

BARRON'S Alternatives Monthly

Hedge Funds, Alternative Mutual Funds, Private Equity, Commodities, Master Limited Partnerships, Real Estate Investment Trusts



STREET SMART

Andrew Sandler's hedge fund is unusual by today's standards. How he parlayed leverage and risk-aversion into double-digit gains in 2015.

SPECIAL REPORT

Andrew Sandler was a rare hedge fund winner in 2015. Here's how he keeps a handle on equity risk, while owning a big piece of Facebook.

Avoiding Trouble Spots

by **Eric Uhlfelder**

Photography by Laura Barisonzi

In 1987, when he was a student at the University of Wisconsin, Andrew Sandler started to invest in stocks. Not long afterward, he got clocked by the famous October market crash. A couple of years later, at his first job, Sandler was an equity analyst for hedge fund Perry Partners, which then focused on risk arbitrage. But in 1989, junk bonds imploded, tougher banking regulations kicked in, and many acquisitions unraveled, causing huge market losses. • “The lesson I took away from my early years in equities,” Sandler recalls, “is the importance of also keeping an eye on credit and macro conditions.” • Started by



Andrew Sandler

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his father; Harvey, in 1980, Sandler Capital Management is a long/short equity hedge fund firm that runs about \$880 million: the \$320 million flagship, Sandler Associates; the \$480 million Sandler Plus, a leveraged version of the original; and another \$80 million in credit-related, separately managed accounts.

The younger Sandler joined the firm as a stock analyst in 1991, and six years later assumed management of the Associates fund. Mindful of his early experience, he put his stamp on the fund, changing it from a mostly long tech, media, and telecom fund to a more diversified multisector vehicle that actively managed its risk exposure, mostly between 10% and 40% net long. The aim was to provide consistent performance with low volatility.

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Associates mostly delivered on its promises, but some of the fund's institutional clients wanted a more aggressive version. Sandler didn't want to change his investment strategy, so he boosted leverage for Sandler Plus, launched in October 2005. The newer version is more volatile because its long equity exposure—between 20% and 80% net long—is twice that of the flagship. But its returns have been stronger than Associates'. Both funds pay close attention to spreads in the credit and swaps markets, fund flows into and out of markets, and cyclical economic factors. Sandler's conservatism hasn't prevented him from owning growth companies like **Facebook** (ticker: FB).

Sandler, 49, embraces broad investment themes that guide his long and short ideas alike. Among the current ones are the collapse of energy prices, the value in innovative original-equipment manufacturers, and e-commerce's systemic threat to bricks-and-mortar retailers.

"Our 15-person team of analysts and traders have done well seeing the larger picture," explains Sandler. And this has been borne out by performance. From its launch more than 10 years ago through the end of 2015, Sandler Plus posted net annualized returns of 11.8%. That's 4.5 percentage points a year better than the Standard & Poor's 500 index and more than eight percentage points a year better than the HFRI Equity Hedge [Total] Index average return. Last year's return of 13.3% was particularly impressive in light of the many better-known hedge funds that failed to make money for clients.

Although it swings more than the flagship, Sandler Plus is far less volatile than the market. Its annualized standard deviation has been 10.4%, versus 14.9% for the S&P 500. And when the market's worst drawdown over the past decade has exceeded 50%, Sandler's was less than 15%.

The manager generally makes small wagers on 75 to 100 positions on both the long and short side. The extensive holdings help him control volatility. Sandler also doesn't hesitate to downshift equity exposure when he senses trouble.

In 2007, for example, high-yield spreads began to widen dramatically. So he slashed net long exposure from 95% in May 2007 to 13% as of June 2008. This helped him end 2008 down just 8.1%, while the S&P 500 collapsed 37% and the HFRI benchmark was off nearly 27%. The small loss also

helped preserve Sandler's 55% gains from 2007.

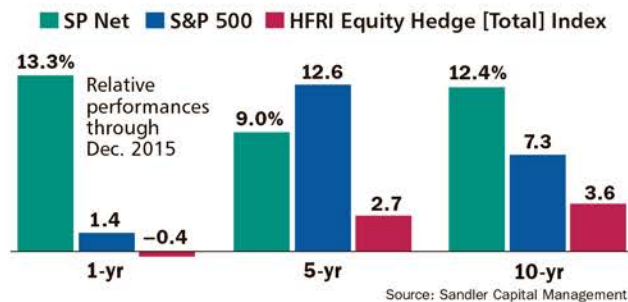
When the European sovereign-debt and banking crises turned critical during the summer of 2011, Sandler needed just a month to dial back a 70% net long exposure to a 5% net long position.

