Fewer musty corners to hide.
Tony Tassell in London
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Somewhere in one of the more remote parts of the Russian tundra, there is supposedly a hedge fund employee with an unusual job. His business card may have some made-up title but his real task is go to the local watering holes and buy drinks every night for the workers at nearby oil and gas drilling fields.

The hope is that some precious, price sensitive information will be let slip amid the shots of vodka. The tale, related to me by a hedge fund contact, is probably apocryphal. But it is not beyond the realms of possibility given the energy and invention of some hedge funds in seeking an information edge from cold-calling suppliers to carrying out intense studies of arcane commodities.

This is not to imply anything illegal, although any trades arising from the Russian story would be dubious. It is more that to justify their lucrative fees, hedge funds look for areas where there are the most pricing anomalies to exploit so they can outperform the traditional fund manager. Two obvious sources of those anomalies are lack of information or liquidity.

That might explain the rising presence of hedge funds in small and mid-sized stocks. In FTSE 100 companies, it is hard to claim there is a lack of research or trading volumes. That is not the case in smaller companies. It is difficult to quantify the degree of hedge fund investment in smaller companies. Many stakes appear under anonymous nominee accounts or fall below the "notifiable" level that is required to inform the stock exchange.

The stakes of other hedge funds that are part of a traditional investment house are often just disclosed under their parent's name. Some exposure is also taken through derivatives or contracts for difference.

But a survey by Greenwich Associates, the consulting and research house, of pan-European equity hedge fund managers found their level of assets invested in small and mid-cap stocks has risen from 19 per cent in 2003 to 30 per cent in 2005. This represents astute allocation given the outperformance of small and mid caps in the past two years.

Mid and small cap brokers also report rising orders from hedge funds. And some hedge funds are regularly popping up on shareholding registers with punchy stakes in companies. "They are certainly drilling down into the smaller companies," says John Pearce, chief executive of the Quoted Companies Alliance, a representative body of small listed companies.

Rab Capital, a hedge fund that is itself a small-cap on Aim, has built up a string of sizeable holdings in small resources stocks such as Falkland Oil & Gas, Asia Energy and Archipelago Resources. In its first year in 2003, RAB's Special Situations fund, managed by Philip Richards, achieved gains of 1,274 per cent after fees. It followed this up with gains of 49.2 per cent in 2004.

Lansdowne Partners is another prominent investor in small and mid caps. It has held stakes in companies ranging from Dawnay, Day Carpathian, the property company, to Peter Hambro Mining, a gold miner, to Burtonwood Brewery. The firm was set up in 1998 by Paul Ruddock, a Schroders man, and Steven Heinz, a fund manager with Harvard Management Company. Other active hedge funds in the small and mid caps include Ennismore and Meditor.

One implication of such a rising presence is greater competition for the traditional UK stockpicking investor such as Anthony Bolton, the renowned manager of the GBP5.4bn Fidelity flagship, the Special Situations fund.

Although he does invest in large companies, Bolton's great skill has been in identifying value in mid and small cap stocks that have fallen out of fashion or have been overlooked, using judgment and often eclectic sources of information. The few times his performance has suffered on a relative basis against the market have been periods when large caps have been in favour such as the late 1990s.

But there are now fewer dark and musty corners of the market to find overlooked bargains. If hedge funds or other fund managers do not spot pricing anomalies, then the private equity world is likely to. In that context, this week's move by Fidelity to split the Special Situations fund into two seems highly prescient. The move is being driven by concerns that the fund's sheer size might eventually make it difficult to manage effectively. To compete, the fund will have to be nimble.