungry investors, in other words, were demonstrating a considerable appetite for risk. The benign environment for leveraged financing was particularly good news for private-equity firms, which were able to fund their ever-bigger deals with large amounts of low-cost debt.

Toward the end of the second quarter, however, credit-market conditions began to turn a little less favorable. The proximate cause was a sharp upturn in default rates on subprime mortgages, the lowest-rated category of loans secured by residential real estate. Rising defaults caused debt obligations collateralized by subprime mortgages to plunge in value, wrong-footing hedge funds and other investors who had made leveraged bets on these risky securities. The carnage in mortgage-backed bonds represented a wake-up call for fixed-income investors generally, who started demanding higher interest rates and better credit protection from issuers of lower-rated debt.

Turmoil in the fixed-income markets caused arbitrage spreads on many pending going-private deals to widen. Although a careful reading of the merger agreements would have suggested otherwise, the common perception was that buyout firms could use changing market conditions as an excuse to walk away from some of these transactions. Sentiment probably would have turned even more negative had new-deal activity dried

up, but it didn't, indicating that private-equity groups believe they can still generate attractive returns in a more risk-averse lending environment.

The Beat Goes On

Buyout firms accounted for roughly 40% of U.S. M&A activity in the June quarter, the highest level ever. New LBO investments in the Fund's portfolio include Alliance Data Systems Corp., a provider of credit-card marketing and transaction-processing services, to be taken private by Blackstone Group LP; Avaya, Inc., which designs, builds and manages Internet-based communications networks, in the process of being acquired by Silver Lake Partners and TPG Inc.; CDW Corp., a leading distributor of computers and other electronic equipment, to be purchased by Madison Dearborn Partners, LLC and Providence Equity Partners Inc.; Harman International Industries, Inc., a manufacturer of audio products and automotive electronics systems, going private in a buyout organized by Kohlberg Kravis Roberts & Co. L.P. and GS Capital Partners, a unit of Goldman Sachs Group Inc.; and Penn National Gaming, Inc., operator of racetracks and casinos in West Virginia, Mississippi, Louisiana and Pennsylvania, to be purchased by Fortress Investment Group LLC and Centerbridge Partners LP.

Other going-private transactions that were recently added to our portfolio include Nuveen Investments Inc., a 109-year-old asset-management company, being acquired by an investment group led by Madison Dearborn; Guitar Center, Inc., the country's largest retailer of musical instruments, which has agreed to be bought by Bain Capital Partners, LLC; Reddy Ice Holdings, Inc., a manufacturer and distributor of packaged ice, going private in a transaction organized by GSO Capital Partners LP; Hilton Hotels Corp., being acquired for \$18.5 billion by Blackstone, already a major player in the global hospitality industry thanks to a string of acquisitions over the past 15 years; Huntsman Corp., a supplier of both commodity and specialty chemicals, which now will be purchased by Hexion Specialty Chemicals, Inc., an affiliate of Apollo Management L.P., after the buyout group topped an agreed-upon deal with Dutch chemical company Basell AF; and BCE Inc., Canada's largest telecommunications group, to be taken private by the Ontario Teachers' Pension Plan and two U.S.-based private-equity firms, Providence Equity and Madison Dearborn, in a \$32-billion transaction that not only represents Canada's biggest-ever takeover but is also the world's largest leveraged buyout.

New Strategic Deals

In a record-breaking quarter for mergers and acquisitions, corporate buyers were active as well. The Fund's new strategic deals include International Securities Exchange Holdings, Inc., operator of an all-electronic trading platform for equity options, to be acquired by Frankfurt-based Deutsche Boerse AG; IPSCO, Inc., a Canadian manufacturer of steel pipe for the oil and gas industry, in a takeover pact with Sweden's SSAB Svenskt AB; Ohio Casualty Corp., being acquired by Liberty Mutual Group; Reuters Group plc, the U.K.-based financial news service, to become part of The Thomson Corp., one of its U.S. rivals; Capitalia SpA, an Italian bank, which is combining with another Italian financial institution, UniCredito Italiano SpA; and Cytoc Corp., a manufacturer of diagnostic equipment and supplies used to screen for cervical cancer, to merge with Hologic Inc., a maker of medical-imaging systems used to test for breast cancer and osteoporosis, in a transaction designed to create a stronger player in women's health.

Other new investments in strategic combinations include aQuantive, Inc., a provider of Internet-based advertising services, being purchased by Microsoft Corp.; Alcan Inc., the Canadian aluminum maker, which fended off a hostile takeover attempt by Alcoa Inc. by agreeing to be bought at a surprisingly rich price by London-based Rio Tinto Group; the Stride Rite Corp., a leading shoe manufacturer whose brands include Stride Rite, Keds and Sperry Top-Sider, to be acquired by Payless ShoeSource Inc., the largest U.S. footwear retailer by store count; Digene Corp., a developer of DNA and RNA tests for disease detection and management, to combine with QIAGEN NV, a Dutch manufacturer of instruments and consumables for gene research; eFunds, an electronic-payments processor, which has agreed to be acquired by rival Fidelity National Information Services; Hanson plc, a U.K.-based cement company, to become part of Germany's HeidelbergCement AG; and Royal Numico NV, a Dutch maker of baby food and clinical nutrition products, being acquired by France's Groupe Danone SA.

Other New Positions

The Fund has also invested in several new “pre-deal” situations, including Affiliated Computer Services, Inc., the leading processor of U.S. student-loan payments, which is soliciting other offers following a takeover approach from the company’s founder and chairman; Applebee’s International, Inc., the restaurant chain, which has just concluded a review of its strategic alternatives by announcing the sale of the company to IHOP Corp.; Ryerson Inc., a distributor and fabricator of steel products, which is looking for ways to boost shareholder value in response to an effort by Harbinger Capital Partners, a 9.6% holder, to take control of the company’s board; United Rentals, Inc., in the process of negotiating with potential acquirers; Imperial Chemical Industries plc, a U.K.-based maker of paints and specialty chemicals, the target of an unsolicited takeover attempt by Dutch rival Akzo Nobel NV; and Virgin Media Inc., Britain’s largest cable-TV operator, which has begun exploring strategic alternatives in the wake of takeover interest from a private-equity group.

With so many new names added to our portfolio, The Merger Fund® currently holds positions in 68 arbitrage situations, a record number, and is about 130% invested. We look forward to a rewarding second half.

No More Calls and Letters

Finally, I am pleased to report that at a special meeting held on July 17, our shareholders approved all of the proposed changes in the Fund’s investment policies that had been recommended by the Fund’s adviser and independent trustees. These revised policies should not affect the Fund’s fundamental investment approach or risk profile, but they will provide your portfolio-management team with additional tools and increased flexibility to pursue the Fund’s merger-arbitrage strategy. A new prospectus reflecting the changes is enclosed. We apologize if some of you found our proxy solicitors to be overly aggressive, but getting out the vote was important to us, and it should be a long time before we need to hold another special meeting.

Sincerely,

A handwritten signature in black ink, appearing to read "Fred Green", written in a cursive style.

Frederick W. Green
President

Note: The performance figures discussed in this letter represent past performance and may not be indicative of future results. The Fund's share price and return will vary, and investors may have a gain or loss when they redeem their shares.