The fund's relative performance turned on the third quarter, when the market fell 13.9% and Sandler was flat. This helped sustain the fund's 2011 gain of more than 9%, built on short selling of industrials such as **Caterpillar** (CAT), paper maker **Resolute Forest Products** (RFP), and European banks including **Banco Santander** (SAN.Spain). By year's end, the market had eked out just a 2.1% gain, while the average hedged equity manager lost more than 8%.

Sandler entered 2015 bullish, or about 80% net long during the first half of the year. But he grew increasingly concerned as credit spreads widened, equity mutual fund net outflows increased, and the industrial economy continued to slow. By mid-August, he ratcheted back net exposure to 10%, where he largely remained for the rest of the year, which paid off.

What? A 2015 Hedge Fund Success

The Sandler Plus fund (SP, below) delivered a total return of 13.3%, net of fees, last year, easily topping the performance of both the Standard & Poor's 500 and similar hedge funds. The years 2012 and 2013 were not as good, but over 10 years the fund has excelled.



It isn't a flawless system. Sandler concedes he has had a hard time gauging the effects of central banks' quantitative easing. Distorted credit markets and cheap money have sustained weak businesses whose shares the firm thought would fall. This contributed to the fund's significantly underperforming the market in 2012 and 2013. The fund cumulatively gained nearly 17% over this period, while the S&P 500 soared nearly 50%.

As deft as Sandler's handling of net equity exposure has been, consistent returns ultimately depend on good stock-picking.

In late 2013, Sandler was seeing a number of energy exploration-and-production companies primed for a selloff. Houston-based **Linn Energy** (LINE) was "masquerading as a master limited partnership, paying nearly a 10% dividend based on unsteady revenue flows while bleeding cash every quarter," recalls Sandler. That year, says Sandler, the company funded its entire dividend payout with debt. "This was being done," he explains, "to drive the stock price so it could

be used to finance acquisitions." By late 2014, energy prices had begun to fall, further straining Linn.

The manager started buying puts during the second half of 2013, and then shorted the common in 2014 at an average price of \$28.60. The position peaked at 2% of the fund's net asset value. The fund covered its position by the end of 2014 at an average price of \$19.75. Sandler again shorted a smaller position, this past summer, at \$6.50. The stock dropped by a third in a month. The fund quickly covered this position, which boosted Sandler's total return by 1.23 percentage points.

The fund also shorted **Gap** (GPS) and other mall retailers, believing that e-commerce would eat bricks-and-mortar retailers' lunch. Gap was particularly vulnerable because it was also losing market share to "fast fashion" chains Zara, **Hennes & Mauritz** (HMB.Sweden), and Forever 21. These factors have weighed on Gap's adjusted operating margins and profits, which have been falling since 2013.

Sandler started shorting shares in September 2014 and established a nearly 2% position at prices between \$43 and \$39. He completed covering his short at the end of 2015 at \$27, which in total added 0.33 percentage point to returns.

Facebook has become the fund's largest position, at 6% of net asset value. "This is a multifaceted story," explains Sandler. "It's about the Internet and the most dominant social networks. But financially, it's about pulling advertising dollars away from traditional media to the Web, where potential customers can be more effectively targeted." Sandler believes that few companies are doing this as well as Facebook is. That gives the company a wide defensive moat that's fairly well insulated from macro and credit issues.

The fund has held a significant long position in Facebook since mid-2014, ranging between 4% and 8% of its book. Its present average cost is in the high \$70s. Facebook almost touched Sandler's target price of \$110 in November. So far, the investment has cumulatively added 2.45 percentage points to the fund's returns.

Not so successful has been a stake in **Gentherm** (THRM), the Michigan-based manufacturer of popular climate-control automotive seats. In North America alone, market penetration of these seats has doubled over the past two years to 8%, and worldwide, Gentherm's market share has grown to 75%. Sandler moved into the company between April and May 2015 at an average cost of \$53. The position peaked at 2.5% of its portfolio as Sandler saw further upside in the technology's application to engines, batteries, and even mattresses, and he thought \$60 was in easy reach.

But rapid deterioration of emerging market sales—especially in China, exacerbated by falling foreign-exchange rates—led management to halve its original 2015 revenue guidance of 10% to 15% growth. By October, the fund was out of the shares at an average price of \$45, which cost it about half a percentage point of return.

Sandler says volatility will continue through much of 2016. With margins high and little pricing power, companies will find it tough to sustain profit growth. As a result, he wouldn't be surprised if his portfolio remains market-neutral for long stretches. But the manager expects to find opportunities even in gloomy environments, a challenge he has met in the past. ■