Sabrient *Baker's Dozen* – April 2019 Commentary (as of 4/18/2019)
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Investors could be forgiven for thinking the powerful rally from Christmas Eve through February was nothing more than a proverbial "dead cat bounce," given all the negative news about a global economic slowdown, the still-unresolved trade war with China, an ugly Brexit, forecasts of a US corporate earnings recession in Q1 and Q2, and the Fed's sudden dovish about-face on rate hikes. But instead, stocks have resumed their upward march and appear to be ready to take another run at all-time highs. Nevertheless, I think investors are likely to become more selective as the year progresses, with some stocks doing quite well even if the broad market indexes show only modest growth this year.

Overall, the US still enjoys low unemployment, rising wages, and strong consumer sentiment, as well as a supportive Fed ("Don't fight the Fed!") keeping rates "lower for longer" (and by extension, debt servicing expenses and discount rates for equity valuation) and maintaining $1.5 trillion in excess reserves in the financial system. Likewise, the ECB extended its pledge to keep rates at record lows, and China has returned to fiscal and monetary stimulus to revive its flagging growth stemming from the trade war. Meanwhile, Corporate America has been quietly posting record levels of dividends and share buybacks, as well as boosting capital spending plans – and I think capex will accelerate once a trade deal with China is signed (which just became more likely with the benign findings of the Mueller investigation, as China now knows who the US President will be for at least the next 20 months). In addition, the bellwether semiconductor industry is presenting a more upbeat tone and an upturn from a cyclical bottom, while crude oil has broken out above overhead resistance at $60, boosting the Energy sector.

On the other hand, there is understandable concern about US corporate earnings forecasts being revised downward to flat or negative for the first half of 2019. Of course, it would be far preferable to see a continuation of the solid earnings growth and profitability of last year. But the good news is that revenue growth is projected to remain solid (at least 4.5% for all quarters), and then earnings are expected to return to a growth track in 2H2019. Moreover, upside surprises are more likely given the low bar that has been set, and the concurrent reduction in the discount rate (due to lower interest rates) supports higher forward valuation multiples in stocks. And although the yield curve indeed inverted briefly, it wasn't caused by *rising* inflation that the Fed had to stomp out. Instead, it was caused by falling rates at the long end of the curve due to *low* inflation, low (or negative) yields abroad, dovish moves in monetary policy by global central banks, and elevated political risks, so I'm not worried about it.

No doubt, market distortions over the past several years due to things like central bank monetary policies, trade wars, algorithmic trading, and massive capital flows into passive indexes rather than active selection, not to mention fear-based or headline-driven trading, can lead individual investors to lose confidence in the rational behavior of markets. But history suggests that although valuations can become disconnected from fundamentals for stretches of time (whether too exuberant or too pessimistic), share prices *eventually* do reflect fundamentals.

And despite periods of fear-driven market behavior, like 2H2015 (China weakness and currency devaluation leading to narrow "FANG" or nothing) and 2H2018 (trade wars and Fed "autopilot" rate hikes leading to unwarranted risk-off defensive rotation), we at Sabrient continue to stick to our belief that active selection based on a disciplined growth-at-a-reasonable-price (GARP) investing approach is timeless and tends to outperform passive market benchmarks over time. Nevertheless, history has shown that investors tend to throw in the towel at precisely the wrong time. The V-bottom recovery following the Christmas Eve selloff is a great case in point. The S&P 500 started 2018 at a forward P/E of around 18.5x, a *speculative* valuation based on the passage of the tax reform bill but finished the year all the way down at 14.5x, a *defensive* valuation based on trade wars and a hawkish Fed that seemed more reflective of imminent global recession and Treasury yields of 5%. And risk-on cyclical sectors fared even worse, with a sector like Steel (represented by SLX) falling from a forward P/E of 14.2x down to only 6.4x at year-end (a 55% fall!). But those investors who engaged in panic-selling and didn't reenter right away missed out as stocks have repriced higher to better align with the positive fundamental outlook. Indeed, the forward P/E for SLX has risen 30% to 8.3x, and many of Sabrient's portfolios have significantly outperformed since Christmas Eve.

