The best little hedge fund in Texas?

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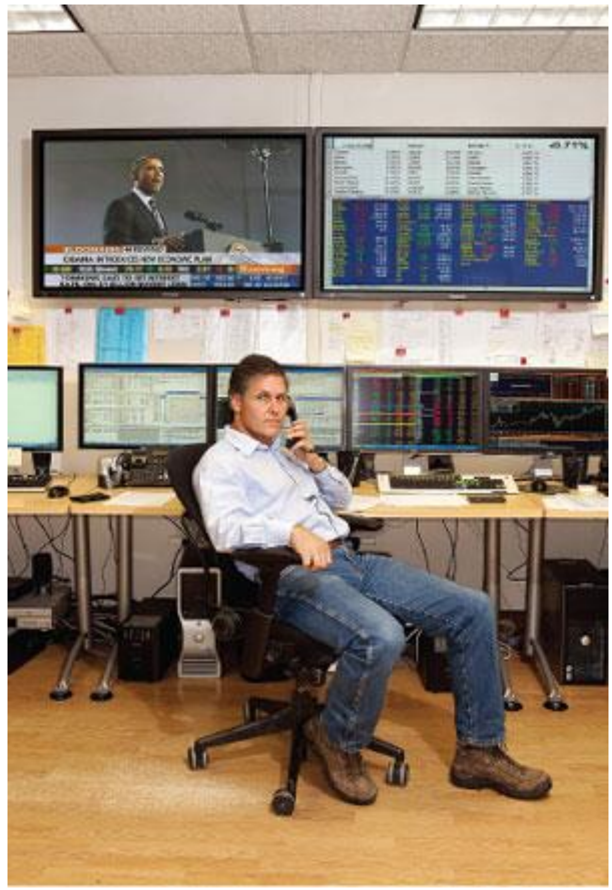
Salem Abraham's once high-flying fund has faced a tough year.

By Irwin Speizer



Photographs by Brent Humphreys

This is a tale of Texas —the Panhandle of Texas, to be exact—and a little oasis of a town along the Canadian River perched on the edge of the often-parched Great Plains that would feel at home in a Larry McMurtry novel, with its single-screen movie theater and the only two stoplights for 45 miles. It is a saga of the railroad, ruined ranchers, buried natural riches, and a family dynasty that traces its legacy from Lebanese immigrant peddlers to a systematic futures trader who now manages nearly a half billion dollars from an office above the town's steak house. If McMurtry were writing this story, he might call it "The Best Little Hedge Fund in Texas."

Barron's named that trader's fund, Abraham Trading, one of the top 100 hedge funds in the world in both 2009 and 2010, based on a review of the previous three years of returns. Those returns were generated in the tiny town of Canadian, Tex. (population 2,281), a sleepy location about as distant in time and temperament from places like New York and Chicago as one could imagine.

But this year at Abraham Trading has been a challenge, less like a pleasant hayride than a prolonged period in the saddle of a bucking bronco. Salem Abraham, the 44-year-old president and owner of Abraham Trading, who comes to work in jeans and work boots in an office adorned with giant paintings of rodeo cowboys in chaps, has been struggling with ornery commodity trends that he has been unable to harness with his computer models. This led to a losing streak that lasted for more than a year until he finally scored a strong positive month in August.

Abraham trades 59 futures markets, but 56% of his focus is on commodities, where bumpy price movements without clear directions have been particularly troublesome to his systems, resulting in regular losses. Of his 15 worst-performing investments in 2010 through July 26, all but two were commodities. Only one commodity, platinum, made it into his top 15 best performers.

His biggest money losers for the period were cotton (down 1.599%), crude (-0.886%), heating oil (-0.879%) corn (-0.845%) and Kansas wheat (-0.726%). His biggest gainers were the euro (up 1.589%), Japanese government bonds (0.791%), the Nikkei (0.652%), the Australian 10-year bond (0.642%) and the S&P 500 (0.622%).

Abraham Trading lost 5.55% in 2009 through its trading programs. Even after gaining 3.72% this August, Abraham Trading was still down 6.22% year-to-date through the end of the month. The disappointing results were troubling enough for Salem Abraham to write a letter of explanation to investors in his Salem Global Opportunity Fund, the flagship hedge fund.

