

THE MERGER FUND®

October 10, 2007

Dear Fellow Shareholder:

All's well that ends well. July and August were unusually challenging months for most investment strategies, including merger arbitrage, but by the end of the quarter, The Merger Fund® had managed to show a modest gain. In the three months ended September 30, the Fund's NAV rose from \$16.37 to \$16.55, an increase of 1.1%. For the first nine months of calendar 2007, we were up 6.0%. For its September fiscal year, the Fund recorded a gain of 8.2%.

Turmoil in the credit markets caused M&A activity to slow significantly in the third quarter, with global merger volume down more than 40% from second-quarter levels. Of greater importance to the Fund's short-term performance, arbitrage spreads—the per-share profit to be made if the deal goes through—went on a roller-coaster ride, as investor perceptions of the outlook for pending transactions vacillated between extreme optimism and throw-in-the-towel pessimism. Reflecting this manic-depressive behavior, the Fund's NAV exhibited uncharacteristic volatility from one day to the next. In the end, the Fund experienced only one failed deal during the quarter—our first of the year—but at times it felt much worse. Overall, 21 of our arbitrage holdings showed meaningful gains in the July-September period, while eight posted material losses.

Risk Gets Repriced (Part II)

When we wrote about the repricing of risk in our second-quarter letter, we didn't realize how much further the process had to go. Rising defaults on subprime mortgages were just the first act of the credit crisis that rattled the financial markets this past summer. The carnage in mortgage-backed securities—and the risk-aversion it engendered among fixed-income investors—precipitated a flight to safety that sharply limited financing options for all but the most creditworthy borrowers. The commercial paper market, an important source of short-term funding for a big chunk of Corporate America, was closed to many issuers. At the peak of the crisis, even the largest European banks refused to lend to one another for more than a few days, and some investors worried about the solvency of at least one major U.S. brokerage firm. The high-yield bond market ceased to function as a source of leveraged financing.

Against this background, investors were understandably concerned about the fate of pending mergers and takeovers, especially going-private transactions requiring large amounts of debt that had yet to be funded. But other market forces also weighed on deal stocks. The third quarter witnessed the collapse of several credit-oriented hedge funds—the victims of bad bets and excessive leverage—and scores of other funds with heavy exposure to mortgage-backed securities scrambled to avoid a similar fate. More than a few multi-strategy hedge funds discovered that diversification across a variety of asset classes was no panacea; during the meltdown, all of their investment strategies were unprofitable. And some of the largest “quant” funds, which are routinely leveraged over 10-to-1, suffered sizable losses when their statistical models temporarily stopped working. At the same time that their hedge-fund customers were feeling pain, Wall Street proprietary trading desks that held similar investments were also awash in red ink. The response to these losses was a massive de-leveraging of portfolios, often accomplished by mechanical, across-

the-board selling that left little room for qualitative judgments. Because many of the funds involved in this de-leveraging normally allocate at least a portion of their assets to merger arbitrage, the stocks in our investment universe, already under pressure, were pummeled further.

To put this sell-off in perspective, at one point in August, the median annualized rate of return for the 160 pending mergers and takeovers that we were monitoring was over 39%, a number never before seen in our 28 years as arbitrageurs. Looked at another way, the market was implying only a 74% chance that the average deal would close on its original terms, which compares to an historical completion rate of close to 95%. During this difficult period, The Merger Fund® wasn't shaken out of any positions and selectively added to its arbitrage investments. With one exception, our strategy was right on the money.

We Didn't See It Coming

Harman International, a leading manufacturer of high-end audio equipment and car navigation systems, agreed last April to be acquired by Kohlberg Kravis Roberts & Co. and GS Capital Partners, an affiliate of Goldman Sachs. This \$8 billion going-private transaction was noteworthy in two respects: (1) Harman shareholders were offered the opportunity to co-invest with the buyout group in the privatized company, subject only to a limit on the number of shares that could be exchanged for the "stub" equity; and (2) in the first week after the buyout was announced, Harman shares traded above the deal price, indicating that at least some investors believed that the takeout price was too low and that another offer could be forthcoming.

With a debt-free balance sheet and a dominant market position—Harman supplies audio-video systems to Mercedes, BMW, Audi, Porsche, Lexus and Land Rover, among others—Harman appeared to be an excellent LBO candidate. But we weren't about to pay through the deal price absent some clear indication that another suitor was waiting in the wings. As time passed, however, speculation about a topping bid faded, and the shares traded at more reasonable levels. The Fund established a small position. Later, when market sentiment toward highly leveraged transactions was at its most pessimistic, we added to the position. At the time, we took comfort from comments made by George Roberts, one of KKR's founders, regarding KKR's then-pending deals, comments that presumably applied to Harman. Roberts said, "We made commitments to the boards of directors...and we expect those transactions to close." Less than a week later, KKR and Goldman notified Harman that they no longer intended to complete the buyout, claiming that a "material adverse change," or MAC, had occurred at the company. Roberts, apparently, hadn't received the memo.

In our view, Harman is essentially the same company today that it was when the deal was signed—meaning no MAC—although we recognize that changed credit-market conditions made the transaction less attractive for the buyers. This deal is almost certainly dead, but Harman would still be entitled to a \$225 million termination fee should a court decide that KKR and Goldman had no legal basis to pull the plug.

Winners

The Fund's most profitable holding last quarter was ABN Amro, the Dutch bank, which was the object of competing takeover offers from London-based Barclays and a consortium consisting of Royal Bank of Scotland, Spain's Banco Santander and Fortis, a bank with joint headquarters in Belgium and the Netherlands. Facing mounting pressure from unhappy shareholders, ABN had originally agreed to do a friendly deal with Barclays, but shortly thereafter, the RBS-led consortium crashed the party and put a richer offer on the table. The battle had begun. ABN management favored the Barclays bid, in part because the buyer planned to keep ABN's operations mostly intact, whereas the consortium planned to carve up ABN and divide the bank's various units among the three buyers.

