Sabrient – March 2019 *Baker's Dozen* Commentary (as of 3/1/2019)
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The first two months of 2019 have treated Sabrient's portfolios quite well. After a dismal 2H2018, in which our cyclicals-heavy portfolios trailed the broad market amid a fear-driven defensive rotation that began in mid-June, culminating in the Christmas Eve "capitulation day," the market reversed into a V-bottom recovery led by the forsaken small-mid caps and cyclical sectors. All of our 12 monthly all-cap *Baker's Dozen* portfolios from 2018 have handily outperformed the S&P 500 benchmark since then, as fundamentals seem to matter once again to investors. Indeed, although valuations can become disconnected from fundamentals for a given stretch of time (whether too exuberant or too pessimistic), share prices *eventually* do reflect fundamentals – and my observation has been that Sabrient's growth-at-a-reasonable-price (GARP) portfolios tend to outperform their benchmark *when fundamentals matter to investors*. Indeed, it appears that institutional fund managers and corporate insiders alike have been scooping up shares of attractive-but-neglected companies from cyclical sectors and small-mid caps in what they evidently saw as a buying opportunity.

And why wouldn't they? It seems clear that 4Q2018 was unnecessarily weak, with the ugliest December since the Great Depression, selling off to valuations that seem more reflective of an imminent global recession and Treasury yields of 5%. But when you combine earnings beats and stable forward guidance with price declines – and supported by a de-escalation in the trade war with China and a more "patient and flexible" Federal Reserve – it appears that the worst might be behind us, as investors recognize the opportunity before them and pay less attention to the provocative news headlines and fearmongering commentators. Moreover, I expect to see a renewed appreciation for the art of active selection (rather than passive pure-beta vehicles). However, we must remain cognizant of 2018's lesson that volatility is not dead, so let's not be alarmed if and when we encounter bouts of it over the course of the year.

As we enter March, here is a summary of Sabrient's key talking points with respect to our selection process, the impact of 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 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.

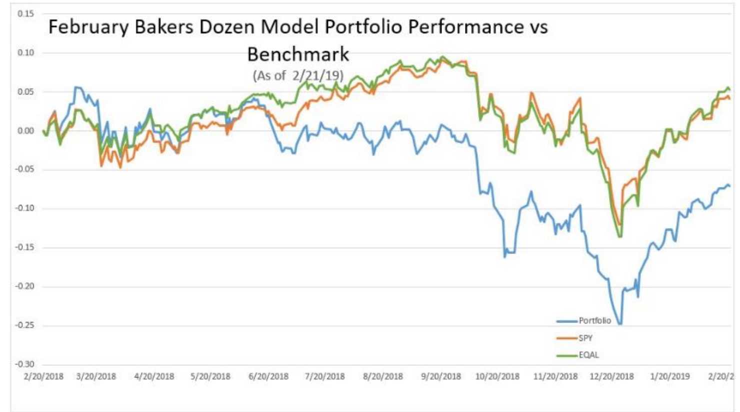
3. Most of **our underperformance occurred during the timeframe 6/11–9/20 as the market starkly bifurcated**, with the S&P 500 large-cap index continuing to rise on the backs of defensive sectors and mega-caps while risk-on cyclical sectors and small-mid caps fell. But this was not healthy behavior, and ultimately, a rotation back into the risk-on sectors didn't happen, and instead the broad market sold off, led to the downside by mega-caps AMZN and AAPL. In my view, investors essentially were pricing in a global recession and 5% Treasury yields.

4. But the reality is that the economic outlook and corporate forward guidance remained stable, or in many cases *improved*, while interest rates remained low. So, as a result of the selloff, **forward stock 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. For example, a cyclical industry like Steel (using an ETF proxy like SLX) started 2018 at a 14.2 forward P/E, but by the start of 2019 it had fallen to a meager 6.4.

5. Indeed, the market has been strong since the Christmas Eve "capitulation day," led by cyclicals and small-mid caps, and in fact **all 12 of our 2018 Baker's Dozen monthly portfolios have handily outperformed** the benchmark on a gross performance basis ever since—averaging +27.0% vs +18.8% for SPY from 12/24/18 thru 2/20/19 when the Jan portfolio terminated, and the 11 Feb-Dec portfolios averaged +26.1% vs +18.9% for SPY during 12/24/18–2/28/19.

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 the portfolio rebounded strongly each time, and early results following this most recent drawdown suggest the same might hold true again.

