# Sabrient Commentary – April 2020 (as of 3/31/2020)

**Scott Martindale, President & CEO, Sabrient Systems, LLC**

This month's commentary discusses these topics:

1. **A "new normal" of unpredictable market conditions:** After 6-1/2 years (2009-1H2015) in which the *Baker's Dozen* portfolios consistently outperformed, mid-2015 marked the beginning of a "new normal" of persistent periods of irrational/unwarranted defensive sentiment despite consensus expectations of continued growth, especially during the 18 months (March 2018 through August 2019) of the China trade war that led to a historic valuation divergence of large-cap/low-volatility/defensives over small-cap/value/cyclicals. This has been unfavorable for Sabrient portfolios and most broad-market equal-weight indexes.
2. **COVID-19 hits a highly-valued stock market in a highly-leveraged economy:** The building valuation *divergence* finally gave way to a nearly 4-month risk-on *convergence* starting in August 2019 that boosted Sabrient portfolios, but the emergence of COVID-19 turned investor sentiment defensive once again. And given elevated P/E ratios, the market was ripe for a correction, which triggered when the virus turned into a pandemic, exacerbated by the oil price collapse, a lack of market liquidity in a leveraged global economy, and the predominance of algorithmic trading. This turn of events further hurt Sabrient portfolios.
3. **New process enhancements:** In response to the "new normal" market conditions, Sabrient has developed and introduced two new process enhancements to our strategy for new portfolios going forward: 1) new limits on extreme sector "tilts" versus the benchmark's allocations to reduce relative volatility, and 2) our new proprietary *Growth Quality Rank* as an alpha factor in the quant model to provide better *all-weather* performance with *minimal reduction to upside potential* by scoring the *consistency and predictability* of a company's earnings. It also puts *secular* growth companies on more equal footing for consideration.
4. **Review of terminating March 2019 and April 2019 *Baker's Dozen* portfolios:** Relative to the benchmark, both portfolios launched with equal weights (vs. market cap weights) on all positions, and overweight allocations to small/mid-caps, cyclical sectors, and the value factor. *Each of these four tilts (position weightings, cap sizes, sectors, and growth/value) hurt the relative performance versus the market-cap-weighted benchmark, which is dominated by mega-caps, the Technology sector, and the growth factor,* giving the benchmark a big advantage over Sabrient's portfolios and most broad-market equal-weight indexes.

**Market Observations:**

The COVID-19 pandemic has become a *generational event* – and the very definition of the proverbial Black Swan we all dread – bringing the global economy to its knees, at least temporarily. As a result, Q1 closed with a rare and dreaded trifecta of three down months. It was the worst Q1 performance since 1987. Moreover, from its intraday all-time high on 2/19/20 to the intraday low on 3/23/20 (i.e., less than one month), the S&P 500 fell an incredible -35.3%, wiping out over $10 trillion in market cap and the entire "Trump Bump" market rally since 11/8/2016 in the blink of an eye. Moreover, asset classes were highly correlated, leaving no place to hide other than US Treasuries or cash (thus strengthening the US dollar). Even gold and cryptocurrencies largely failed to serve as the safe havens from financial distress they are intended to be, at least initially, as traders liquidated everything into cold hard cash. Indeed, money market funds have surged about $4 trillion for the first time ever.