"The last 19 months of trading have been difficult as many markets we trade have been volatile and without direction," Abraham wrote in his August 5 letter. Abraham says he has no doubt results will soon move back in his favor, as they have after past periods of lackluster performance that were followed by more predictable trends, and he recently upped his own investment in Abraham Trading by about $3 million.

"I am confident that our systems are sound," Abraham says. "One of the biggest lessons I have learned in 23 years of trading is to not let the inevitable periods of poor performance overshadow the bigger picture of making smart bets. Smart bets sometimes end up being losing bets, but they were still the right thing to do."

But the poor performance scared off some investors, who pulled about $10 million out of the Global Opportunity Fund through redemptions. Abraham Trading manages about $440 million primarily through Global Opportunity and a collection of separately managed accounts, with almost all using the same systematic futures trading system. Most investors have so far stuck by Abraham, including one well-known Texan: T. Boone Pickens, the Dallas billionaire who also runs his own hedge funds and was among the earliest investors with Abraham.

"I have $25 million with him, and I am sure not uncomfortable with it," Pickens says. "He will make whatever adjustments he needs to make, and he will make money. Don't worry about Salem."

Like other longtime investors, Pickens points out that Abraham occasionally has down periods but has always recovered to deliver decidedly positive long-term results. Before his losing streak started, Abraham had a record of greater than 20% average annual returns since inception in 1988. Even with the recent down periods, Abraham Trading still boasts average annual returns of 19.41% since inception in January 1988.

Adventist Health System, headquartered in Winter Park, Fla., has been an investor with Abraham since 2003, and David P. Singleton, the treasurer and chief investment officer of the hospital company, says it remains loyal. "His performance would have to be off substantially for quite a while for us to reevaluate our desire to have exposure to him," Singleton says. "Other than periods like this summer, where market chop has dampened returns, we are very happy."

As Singleton points out, Abraham provided a portfolio lifeline during the market meltdown of 2008, posting a 28.78% gain for the year.

Singleton vividly recalls his first trip to Canadian to meet with Abraham. He flew first to Oklahoma City, Okla., then took a commuter plane to the tiny Canadian airport. His flight was delayed because another plane had hit a deer on the Canadian runway.

"We invest in hedge funds all over world," Singleton says. "I have never been anywhere like Canadian. Salem's ability to attract talent and investors to a business that is run in a really off-the-map kind of spot speaks a lot to his entrepreneurial drive. The guy is smart and down-to-earth. You walk around town with him, everyone knows him. It is obvious people respect him. He is a very interesting guy."

Abraham is also an engaging conversationalist who delights in spinning yarns about his family history and his own endeavors to revitalize his beloved hometown, where he owns or has investments in a third of the 30 buildings in the compact downtown, including the movie theater (which he remodeled with the latest sound system), the former hotel that houses his offices and the steak house, and several other storefronts. A trip to visit Abraham Trading invariably includes a town tour with Abraham at the wheel of his four-wheel pickup as he drives past the sights, then heads off-road onto some of the 30,000 acres he owns with his two brothers, most of it bought with Abraham Trading profits.

The town has prospered along with his hedge fund operation and is atypical of many of the struggling small towns of Texas. The local school district (Abraham serves on the board) boasts some of the highest teacher salaries in the region and some of the most modern facilities, and the high school excels not only in sports (it has a championship football team) but in academics. Of the 35 graduates of Canadian High School in 2010, two are now at Harvard University. One is Abraham's oldest daughter; the other worked as a summer intern in Abraham's office.

On one recent tour Abraham led of the town, Abraham stopped on a slight rise beside the Canadian River, which runs through his land, put the truck in four-wheel mode and drove straight through the river. On the other side was a bulky yellow tractor called an excavator that he had used to rearrange some of the riverbank. "I bet you don't know many hedge fund managers who own an excavator," he says, "and know how to drive it."

The hedge fund is not the only source of income for Abraham. His land sits atop rich oil and gas deposits and also bestrides the Ogallala Aquifer, a vast and valuable source of fresh water. A few years ago, Abraham brought together neighboring landowners and struck a deal for future water rights with the city of Amarillo that netted him $9 million dollars.