Let me reiterate Sabrient's <u>key talking points</u> with respect to our selection process, the impact of 2H2018 market conditions on performance, and our market outlook:

1. Sabrient employs a **disciplined, model-driven, bottom-up, GARP (growth at a reasonable price) selection process** that includes a forensic accounting review (by our wholly-owned subsidiary Gradient Analytics). Our approach historically has tended to *outperform when investors are fundamentals-driven*, rather than headline-driven (which is typically transitory behavior). And over time, stock valuations eventually do reflect fundamentals.

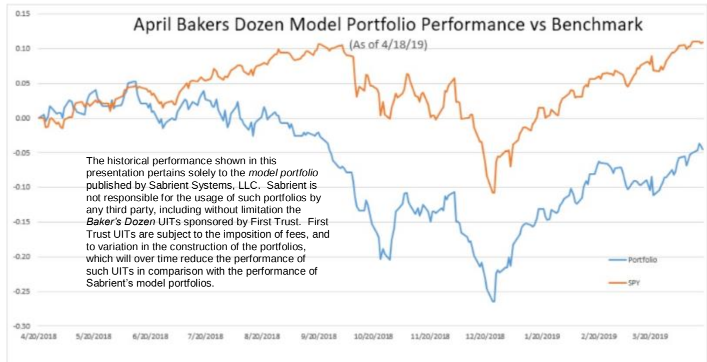
2. On 6/11/2018, the trade war with China escalated, and when combined with increasingly hawkish Federal Reserve comments, the market embarked upon a **fear-based risk-off rotation into defensive sectors** (like Healthcare, Utilities, Consumer Staples, and Telecom) and mega-caps (including AAPL, AMZN, MSFT – the three largest holdings in the S&P 500), despite little change in the positive economic outlook.

3. Much of our **underperformance occurred during the timeframe 6/11/18–9/20/18 as the market starkly bifurcated**, with the S&P 500 large-cap index continuing to rise thanks to defensive sectors and mega-caps while risk-on cyclical sectors and small-mid caps fell. This was not healthy behavior, and rather than a rotation back into the risk-on sectors, the broad market sold off, led by mega-caps AMZN and AAPL. In my view, investors essentially were pricing in a global recession and 5% 10-year Treasury yields.

4. But the reality is that the economic outlook and corporate forward guidance was still good and interest rates remained low. So, as a result of the selloff, **forward valuations were much more attractive going into 2019**, setting up a terrific buying opportunity – particularly among the small-mid caps and cyclical sectors that typically thrive in a growing economy, as well as in strong dividend payers given the lower interest rates in fixed income.

5. Indeed, the market has been strong since the Christmas Eve “capitulation day,” including **strong recovery in the cyclical sectors and small-mid caps that predominate our Baker’s Dozen portfolios**.

6. Investors should keep in mind that our disappointing 2H2018 performance actually was **the fourth notable news-driven drawdown in our 10-year history of overall strong performance**. The others were in 1Q2009, mid-2011, and 2H2015. Selling out of the portfolio after each of the three previous instances would have been the wrong thing to do, as strong recoveries ensued.



Typically, holding small-mid caps and cyclicals displaying strong growth forecasts, solid earnings quality, and attractive forward valuations is a profitable approach when the economy is growing and interest rates are low, but it didn’t work very well in 2H2018. For example, the **April 2018 *Baker’s Dozen* portfolio** initially performed in line with the benchmark, but the defensive rotation and market bifurcation during the 6/11/18-9/20/18 period was particularly painful, as illustrated in the accompanying chart.

