A Long/Short Strategy Focused on Small-Cap Consumer Growth

Lori Wachs is the Co-Founder and Investment Manager of Cross Ledge Investments. Ms. Wachs is a Magna Cum Laude graduate and a Benjamin Franklin Scholar from the Wharton School of the University of Pennsylvania, where she majored in finance and minored in East Asian studies. She graduated with honors and was elected to Phi Beta Kappa. Immediately after graduating, Ms. Wachs worked as an Analyst in the Equity Risk Arbitrage department of Goldman Sachs from 1990-1992. Having moved back to Pennsylvania in 1992, she joined Philadelphia-based Delaware Investments as an Analyst in the company's small/midcap growth equity group, focusing on the consumer sector. In 1997, Ms. Wachs was promoted to Vice President and Portfolio Manager, where she helped oversee the investment of $4 billion in various institutional and mutual fund products. Active in marketing the investment products she manages, she has been featured regularly on ABC Good Morning America, ABC World News Tonight, CNBC, Bloomberg News and Fox News Channel as an expert on retail and consumer investments, fashion trends, buying behavior and retailing best practices. In August of 2010, Ms. Wachs and two former longtime colleagues from Delaware Investments launched a hedge fund, Cross Ledge Investments. The fund ranked in the top 15% of the HFR All Funds universe when it reached its three-year performance record in August of 2013. Profile (https://www.twst.com/bio/lori-wachs/)

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TWST: Hedge funds have been described by some as mutual funds on steroids. What's your definition of a hedge fund?

Ms. Wachs: Well, there are many different kinds of hedge funds. The type of hedge fund that we run is a long/short equity fund. And I actually do not believe that it resembles a hedge fund on steroids, because we are in effect dampening the volatility while still providing quite a bit of exposure to the upside. We short stocks against our long book, and we tend to run at about a 50% net long exposure.

Over time, we believe stock markets go up, and we want to be positively positioned as it relates to that. But in order to smooth out some of the market bumps and downturns along the way, we like to short what we view as the underperforming stocks against the stocks that we've picked that we believe will outperform over time.

TWST: How much do your strategies, focus, and techniques for managing risk vary according to market conditions? How fluid are they?

Ms. Wachs: Again, this is specific to Cross Ledge. We have set up a band of net long exposure of 40% to 60%, and we feel that that has served us quite well; it gives us some room to move based on the type of market that we're in. However, whereas we pride ourselves on being strong stock pickers, we don't really say that we're going to be outstanding market timers. So we didn't want to give the band too much leeway.

In a very strong market like we saw last year, we saw a lot of hedge funds widen their net exposure to greater than 60%, and then you run into some road bumps earlier in the year, and it's been difficult to kind of rein that exposure back in. So again, that's why we've really stuck to our knitting with this 40% to 60% band.

The same holds for the reverse kind of scenario. We came out of a market a few summers ago where a lot of hedge funds had gotten very bearish with their positioning, and we were still sitting at the lower end of our band but still within that 40% to 60% range, and the market really took off and we were already there, positioned to capture that.

TWST: Please share some of your own career highlights. What motivated you to become a hedge fund manager?

Ms. Wachs: My career path, it's pretty short and sweet. I graduated from Wharton, undergraduate in 1990, and I immediately went to work at Goldman Sachs in New York in their Equity Risk Arbitrage department, and it was part of a two-year training program. And when those two years were up, personal reasons brought me back to Philadelphia and I immediately went to work for Delaware Investments in the Emerging Growth Group, which had several different products, but always focused on quality growth stocks in a classic sense, in both the small and midcap world.

I started there in 1992 as a Junior Analyst and worked my way up to a full-fledged Analyst and ultimately a Portfolio Manager, and I spent 17 years of my career there. And the vast majority of that time was spent focusing on the consumer sector. So I got to a point where I really felt that I knew the consumer sector inside and out. Whereas at a long-only mutual fund, like we were at Delaware, we could do well for our clients by picking companies that would outperform on the long side. But we had just come through a very difficult time in the market, and we weren't able to dampen that volatility. We liked the idea of being able to hedge our bets by going short some of the stocks that we felt would underperform — so we felt that we could do a hedge fund.