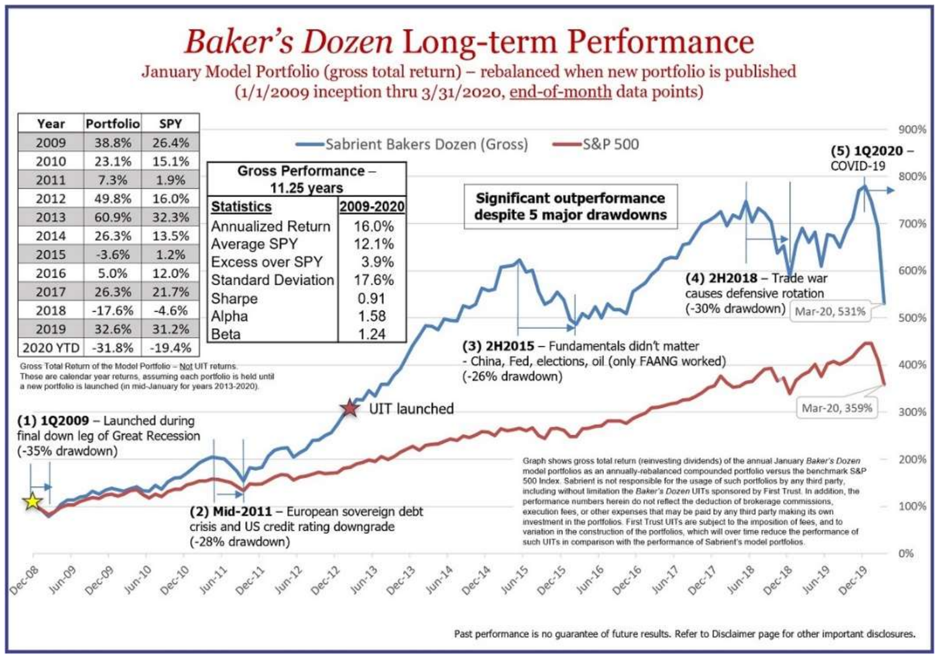
It is worth noting that although the historic market selloff was triggered by the pandemic, it was exacerbated by a few other factors, including extremely overbought technical conditions and lofty valuations, the oil price collapse, and the predominance of algorithmic traders (who now control the bulk of daily trading volume and are only too happy to exaggerate market moves). Indeed, stock valuations had become quite elevated well before the pandemic hit, with the S&P 500 reaching a forward P/E of 19x. As of 3/31/20, the forward P/E fell to 16.2x, although it may well fall further as the analyst community continues to cut forward estimates.


After sustained (and long-overdue) *risk-on rotation* into the value factor, small-mid caps, and cyclical sectors starting on 8/27/19, which boosted the relative performance of Sabrient's portfolios, investor sentiment again turned cautious in the New Year (perhaps due to news of an emerging epidemic in China), even as the market continued to hit new highs. It was the same defensive sentiment that dominated for most of the March 2018 – August 2019 timeframe, driven mostly by the escalating China trade war.

Let's take a closer look (**see chart to the left**) at the timeframe covering the March 2019 *Baker's Dozen* portfolio, which launched on 3/20/19. The portfolio's default benchmark, **the**

**cap-weighted S&P 500 (SPY), -7%, which is dominated by a handful of mega-cap Tech juggernauts, handily beat most of its broad-market equal-weighted brethren,** including the S&P 500 Equal-Weight (RSP), -17%, Russell 1000 Equal-Weight (EQAL), -23%, S&P 400 Mid-Cap Equal-Weight (EWMC), -28%, and S&P 600 Small Cap Equal-weight (EWSC), -34%, through 3/31/20. And even during the waterfall selloff since the market peak on 2/19/20, the outperformance continued. [Note: one exception is the NASDAQ 100 Equal Weight (QQEW), not shown, which slightly outperformed SPY over the period. But QQEW is 40% Tech sector! (SPY is 25%.)]

This illustrates how difficult it has been for any cap-diversified equal-weight portfolio, or in fact most active strategies, to keep up with the narrow leadership of the S&P 500. In fact, S&P Dow Jones Indices (SPDJI) reported for 2019 that 71% of active large-cap equity funds under-performed the S&P 500 Index for the 10th consecutive one-year period, while 97% of US large-cap value funds trailed the S&P 500 Value Index. Moreover, SPDJI reported that the value factor and small-mid caps have lagged the growth and momentum factors and large caps throughout. Thus, the historic performance *divergence* of large caps and low-volatility/defensives over small caps and value/cyclicals keeps widening, despite the almost 4 months of *convergence* from 8/27/19 through year-end.




Although Sabrient doesn't employ a value strategy per se – which is why we were able to outperform the benchmark for most of the past 10 years, as shown in the **chart to the right** – our *Growth at a Reasonable Price* (GARP) approach tends to reflect a value bent, which became the proverbial "albatross around the neck" of many of our portfolios during this anomalous time.

**Sabrient introduces process enhancements:**

Over the past few years, Sabrient's long-standing model has favored cyclicals (e.g., Materials, Energy, Industrials, and Financial sectors, plus industries like homebuilding, semiconductors, transports), which tend to display strong earnings growth in a growing economy, as well as small and mid-caps, as secular-growth Technology companies and large caps in general were largely "bid up" to high valuations. Such tilts represent areas in which an investor historically would want to be positioned in a growing economy – and especially today for a convergence of the relative-valuation bubble. But it appears that perhaps a "new normal" has set in.