However, before dismissing these stocks as “bad picks,” let’s look at how their fundamental expectations actually played out. The accompanying table illustrates the improved forward valuations and actual earnings growth achieved versus the projections upon launch. Although some fell short, others handily beat expectations. Overall, the aggregate forward P/E of the portfolio *fell* -12%, but top performer POST (which is up better than +40%) was the notable exception as its forward P/E *increased* by 27% even though it was one that *fell short* of projected EPS by 25%. It benefited from being in the defensive Consumer Staples sector, rising 21% during that 6/11/18-9/20/18 timeframe. Other top performers include oil & gas firm COG, which has benefited from rising energy prices; USFD, which is another from the Consumer Staples sector; and homebuilder PHM. Homebuilders in general struggled last year (after strong performance in 2017) as rising interest rates and higher material prices made investors cautious, but we saw no demand problem with housing, only a lack of affordable supply, which seems to be correcting as mortgage rates retreat while wages rise, millennials come into the market, and single-family home sales surge.

Ticker	Company Name	Original Fwd P/E at Launch	Current Fwd P/E	Est. NTM EPS Growth at Launch	Actual EPS Growth
BLDR	Builders FirstSource, Inc.	11.0	8.4	41.0%	50.4%
CMC	Commercial Metals Compa	11.5	7.4	89.3%	55.2%
COG	Cabot Oil & Gas Corporatio	21.3	13.3	112.5%	128.3%
CVX	Chevron Corporation	19.1	17.2	74.8%	117.5%
EXTR	Extreme Networks, Inc.	10.1	13.9	88.5%	0.0%
NGHC	National General Holdings	11.1	9.1	120.2%	108.9%
OLN	Olin Corporation	14.8	13.0	121.6%	101.4%
PATK	Patrick Industries, Inc.	13.0	11.6	45.1%	59.8%
PHM	PulteGroup, Inc.	9.6	9.6	39.5%	61.4%
POST	Post Holdings, Inc.	16.8	21.4	62.5%	46.6%
RYAM	Rayonier Advanced Materi	11.6	11.7	104.5%	81.9%
TEX	Terex Corporation	16.0	8.8	81.6%	95.7%
USFD	US Foods Holding Corp.	16.8	16.3	49.4%	47.1%
	Average	**14.1**	**12.4**	**79.3%**	**73.4%**

The worst performers are EXTR, RYAM, and BLDR. EXTR primarily suffered from difficulties and delays in assimilating the data center business from its acquisition of Brocade. RYAM and BLDR both were dragged down by the rotation out of Materials and Industrial sectors last year. BLDR supplies building materials to US homebuilders, while RYAM sells specialty chemicals worldwide. These and the other Industrial/Materials names in the portfolio that have lagged (notably TEX, CMC, and OLN) may well see a boost in guidance once the trade wars are behind us. Overall, the aggregate forward valuation of the portfolio is even more attractive today, with some of the holdings now displaying a single-digit forward P/E even after the bullish recovery since Christmas Eve. Our model-driven approach simply seeks quality companies with strong growth expectations selling at a reasonable price, but it can’t predict irrational investor behavior. Some of the names continue to display sufficiently attractive forward GARP properties to make them eligible for new portfolios, and in fact this portfolio has outperformed its benchmark by over 5% on a gross performance basis since the market recovery began: +29.8% vs +24.4% for SPY during the 12/24/18–4/18/19 timeframe.

In closing, with the Fed on the sidelines (and other central banks back in dovish mode), I think that once a trade deal with China is consummated we may see US companies further ramp up capital spending plans and restate guidance higher, thus enticing risk capital back into stocks – particularly high-quality dividend payers (among yield-seeking investors) and companies from cyclical sectors that typically thrive in a growing economy (among growth-focused investors). This bodes well not only for our *Baker’s Dozen* portfolios, but also for our other growth and dividend-oriented portfolios, like Sabrient Dividend and Dividend Opportunity, each of which comprises 50 GARP stocks paying an aggregate yield in excess of 4% in what is essentially a growth-and-income strategy.