Holding small-mid caps and cyclicals displaying strong growth forecasts, solid earnings quality, and attractive forward valuations is *normally* the profitable thing to do when the economy is growing and interest rates are low, but it didn't work very well in 2H2018. For example, the **February 2018 *Baker's Dozen* model portfolio** initially tracked the market as it struggled to find footing after the February market correction, but the defensive rotation in June was painful. As the chart shows, most of the underperformance versus the S&P 500 benchmark occurred during the 6/11-9/20 period of bifurcation due to its tilt toward cyclical sectors and small-mid caps.



However, before dismissing our selections as "bad picks," let's look at how their fundamental expectations actually played out. Indeed, the accompanying table illustrates the improved forward valuations when we compare the original EPS forward estimates with actual reported EPS numbers. Overall, **the aggregate earnings growth of the portfolio came in nearly +20% *better* than expected while the forward P/E *fell* -20%.** That's not the way it's supposed to work when your stocks produce even better earnings than expected. As a result, the forward valuations are much more attractive today, with some of the holdings now displaying single-digit forward P/Es, even after the bullish recovery of the past two months. Our model-driven approach simply seeks strong growth at a reasonable price, but we can't predict illogical investor preferences.

Ticker	Company Name	Original Fwd P/E at Launch	Current Fwd P/E	Est. NTM EPS Growth at Launch	Actual EPS Growth
CMA	Comerica	15.0	10.5	38.4%	53.6%
COG	Cabot Oil & Gas	29.8	13.4	95.6%	92.7%
CVX	Chevron	16.7	18.2	81.2%	117.5%
FMC	FMC Corp	15.2	15.7	87.8%	115.4%
LUV	Southwest Airlines	11.6	10.5	43.0%	21.7%
ON	ON Semiconductor	9.6	12.2	48.0%	67.0%
PHM	PulteGroup	12.5	8.7	38.8%	61.4%
STLD	Steel Dynamics	16.8	9.0	49.0%	107.2%
STM	STMicroelectronics N.V.	13.0	14.9	42.4%	54.1%
TMUS	T-Mobile US	16.7	18.8	63.1%	53.6%
TRV	The Travelers Companies	13.1	12.0	48.5%	23.0%
URI	United Rentals	11.3	7.0	40.5%	54.0%
XPO	XPO Logistics	27.3	13.9	72.6%	64.9%
	Average	**16.0**	**12.7**	**57.6%**	**68.2%**

The worst performers are two names that have appeared in several monthly *Baker's Dozen* portfolios, namely XPO and STM, but both remain attractive as longer-term investments, according to our model. XPO had a hiccup with one of its main customers (likely Amazon) but is still growing well. STM focuses on cutting-edge technologies, like 3D and infrared sensors and application-specific chips for smartphones, AI, robotics, and autonomous vehicles. Homebuilders like PHM languished as interest rates and higher material prices have made investors cautious, but we see no demand issue with housing, only an affordable supply issue, which should correct itself. STLD and URI both sold off with the Industrial and Materials sectors, even though they greatly exceeded EPS estimates. The top performer is TMUS. Even though it fell short of estimates, *it still benefited from being in the defensive Telecom sector*. Several of the names continue to display sufficiently attractive forward GARP properties to make them eligible for new portfolios. Unless guidance suddenly weakens significantly, we expect these stocks to continue to recover, as valuations are more reflective of a recessionary economy and much higher interest rates.

Looking ahead, economic conditions appear favorable for stocks, with low unemployment, rising wages, strong consumer sentiment, and solid GDP growth. Moreover, Q4 corporate earnings are still strong overall, with rising dividends, share buybacks at record levels, and rejuvenated capital investment. So, with the Fed on the sidelines and China desperately needing an end to the trade war, I would expect that any positive announcement in the trade negotiations will recharge the economy in supply-side fashion, as US companies further ramp up capital spending and restate guidance higher, enticing risk capital back into stocks (but again, not without bouts of volatility). This should then encourage investors to redouble their current risk-on rotation into high-quality stocks from cyclical sectors and small-mid caps that typically flourish in a growing economy – which bodes well not only for our *Baker's Dozen* portfolios, but also for others of our GARP portfolios, including Rising Rate, Small Cap Growth, Defensive Equity, and Sabrient Dividend (which comprises 50 GARP stocks paying an aggregate yield in excess of 4% in what is essentially a growth-and-income strategy).

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