Small funds with some unorthodox approaches

Omni regulates its limited, concentrated investments and risk by trading liquid leveraged contracts. Gaining exposure in this fashion enables the fund to maintain significant cash balances. The fund does not explicitly limit leverage at the portfolio level, which typically runs about 150 per cent, occasionally reaching 275 per cent.

Foreign exchange-focused and peppered with commodity, equity indices, and interest rate exposure, Mr Rosen's positions reflect macro theses or their temporary dislocation.

For instance, in November 2010 with the restart of QE, markets feared soaring prices. As an inflation hedge, investors ploughed into precious metals. Mr Rosen agreed with the implications of capital flooding into markets, but he had not yet seen evidence of inflation.

Three-month US Treasury rates were just a few basis points and global growth was still slow.

The doubling of silver prices in early 2011, in his mind, was a result of investors becoming transfixed by a thesis.

In late April, using front futures contracts, Mr Rosen began shorting silver in several pair trades, being long gold and oil.

When he unwound the trades in late May, the fund gained 4 per cent.

Parus Fund
Strategy: Equity long/short
Managers: **Fabrice Vecchioli and Edouard Vecchioli**

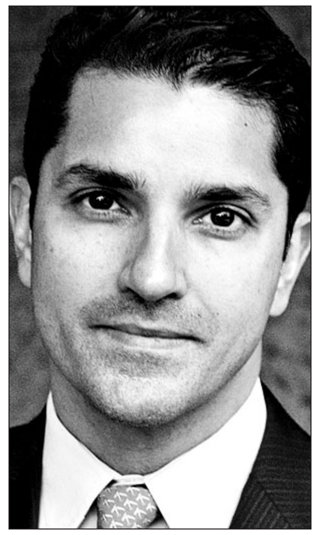
Parus' managers avoid looking into the eyes of company executives. "We prefer instead to sift for evidence of disruptive innovations to help clue a position, avoiding misplaced sentiment that can come from visiting people and places," says Fabrice Vecchioli, co-manager of the $132m fund.

This unorthodox approach may have emanated from the fund's founders having cut their teeth as fixed income specialists. Mr Vecchioli and his younger brother Edouard believed their understanding of company financials and business models would give them an edge in bottom-up stock picking.

Being market-capitalisation, sector, and geographically agnostic, the four-manager team relies exclusively on their own and independent research along with fundamental analysis to assemble a portfolio around competitive themes. Typically, two thirds of the fund's 45 positions are long and one third are short.

When the fund started, its long positions focused primarily on growth stocks and its short positions on solid companies that were deemed to be overvalued. This did not work, "so we adjusted our strategy," explains Fabrice, "making sure our longs included growth companies with distinct competitive advantages and our shorts targeted lesser quality operations getting hit by structural issues."

Fabrice Vecchioli: avoids misplaced sentiment



Hanif Mamdami: his fund offers daily pricing

This approach has served the Paris-based shop – which is presently relocating to London – very well. Since its inception in December 2002, the fund's dollar share class has generated annualised returns of more than 17 per cent.

The ride has remained a bit bumpy with trailing five-year average standard deviation of over 15 per cent. But this is primarily the result of having investment horizons of three to five years for its long positions and one to two years for shorts. And the fund's worst drawdown, 15.5 per cent, reflects the underlying soundness of the managers' ideas and their ability to reverse their positions when investment theses change.

The fund's performance when volatility has been at elevated levels is noteworthy. Between 2007 and 2009, Parus outdistanced its benchmark MSCI World stock index by an average of 25 percentage points each year.

It presciently cut its net long exposure of 70 per cent-plus to under 30 per cent in May 2006 in response to deteriorating business specific conditions. It built a 20 per cent short position in various financial stocks, having seen the deteriorating quality of mortgage securitisations. This generated cumulative returns of 33 per cent in 2007 and 2008.

The fund resumed its long stance in October 2008, and in March 2009 it started building positions in the credit card industry. The market was projecting it as the next subprime; the managers concluded otherwise. By July, Parus had an 8.1 per cent long position in American Express, Visa, and Mastercard, which added more than 5.3 per cent to the fund's performance by the year's end.

Phillips, Hager & North Absolute Return fund
Strategy: Multi-strategy
Manager: **Hanif Mamdami**

This is an unusual fund. It offers daily pricing and liquidity. Its management fee is 1.45 per cent. It charges no performance fee and its minimum investment is C$150,000.

In contrast with many funds that are struggling to attract and sustain capital, it has been hard closed for nearly two years to help it sustain consistent performance. Since it started in October 2002, the fund has delivered annualised returns of 15 per cent. Trailing five-year annualised volatility is 7.6 per cent, and its worst drawdown is 7.8 per cent.

This hedge fund could be suggesting where the industry may be heading. That is a key reason why, despite having C$732m, we decided to include it in this year's survey. The fund was established by one of Canada's oldest independent investment firms, Phillips, Hager & North, which Royal Bank of Canada bought in 2008. It then made Hanif Mamdani head of alternative investments.

The fund has generated its compelling risk-return profile by focusing on Canadian and US securities.