In an effort to fend off the interlopers, ABN announced that it would sell its U.S.-based LaSalle National Bank—one of the assets most wanted by RBS—to Bank of America. But the consortium remained in the hunt. During the steep sell-off in financial stocks over the summer, the value of the consortium's largely cash offer held up much better than Barclays' mostly stock bid. And with Barclays' own shareholders cautioning management against raising its offer, it appeared that only unexpected opposition to the consortium's break-up plan from European regulators or a major dislocation in the financial markets that caused the joint bidders to conclude they were overpaying had the potential to change the outcome. Neither threat to the deal materialized, and the consortium has just declared victory. Nervousness surrounding financial stocks contributed to an unusually attractive arbitrage spread throughout most of this deal's life cycle.

Other third-quarter winners included Alcan, the Canadian aluminum producer, which was able to thwart Alcoa's hostile takeover attempt by finding a cash-rich "white knight," London-based Rio Tinto Group, the world's third-largest mining company; Huntsman, a major chemical producer, whose shareholders experienced a mini windfall when the company's friendly deal with a unit of Access Industries Holdings was topped by a higher offer from Hexion Specialty Chemicals; and First Data, Texas Utilities, Alltel, Hilton Hotels, Harrah's Entertainment and Canada's BCE, all companies involved in going-private transactions that either have recently closed or appear to be moving smoothly toward completion, confounding skeptics who believed that large LBOs would be among the first casualties of the credit crisis.

New Strategic Deals

Reflecting a less hospitable financing environment for highly leveraged transactions, almost all of the Fund's new arbitrage holdings are companies involved in strategic combinations, including Dobson Communications Corp., a provider of wireless phone service to rural and suburban markets in 17 states, to be acquired by AT&T Inc.; Rural Cellular Corp., another wireless carrier, in a takeover pact with Verizon Communications Inc.; Dade Behring Holdings, Inc., a leading manufacturer of diagnostic testing equipment, soon to become part of Germany's Siemens AG in a \$7 billion transaction that strengthens the buyer's already formidable presence in medical technology; Kyphon Inc., a medical device maker whose products are used by orthopedic surgeons to restore spinal function, being acquired by Medtronic, Inc.; CheckFree Corp., a leader in online banking and other electronic payment services, to combine with Fiserv, Inc., a provider of information- management services to the banking and insurance industries; Coles Group Ltd., an Australian operator of supermarkets, department stores and other retail outlets, in the process of being acquired by Wesfarmers Ltd., a conglomerate whose operations include Australia's largest chain of home improvement stores; and Sirenza Microdevices, Inc., a supplier of electronic components for wireless devices, merging with another company operating in the same space, RF Micro Devices, Inc.

Other new strategic deals include Lyondell Chemical Co., to be purchased for \$12.9 billion by the Basell chemicals subsidiary of Access Industries Holdings LLC, a closely held company controlled by a Russian-born billionaire; PrimeWest Energy Trust, a Canadian oil and gas producer, whose pending acquisition by Abu Dhabi National Energy Co. highlights the global ambitions of many state-controlled entities in the oil-rich Middle East; Navteq, the leader in electronic mapping, which has agreed to be acquired by Nokia Oyj in a transaction that better positions the Finnish phone giant to exploit what is expected to be a huge market for navigation-based cell phone services; EDO Corp., a defense contractor whose products include electronic equipment that U.S. forces are using to disable improvised explosive devices (IEDs) in Iraq, to be purchased by ITT Corp.; and Commerce Bancorp, Inc., a holding company with banking subsidiaries in New York, New Jersey, Pennsylvania and Delaware, to become part of Canada's Toronto-Dominion Bank in an \$8.5 billion deal that ranks as the largest-ever foreign takeover by a Canadian banking institution.

Other New Positions

As noted above, leveraged buyouts represented a sharply smaller share of total M&A volume in the September quarter than was the case earlier in the year, but activity didn't dry up entirely. One new going-private transaction in which the Fund has recently invested is the proposed acquisition of 3Com Corp., a manufacturer of routers, switches and other computer-networking gear, by Bain Capital LLC. In an unusual twist, Huawei Technologies Co., a Chinese telecom-equipment maker that is 3Com's largest customer and a former joint venture partner, will take a 16.5% stake in the privatized company. Although Huawei's involvement makes the deal easier to finance—the Bank of China is part of the lending group—and should expand 3Com's opportunities in Asian markets, the Chinese connection has also raised national security concerns in Washington, where China has few friends and its intentions are widely viewed with suspicion. But just as IBM finally won regulatory clearance to sell its PC business to a Chinese manufacturer, we expect that Bain—possibly by ring-fencing or divesting 3Com's most sensitive technology—should ultimately be able to get this deal done.

The Fund has also invested in one new “pre-deal” situation. After doing battle with activist shareholders for over two years, Wendy's International, Inc., the fast-food chain, announced last April that it was exploring its strategic options, including the possible sale of the company. Nelson Peltz, the billionaire owner of the Arby's restaurant chain, has repeatedly expressed interest in acquiring Wendy's, and in late August the company agreed to give him access to its books. Other groups are reportedly interested in Wendy's, as well. With the shares trading well below their mid-year highs and the chances of a value-enhancing deal seemingly good, the Fund has established a modest position. As the deadline for final offers approaches, we urge all of our shareholders to visit a Wendy's and try one of their bacon double cheeseburgers (or a salad if you're on a diet).

The Merger Fund® currently holds positions in 48 arbitrage situations and is about 115% invested. We remain on track for another rewarding year.

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.