That deal impressed even Pickens, who tried but failed to strike a similar water rights deal with Dallas on land he owns in the same panhandle region.

Pickens thought he could strike a much bigger deal that would encompass more water rights and more land and could be sold to cities as far away as Dallas. Abraham set his sights lower, with rights covering less land and aiming to sell to just to Amarillo, which is closer.

"He didn't believe that the deal could get as big as I thought it could," Pickens says. "He sold out and moved on to something else. Salem read it better than I did."

Pickens knows and understands Abraham as well as anyone. He not only owns considerable land in the same area, he is also a longtime friend of the family, having known Abraham's grandfather since the 1970s. Salem Abraham says he first got to know Pickens in 1989, when he, his two brothers and his grandfather took a tour of Pickens's ranch about 30 miles west of Canadian. Pickens subsequently became an early investor in Abraham's fund and even mentioned the investment in his 2008 autobiographical book, "The First Billion Is the Hardest."

But landing a local billionaire who happened to be a friend of his grandfather wasn't nearly as challenging as convincing sophisticated outside investors like Adventist to join in. To do that from a place like Canadian took a special kind of sales talent. In Salem Abraham's case, he apparently inherited his deal-making acumen from his Lebanese ancestors.

The Abraham family of Canadian started out as the Maloufs of Lebanon. Searching for opportunity in the United States, Nahim Abraham Malouf, Salem Abraham's great-grandfather, followed the railroad west, ultimately getting off in the train depot town of Canadian to sell work clothes out of a suitcase to ranchers and farmers. Nahim dropped the Malouf name and simply called himself Nahim Abraham, doing well enough to eventually open a store in town in 1913. When the Dust Bowl hit, Nahim had saved enough not only to survive the bust but to thrive, able to buy foreclosed properties cheap that the bank took back from ranchers and farmers who had gone broke. The Depression started the Abraham family on the road to fortune.

Nahim brought the original family name back as the first name of his son. Malouf Abraham grew up to marry the daughter of a local rancher who had Irish roots. Their son, Malouf Abraham Jr., was a successful allergist whose practice in Canadian attracted patients throughout the region and into Oklahoma. Malouf Jr. also married a woman of Irish descent, and as a result their son Salem Abraham considers himself three-quarters Irish and one-quarter Lebanese. But the person who exerted the strongest influence on Salem Abraham was his grandfather, Malouf Abraham Sr., an irrepressible deal maker and sometime politician.

Malouf Abraham Sr.'s oil and gas deals made the family truly rich, while his civic interests got him elected town mayor and then to the Texas legislature. Known as "Oofie," he became a respected civic benefactor and philanthropist. He was also generous to his family, doling out $50,000 stakes to each of his grandchildren that they could do with as they wished when they reached maturity. "I think most people would describe it as a prominent family," Abraham says today.

Growing up, Abraham exhibited an aptitude for math, winning a regional math competition and placing in the top 1% with his math SAT score. He thought about following his father into medicine but ultimately decided against it after concluding that his grandfather had a lot more fun and made a lot more money than his father. He went to the University of Notre Dame in 1984 to pursue a finance major and applied himself with enough focus to complete the degree in three and a half years.

Abraham settled on two career goals: one was to own a business, and the other was to run it in Canadian so he could stay close to his family roots and learn from his grandfather. His first idea was a mail-order business. But as he drew up his business plan, he decided that the initial investment required for an operation of any size would be millions; he had the $50,000 in capital his grandfather had given him and figured he would never be able to raise the rest.

Just at that moment he made a serendipitous connection. At a family gathering in Texas, he met the husband of a cousin of a cousin, one Jerry Parker, who had about nine years on Salem Abraham, who was 21. (Parker and his then-wife have since divorced.)

"So I start quizzing him about what he does," Abraham says. Parker ran a futures trading operation out of his house in Virginia, using a systematic, trend-following approach. And he apparently did quite well. "I was intrigued," Abraham says. "Clearly, he was making money. What I took away from it is that this guy is getting the odds in his favor using a systematic method to trade futures."