Two thirds of the fund's exposure is in investment and non-investment grade corporate bonds and income trusts, which Mr Mamdani believes are the most reliable sources of absolute returns. He then mixes in market neutral arbitrage and opportunistic plays in long, distressed, and event-driven investments.

Last November his team, including analysts Emil Khimji and Justin Jacobsen, uncovered six-year Goldman Sach's Canadian-dollar subordinated bonds trading 650 basis points above Canadian government bonds, despite the bank having made substantial improvements to its balance sheet.

Mr Mamdani established a 4 per cent stake, which has so far returned 18 per cent.

Several years after Loral Space and Communications led a leveraged buy-out of Telesat, a global satellite service operator, Mr Mamdani saw significant balance sheet improvement, which cut leverage as a multiple of underlying earnings nearly in half. He felt this would lead to the refinancing of 11 per cent senior notes due in 2015 on the first call date. This happened in May 2012 and produced a short-term net gain of 9.5 per cent.

The fund's equity position in Cogeco Cable, a Quebec-focused cable company, has not worked so far. Mr Mamdani thought the market's overreaction to a pending acquisition, which sliced 15 per cent off the stock, was overdone.

A further decline in the share price now makes the manager believe Cogeco may be "the cheapest cable stock in the continent". Despite being down on the trade, Mr Mamdani has bumped up exposure, making it the fund's largest holding, demonstrating he is not afraid of following his convictions.

How last year's selected funds fared till mid 2012

Last year's model funds showed that when investors do their homework, hedge fund exposure can deliver superior returns both in relative and absolute terms. Calculated as an equally-weighted portfolio, the five funds we selected last year generated a net return of 3.19 per cent in the year to June 2012. That was nearly 6 full percentage points better than the average return of the five strategies cited. And it was more than 7.5 percentage points better than the BarclayHedge average for all single-manager funds. This outperformance was also achieved with a lower level of risk than that exhibited by the industry at large. The average standard deviation of our five funds over the year to June was 7.65 per cent. The BarclayHedge average for all single-manager funds was 8.34 per cent for the same period.

The largest absolute outperformance was delivered by Jeff Osher's Harvest Small-Cap Partners Strategy, a long/short equity fund with a market neutral focus that was up nearly 9 per cent, while his average peer was down nearly 4 per cent. The average hedge fund lost 4.3 per cent.

Scott Schaeffer's Steelhead Pathfinder Strategy, a convertible arbitrage fund, was up 7.29 per cent, topping his peers by more than 6 percentage points and the average fund by more than 11.5 percentage points.

Emerging market debt funds have struggled over the past 12 months, losing 2.26 per cent on average. But Paul Crean's Finisterre Sovereign Debt fund had a gain of 3.67 per cent.

Jack Doyle's Wexford Credit Opportunities Fund – which invests in distressed securities – delivered the weakest performance, losing 2.18 per cent. But the average fund return in this category lost even more: 6.54 per cent.

The macro fund on the list, Ray Bakhramov's Forum Global Opportunities, was the other fund that lost money. Down 1.64 per cent, the fund slightly underperformed the strategy average of -1.62 per cent.

While we are reticent to highlight such a short timeframe and are mindful of the S&P 500's gross return of 5.45 per cent over the same period, the performance of these selected funds during an especially rocky year appears to show that the search for quality can pay off, increasing returns and reducing risk.

Eric Uhlfelder and Jonathan Kanterman

How did last year's hedge fund picks perform?*

Name of fund	Fund assets ($m)	Strategy	BarclayHedge strategy average*	One-year return (%)	Three-year annualised return (%)	Five-year annualised return (%)	Annualised return since inception	Worst drawdown since inception	Volatility** past one-year	Volatility** past five-years	Sharpe ratio past five years
Harvest Small Cap Strategy	**279.0**	Equity long/short	**-3.96**	**8.8**	**4.54**	**11.26**	**14.87**	**7.37**	**9.44**	**9.43**	**1.15**
Forum Global Opportunities fund	**341.6**	Global macro	**-1.62**	**-1.64**	**10.43**	**18.82**	**22.24**	**10.03**	**10.99**	**17.9**	**1.39**
Wexford Offs. Credit Opps Class A	**104.1**	Distressed securities	**-6.54**	**-2.18**	**8.79**	**6.94**	**14.16**	**12.55**	**8.38**	**9.18**	**0.68**
Steelhead Pathfinder fund	**439.4**	Convertible arbitrage	**1.1**	**7.29**	**12.45**	**10.22**	**10.24**	**12.49**	**3.02**	**6.35**	**1.5**
Finisterre Sovereign Debt fund	**741.2**	Emerging market debt	**-2.26**	**3.67**	**12.68**	**10.58**	**9.66**	**21**	**6.44**	**9.92**	**0.99**
		FTfm 5- fund average		**3.19**					**7.65**		
		Aggregate 5-strategy average		**-2.66**							
		BarclayHedge fund average		**-4.32**					**8.34**		

* One-year period was from 1 July 2011 to 30 June 2012. Three and five-year periods are to 30 June 2012
** Annualised standard deviation, moving average over past year and past five years

Source: BarclayHedge and cited hedge funds