Another important thing in the small-cap space, you want to make sure that your assets don't get too big. Obviously this is in quite a bit of conflict with an asset-gathering firm, because they get paid on growing their assets. And in the small-cap space, it becomes difficult to outperform when you get an asset base that's over $1 billion. So we felt that we could set something up at Cross Ledge that would be a best of all worlds, that we would be able to apply our expertise in our sectors and we would also be able to do it with a manageable level of assets that should provide us with an extra tailwind to continue to outperform.

TWST: So your focus at Cross Ledge is the small-cap sector, primarily?

Ms. Wachs: Yes, it is primarily small cap. If we find a great company and they pass over into what we define as the midcap space, we won't sell it automatically because it's crossed over. So if we bought it as a small-cap stock and the thesis is still in place, we will continue to hold it. That winds up netting out to about two-thirds of our companies are small cap and one-third are over that small-cap threshold.

TWST: In your long/short strategy, what are the key technical analysis and fundamental analysis tools you use to pick stocks?

Ms. Wachs: Well, we're really a fundamentally driven organization, so we really don't do a whole lot with market technicals. We look at them as an overlay; we will look at the 150-day moving average, and more on a tactical basis, we're looking as we're getting in or exiting a position. But the vast majority of why we're buying and selling a stock really is entirely because of the stock's fundamentals, and it's different based on the sector.

Again, I focus on the consumer sector. One of my partners does energy and industrials. But within the consumer space, we're looking for companies that are growing their top and bottom lines in excess of 15% and that are showing continued improvement on how they manage their operations so that we're getting expansion on the operating margin line as well. We're also looking for companies that are taking market share and a variety of metrics to look at that.

And certainly within the consumer and retail space, an important lens that we need to look through nowadays is what is this company's susceptibility or ability to excel in the online world, and we want to make sure that we're not in a company that can be "Amazoned," for lack of a better description, which is that **Amazon** (AMZN) can step in and start to undercut them on price and it's somewhat commoditized. So those are more types of companies that we look to short in this environment. We go long retailers that have their own proprietary products, or that they have products where shipping would really just be cost-prohibitive or that there's a strong service element.

TWST: Can you share with us the names of some specific equities that you like? I know your views are widely followed in the retail sector, so in the retail sector?

Ms. Wachs: Right. So a company that we did quite well with over the past few years is **Lumber Liquidators** (LL). We started to get involved with it when housing started to turn a little over two years ago, seeing that there would be a bit of a housing play. But we were really impressed with the new management team, and the CEO came from a background in the home improvement arena. The CEO who was there prior to him had not. So there just seemed to be quite a bit of low-hanging fruit for him to go in and start to really increase their market share, and he did that through things such as broadening their advertising message, and whereas the majority of customers that replace their floors are the casual customer who want to have somebody else do it for them, most of their advertising was targeted toward do-it-yourselfers. So he started to broaden out the advertising message and was able to increase traffic dramatically by doing that.

He also started to expand some of the product offerings. It's still a pretty well-edited, flooring-based assortment; whereas before they were targeting do-it-yourselfers. Yet they didn't have any of the tools at the store that a do-it-yourselfer could then go home and do the project. They were just selling the actual flooring. So he started to put some of that and also started to focus their salespeople on making sure they informed the customers that they carried molding at the store. In the past they had their moldings essentially on a large key chain that they would flip through. And they started putting a nice display of it up in the store, which has done a good job of driving it as an add on to their flooring purchase. So he has really just taken on a number of initiatives that have been very impressive and have driven shareholder value quite a bit.

TWST: And that's a company in the retail sector, not the housing and the building sector?