When Abraham asked if he could visit to see the operation, Parker said sure, probably figuring there was no chance Abraham would take him up on it. Abraham immediately did just that, flying to Virginia to see how Parker did what he did. It was a life-changing visit. Parker, it turned out, was a systematic trading master who at the time was working for Richard Dennis, the Chicago commodity wiz, before he founded Chesapeake Capital in 1988, which grew into a billion-dollar hedge fund.

In his popular book "The Complete Turtle Trader," Michael W. Covel chronicled the entwined careers of a group of successful trend-following traders who started out working for Richard Dennis. The book featured Parker as one of the most successful protégés and also included a chapter on Abraham, whom Covel singled out as the next-generation heir to the group's methods.

Abraham says that while he may have practiced a similar long-term trend-following strategy in his early days, he didn't duplicate what Parker was doing, simply because he wasn't sure exactly how Parker's models worked. Parker was tight-lipped about the specifics.

But Abraham says he grasped that by applying statistical methods to basic futures trading data—daily highs, lows and volume—he could map out patterns and develop formulas to try to predict and follow trends that he could bet on. This was all about math, which he liked and understood, and finance, which was his field of concentration at Notre Dame. Abraham determined that starting his own futures trading operation would require a relatively small investment, and he could design and then operate the system just about anywhere.

Abraham went back to Notre Dame and began building his own models. He did much of the calculation by hand, and when he had a working system, he decided to test it. He bought a satellite dish and set it up on the roof of the off-campus house he shared with his roommates, paying $250 a month to receive live futures quotes. He placed small orders in the early morning, then went to class, returning late in the day to see how his trades worked out. By the time he graduated, he had developed his own trend-following system based on 21 markets.

Abraham returned to Canadian near the end of 1987 with his degree and his models, and pitched his new business idea to his grandfather. He recalls his grandfather's response: " ‘Of all the ways to lose money, why did you pick the one to lose money the fastest? These guys in Chicago, they are going to eat you up.' To say he was skeptical was an understatement," Abraham says.

But young Abraham was already a canny salesman and closed the deal by agreeing to a compromise. He would work for his grandfather in the oil- and gas-leasing business for most of the day but also set up the trading operation on the side. His grandfather and his brothers pitched in a combined $55,000, and Abraham added $45,000—what he had left of his stake after his test trades while in college—bringing the initial stake to $100,000. Abraham agreed that if he fell below $50,000, he would, as his grandfather suggested, "drop this nonsense and we'll get back to real business."

He started trading in January 1988, using programs and models he continued to develop on a home computer. It didn't go well at first. By April his $100,000 stake was down to $82,000. By the first week of May, it was $72,000. Abraham was operating in a small nook inside his grandfather's office, and each day his grandfather would poke his head in to ask for an update. Abraham recalls one day in mid-

May when the number was exactly $68,754. "He grins and rubs his hands together and says, just a matter of time now," Abraham recalls. "As it turns out, that day was the bottom."

Abraham's models, based solely on trade data, told him to go long grains and soybeans. He got wildly lucky when drought struck the Midwest, shriveling crops and sending futures prices soaring. He ended May up 32.34%, and his bets kept paying off as the drought lingered. June brought a stunning 72% rise. For the year, he was up 142%—a number he would never come close to equaling again.

He was now officially in the futures trading business, and he had a new motto to live by. "The key to trend following is: don't go broke during dry spells," Abraham says.

His grandfather had received a prospectus from the Dean Witter Principal Guaranteed Fund II and noted that his grandson had done better than the pros at Dean Witter. The fund was run by Commodities Corp., the Princeton, N.J., trading incubator that had spawned such hedge fund managers as Louis Bacon, Paul Tudor Jones and Bruce Kovner. It was now 1989, and Abraham, who was looking for investors, decided to give Commodities Corp. a call. He dialed late in the afternoon, which was about 6:30 p.m. back east, and the person who answered the phone was Elaine Croker, a top executive at the firm who is now president of Moore Capital Management. Abraham was his usual charming and convincing self, and Croker later called back to say she would be in Houston in May, and would he like to come down for a meeting? Indeed he would.

