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# VERTEX FUND

Third Quarter Report, 2012

*"Don't fight the Fed"* - Marty Zweig

Until this quarter, we had been extremely bearish with our market outlook and our dedicated short portfolio has been at its maximum allowable weight of 15 percent. In 2012, shorting stocks has been like shooting fish in a barrel. Regardless of the sector, you could make an intelligent case for it to proceed further into the abyss of bad news and be rewarded almost instantly for it. However, this bearish sentiment changed in the third quarter of 2012 with the Germans caving into the European Central Bank for European sovereign bond purchases and Bernanke announcing unlimited Quantitative Easing ("QEternity"). Bernanke's $40 billion a month of market purchases will continue unabated until the stock and housing markets begin to rise in tandem with unemployment finally decreasing.

Japan and China also announced more QE to keep the printing presses on full blast and it feels like March 2009 all over again. As TED spreads (an indicator of credit/default risk) and two-year interest rates swaps (borrowing cost for banks) have collapsed, we have purchased new, long equity positions.


**Figure 1: USD Interest Rate Swap Spread 2-year (Aug 2011-Sept 2012)**

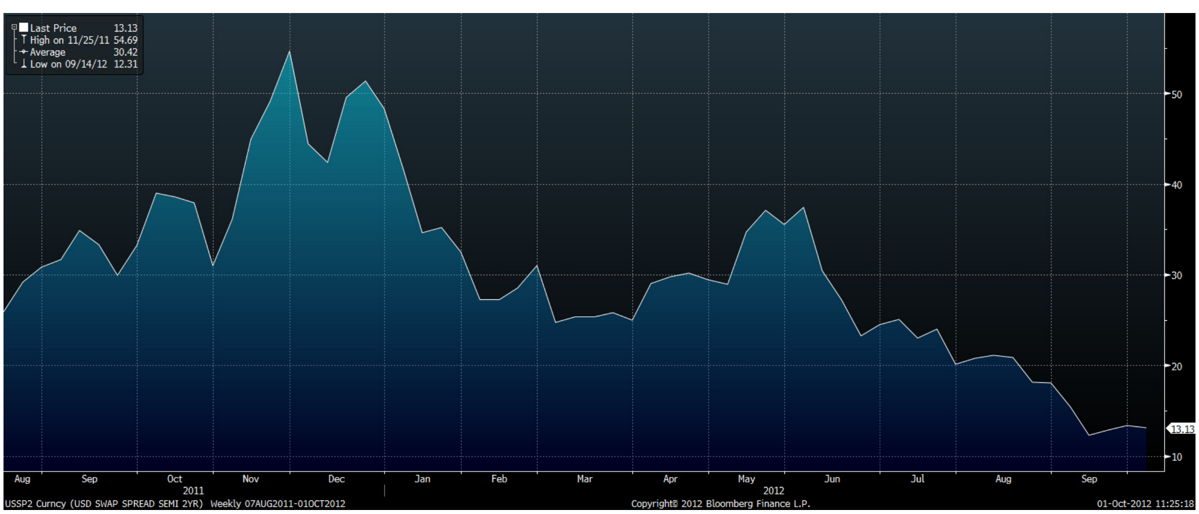


**Figure 2: TED spread (Aug 2011 – Sept 2012)**

It is almost too rosy out there with Bernanke admitting the Fed is targeting higher equity prices; you can't fight the Fed...

Our dedicated short portfolio has been reduced by two-thirds, as most of our out-performance has come from long positions. The Vertex Fund had one of its best quarters in recent memory. All of the announced printing of money is great for real assets like gold and real estate. Our gold warrant exposure is modest but allows for massive exposure to the upside if stocks continue to perform and the warrants become in-the-money. During the nadir of the resource pullback in May we began picking-up Franco Nevada (a gold royalty company) warrants on the cheap. To-date we have purchased over 2 million Franco Nevada warrants. This $13 Million investment represents an opportunity to turn into $170 million of underlying equity over the next five years, should gold continue to perform well. Asymmetric returns like these are the type of investment that we continue to look for.

Mind you, asymmetric picks don't always work out. We had built a position in Freddie Mac and Fannie Mae preferred shares with the idea that these companies had recently become profitable and would be able to restart paying preferred share dividends. This was similar to AIG, Lloyds and RBS where we had co-invested with governments for good returns. Well, maybe they have become too profitable, as the government announced a payback plan that is too onerous for these entities to pay anything back to preferred shareholders. What we thought could have been a fifteen fold increase became an 80 percent loss (less than 1% to the fund), so we sold our shares and moved on.

On the M&A front, merger arbitrage returns continued to be strong in third quarter, driven predominantly by our large position in TMX Group which (finally) closed in the quarter and the raised offer for Progress Energy (being acquired by Petronas). After a surprisingly robust August, M&A activity slowed materially in September, once again leaving us with the challenge of redeploying capital.

We are seeing a barbell effect in merger arbitrage returns, whereby straightforward "safe" deals trade at very unattractive spreads (often below 4% annualized); whilst riskier and more complicated situations are offering disproportionately wide spreads on a risk-adjusted basis. We are more than willing to traffic in the latter type of situation when we feel we are adequately compensated for the risk and hence hold significant positions in the politically-charged acquisition of Nexen by CNOOC (35% annualized rate of return) and the purchase of Shaw Group by Chicago Bridge & Iron (which was as wide as 25% annualized as a result of what we perceived to be a misunderstanding of Shaw's fundamental value).

**S&P 500 Companies Excluding Financials**
**Dividend Yield Higher Than 10-Yr T-Note Yield**

| | % of Companies | | % of Companies |
|---|---|---|---|
| 2012 (a) | 53.3 | 1996 | 3.6 |
| 2011 | 47.8 | 1995 | 4.5 |
| 2010 | 14.7 | 1994 | 2.3 |
| 2009 | 11.4 | 1993 | 5.0 |
| 2008 | 45.5 | 1992 | 0.9 |
| 2007 | 6.6 | 1991 | 1.0 |
| 2006 | 1.7 | 1990 | 4.0 |
| 2005 | 4.8 | 1989 | 2.0 |
| 2004 | 5.5 | 1988 | 3.4 |
| 2003 | 5.6 | 1987 | 3.2 |
| 2002 | 10.1 | 1986 | 5.4 |
| 2001 | 3.6 | 1985 | 3.0 |
| 2000 | 3.1 | 1984 | 1.9 |
| 1999 | 4.7 | 1983 | 3.5 |
| 1998 | 3.8 | 1982 | 7.7 |
| 1997 | 2.2 | 1981 | 2.4 |

(a) As of September 6, 2012
Source: Standard and Poor's, Factset, Bloomberg, and Omega Advisors, Inc.

The long-term case for equities over bonds has rarely been so compelling. Investment grade bonds, viewed by many as a safe haven asset, are looking overly-stretched on valuation. Take the table to the left as an example: investor demand has pushed the yield on 10-year Treasury notes so low that 53% of S&P 500 companies have a higher dividend yield. This period is an anomaly when looking at 30-year historical data.

As always, please call us if you would like more details on the previous analysis.

**PERFORMANCE** (Class A shares as at September 30, 2012)

| Net Asset Value | 3 Month | Year-to-Date | 1 Year | 5 Year+ | 10 Year+ | Since Inception+ |
|---|---|---|---|---|---|---|
| $64.2243 | 7.02% | 12.59% | 5.70% | 5.47% | 14.32% | 16.88% |

+annualized returns