Ms. Wachs: Yes, it's in the retail space. In fact, they have storefronts that are about 1,100 square feet selling in the front, and then they have about 5,000 square feet in the back that has the flooring in stock. Whereas a lot of places you go and you order it, you have to wait for it to be delivered, and this way you can walk in and take the flooring home with you that day. And he's really worked a lot on the supply chain and having the product in stock when the customer is there, and that's also really helped.

Beforehand, if they didn't have it, they would start having to wheel and deal with the customer and offer them discounts to say, "Well, we could get it for you in two weeks and then we'll take 10% off." Now that he's done such a good job with having the flooring in stock, there isn't nearly as much negotiation that has to be done, and that's really helped margins as well.

TWST: Any other picks in the retail sector that you can tell us about?

Ms. Wachs: Under Armor (UA) is another company that has done an extremely good job the past few years of blocking and tackling and getting much more into the women's business. And international has started to take off, as has their footwear. These are initiatives that they've been speaking about since the day they went public, which I think is at about eight years now. But they've really reached a tipping point the past few years.

TWST: What is your view of any headwinds that you see on the horizon in the second half that might affect some of your equities?

Ms. Wachs: We've gotten through a very difficult first quarter for the retail space. From a macro perspective, in terms of much of what we're seeing as it relates to employment trends and wage growth, they're heading in the right direction, and we're anniversarying the payroll tax hike, so that's not a continued headwind. Over the first quarter it was very choppy. Now, a lot of us seem to think it was weather; that seems to be the consensus. And when managements have spoken about the differential between markets that were affected by weather and those that weren't affected by weather, it seems quite real. However, the jury is still out, as we haven't seen the big pickup yet. So that would just be something that we're certainly keeping our ears close to the ground about, to make sure that that is the case, and that the consumer isn't telling us something else.

In terms of other major headwinds, housing has been a bit of a weak link for the past few months, and so things that are related to housing that you would normally see as a result of housing turnover, such as the purchase of appliances, are likely to decelerate in the coming months. So we're keeping a close eye on housing as well, because it's an important component of a continued recovery and for improving consumer psyche through the balance of the year

TWST: When evaluating small caps, do you perform qualitative analysis as well as quantitative? Do you meet with management?

Ms. Wachs: We try to meet with every company and management team before we invest in the company, and I've been doing this for 22 years now, so it's not just meeting with them once. Typically it's multiple times I meet with them through the years. And sometimes it takes many meetings before that first investment; sometimes it's one meeting and I'm ready to invest. But I continue to keep up with them and see them at conferences and when they're coming through Philadelphia, and I listen to their quarterly conference calls.

TWST: Can you share a scenario with us where a meeting with management really changed your view for the better or the worse?

Ms. Wachs: Just because it's top of mind and we just discussed it — **Under Armor**, when we met the CEO, Kevin Plank, it was difficult not to feel the passion and enthusiasm he conveyed. So whereas early on as a public company there were some growing pains, as he adjusted to that — and he didn't have classic management training. He was just a very passionate, enthusiastic, bright guy who saw an incredible white space. That took some time to iron out, but it was very easy for me to bet on Kevin from pretty early on. So that was certainly a case where management really helped seal the deal, so to speak.

TWST: Overall, if you could choose just one sector or asset class, where would you recommend investors put their money now as we move into the second half?

Ms. Wachs: So, I know what I'm good at, and in terms of asset allocation, that's just not my area. I focus on small-cap consumer growth, and we've been through a very difficult first quarter, and small cap has been through a difficult start to the year. And we know how these things work out over time, that there is a bit of a reversion to the mean. Small cap had had a nice string of outperforming over a number of years, but given the beating that it's taken this first part of the year, kind of everybody is waiting to see where the dust settles. But I would think that it should be a strong class in the back half.

TWST: What would you say are the qualities most needed to be successful as a hedge fund manager? What's most difficult about your job?