The Houston meeting went well, and after some extensive due diligence, Commodities Corp. invested $200,000, later raising the stake to tens of millions of dollars as Abraham posted strong results. He was up 17.81% in 1989, 89.95% in 1990 and another 24.39% in 1991. Except for a loss of 10.5% in 1992 and a slight dip of 0.42% in 1996, he posted positive results for the rest of the 1990s. As his assets grew, he began adding to his staff, hiring Barry Sims, a financial software developer who worked in the area, to help with operations and then elevating him to chief operating officer of Abraham Trading.

In 1995 Abraham was managing $137 million, and he was buying thousands of acres of land with his profits. But in the late 1990s, his profits slowed as investor sentiment shifted from commodities to tech stocks. He was posting gains in the 4% to 5% range at a time when the booming tech market sent stock prices soaring. Investors began pulling out to join the tech stampede. Commodities Corp. withdrew $90 million in 1999, other investors followed and by the end of the year Abraham was down to managing $3.7 million, primarily his own and his family's money.

Abraham Trading continued operating but found other ways to make money. In 1999 Abraham used his land holdings to negotiate the water deal with Amarillo. He started a broker/dealer operation and bought 15 seats on the Chicago Mercantile Exchange (which came with shares in the CME) at a bargain price, which he subsequently sold for 10 times what he paid. He also set up one of the first high-speed trading operations, using pioneering electronic entry methods to execute arbitrage trades on the CME that lasted a fraction of a second each and yielded nickel-and-dime profits, which added up to thousands of dollars on typical days. Working out of his Canadian office, he accounted for 1% of the entire CME volume on some days.

In 2000 the tech bubble burst, and Abraham Trading started posting strong results again: up 13.54% in 2000, 19.16% in 2001, 21.51% in 2002 and a hefty 74.66% in 2003. Investors noticed and money poured in again, including big institutional investors like Adventist Health System. Abraham opened an Austin branch in 2003, hiring Shaun Jordan, a former Olympic swimming gold medalist, to handle marketing. Abraham also started a new research operation headed by his cousin Mark Abraham, who joined in January 1995 while still attending the University of Texas at Austin; he graduated in May 1995 with a bachelor's degree in finance. Abraham Trading now employs 20 people, including five in the Austin office.

The firm today operates a group of investment vehicles, with most of the money held either in separately managed accounts that have a $10 million minimum investment or in the Global Opportunity Fund, which has a $250,000 minimum. Investors are split evenly among individuals, funds of funds and institutions. All pay the standard 2% management and 20% performance fees.

Abraham Trading made a major change to its trading methods in 2006. As a long-term trend-following trader with a concentration in commodities futures, Abraham Trading experienced large performance swings, and that volatility had begun to concern institutional investors. The changes expanded the scope of trading, gradually adding new strategies, starting in January 2006. Long-term trend following now accounts for 35.5% of trading, mean reversion 34%, short-term momentum 13.4%, short-term trend following 9.1% and stock index momentum 8%. Abraham Trading is still focused most heavily on commodities futures, which represent more than half of the 59 global futures markets now traded, but the firm now trades financial futures too, including currencies, interest rates and global stocks. The commodity focus is unusually broad, including everything from oil and gas to cattle and milk.

The strategy changes dampened the big swings in performance that had characterized the firm. A chart in Abraham Trading marketing material showing daily rates of return looks like an EKG readout, with the period before 2006 showing big bursts of highs and lows. But after the changes in 2006, the chart flattens out. From June 1999 to December 2005, Abraham Trading performance numbers had an annual standard deviation of 28.94%; since January 2006 that has dropped to 11.78%.

While the changes smoothed out volatility, they didn't disrupt the ability to post solid returns. Abraham Trading gained 8.93% in 2006, 19.2% in 2007 and a strong 28.78% in 2008.

The dip in performance that started in 2009 prompted some questions about whether the strategy changes were in some way the cause. Abraham insists that the problem is not the strategy but rather the markets, which have been unusually unpredictable. The current strategy lineup worked from 2006 to 2008, he figures, and there is no reason to think that it won't return to profitability soon.

"We are 100% confident in our strategy," he says. "Over the next 10 years, we will make a lot of money."

And he is hoping to manage a lot more money as well. The systems he has set up are designed to handle more than a billion dollars in assets.

Chances are there will be a good many more visitors from faraway places taking the four-wheel-drive tour of Canadian with its favorite son behind the wheel. AR