Ms. Wachs: There's such an information overload that I think the hardest thing is just to sift through everything and see where you can find the inflection point to see what is maybe not generally already out there, and act on that. Because you wake up every morning and you have 200 e-mails on the sector that you're looking at and the companies that you're following, and it's just — it's you have to kind of learn what really stands out, what will be an important point as it relates to the company on the up or the downside.

And certainly learning which analysts out there you think are really good and have good relationship with management, because it's impossible for one person to be on top of every single company every day of the week. So when you have other people that you trust, and they are sending you notes on what they think has changed in their last meeting with management, all of those data points are important.

TWST: Can you comment on any particular analyst or even favorite market gurus that you subscribe to?

Ms. Wachs: I think that Faye Landes at Cowen is really good. I also think that Sam Poser at Sterne Agee is really good, and I also like Brian Tunick at JPMorgan.

TWST: What was your performance like at Cross Ledge in 2013 compared to your peers, where I think the average hedge fund was up about 7.4% according to Bloomberg?

Ms. Wachs: We were up on a net basis 18% gross, closer to 20%. As you know, hedge funds encompass many different strategies, and we were fortunate last year in that equity funds were one of the better performing strategies due to the overall strength of the equity markets. We did outperform the average equity hedge fund as well last year, through a combination of strong stock selection and the benefit of structural areas that we're exposed to also performing well.

A hedge fund is there to keep you hedged and to not have you at 100% of exposure in a strong market, because otherwise you can just go out, do a long-only fund. So hedge fund managers are there to short things against their longs. And that in a strong upwardly biased market like we had last year — that eats into returns.

TWST: Can you share with us any current sectors or holdings, companies that you are negative on going into the second half?

Ms. Wachs: As I mentioned earlier, I really am focused on the consumer sector, but the housing sector seems to be challenged. I mean, it came through two very strong years. House price increases are up I believe 27% over the past nine quarters, and we certainly saw what happened with rates last year as they spiked up. There was still some follow-through and some strong turnover as people said, "Let me lock this in," but now people are very much in a wait-and-see. Rates have gone up quite a bit and prices have gone up quite a bit in a relatively short period of time. So that's a sector that we think will continue to have difficulty as it works its way through the balance of the year.

TWST: What type of investor is best served by Cross Ledge Long/Short?

Ms. Wachs: Generally speaking, it has to be somebody that has accumulated money and has experience in the market and has decided how they're going to allocate their different buckets. And we clearly would not be the most aggressive of buckets given our 40%-60% net exposure, but again, a lot of our clients are really happy that we participate quite a bit in the upside. But when markets get tough, they kind of check their balances and they are very relieved to see that when the market is having a really rough month, we are not down or to the extent that the market is. For instance last month, the Russell 2000 had a really rough month; it was down 4% and change, I believe, and we were actually up a bit for the month. So those are the kinds of things that keep investors happy.

TWST: Overall in your years of investment management experience, what would you say are the most valuable investment lessons you've learned?

Ms. Wachs: Most valuable lesson I would say to you is to remain constant. For example, if you meet with a company — and this is one of the reasons I love following small cap — you're finding them when they're pretty small, before the rest of the world hopefully has discovered them. And if you think they have an interesting, innovative product or service that has many, many years of growth ahead of it, it's really rewarding to be able to buy early and stick with it. And there are plenty of times that the market gets choppy and there are rumors out there and the stock is down 15%. I've been doing this a long time. If they really check every box in terms of what makes an outstanding long-term quality growth company, that's when I need to be increasing my bet.

TWST: To conclude, is there anything else you'd like investors to know about Cross Ledge Long/Short? Anything you'd like to add?

Ms. Wachs: I don't think so. We are a women-owned fund which for your average investor may not be that important; however, it is of increasing importance to municipalities and pension plans who have a mandate to invest a portion of their assets in women-owned funds, as well as with emerging managers. So we would hope that based on our long-term strong performance track record, where we have beat the hedge fund index by several hundred basis points on an annualized basis, that should open doors for us.

TWST: Thank you. (VSB)

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