After 6-1/2 years (2009-1H2015) in which the *Baker's Dozen* portfolios consistently outperformed, *temporary* periods would arise in which investor sentiment became misaligned with the consensus fundamental outlook of the sell-side analyst community; it was just normal market behavior. So, we chose to stay true to our disciplined investment process and ride out those fleeting periods of misalignment. However, in retrospect, mid-2015 marked the beginning of a "new normal" of persistent (and often painful) periods of irrational/unwarranted defensive sentiment, and especially during the 18 months (March 2018 thru August 2019) of trade war.

Thus, it became evident to us that the market can no longer be trusted to quickly revert to "rational" behavior, i.e., alignment among investor sentiment, corporate capital spending, and sell-side analyst consensus outlook on fundamentals and earnings. Instead, investors have become capable of displaying persistently irrational behavior unlike anything we had seen or tested on our quantitative model in the past (i.e., ever since the Internet Bubble burst in 2000).

So, Sabrient has implemented two enhancements to its longstanding "Growth at a Reasonable Price" (GARP) portfolio selection approach that seek to address the "new normal" of investor penchant for defensive sectors and *secular* growth. The enhancements *aim to preserve the market-beating potential* investors expect from Sabrient while improving all-weather performance and reducing relative volatility versus the benchmark. The enhancements include new limits on extreme sector "tilts" versus the benchmark's allocations, as well as the addition of a new proprietary *Growth Quality Rank* as an alpha factor in the quant model. GQR measures the *consistency and predictability* of a company's earnings and thus its likelihood of meeting estimates, therefore allowing for more in the way of *secular* growth companies.

**Comments on the terminating March 2019 and April 2019 *Baker's Dozen* portfolios:**

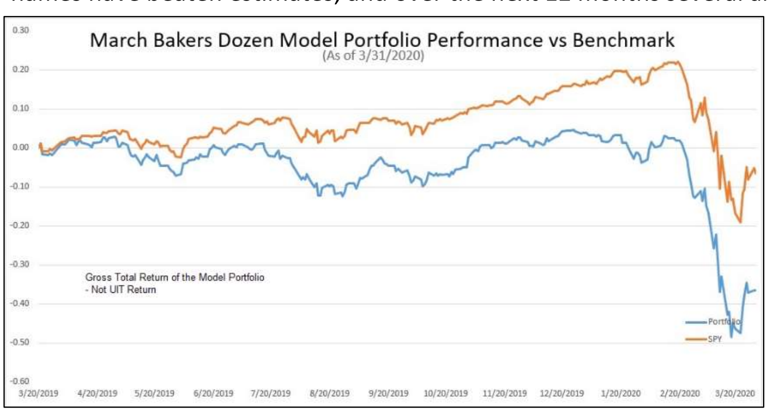
The GARP strategy employed to select the stocks for the Sabrient *Baker's Dozen* portfolio is *forward-looking* in that it relies upon the consensus EPS growth estimates of the sell-side analyst community. It has been favoring the value factor, small and mid-caps, and cyclical sectors (which historically tend to outperform in a growing economy), as the model has indicated that the growth factor, large caps, non-cyclicals, and secular growth technology were already "bid up" to relatively high valuations.

Nevertheless, an investor penchant for those highly-valued market segments has persisted, especially during that challenging 18-month period (March 2018 – August 2019) of trade war overhang, and Sabrient's portfolios that were live during that timeframe indeed absorbed some pain. Of course, with a concentrated 13-stock portfolio, some portfolios will enjoy a few breakout winners that can overcome a number of laggards, but the March 2019 and April 2019 portfolios have lagged the benchmark S&P 500 due to both a lack of breakout stars and an investor preference for mega-caps and defensive sectors. Moreover, there was narrow market leadership during most of the subject timeframe, primarily from mega-cap Tech and "bond proxy" defensive dividend payers, creating a *relative-valuation bubble* that history suggests is unlikely to persist. Notably, the five famed mega-cap FAAAM stocks (Facebook, Apple, Amazon, Alphabet, Microsoft), which are the largest holdings in the S&P 500, were among the top performers by contribution in the benchmark over the subject timeframe.

Relative to the benchmark S&P 500, the portfolios launched with equal weights (vs. market cap weights) on all positions, an overweight allocation to small and mid-caps, an overweight allocation to the highly cyclical industrials, energy, and materials sectors, and an overweight in travel/entertainment industries (which saw outsized impact from the Coronavirus pandemic). In addition, although Sabrient believes all of its stock selections have solid growth outlooks, our GARP (growth at a reasonable price) approach generally creates portfolios with a value tilt, but the growth factor significantly outperformed the value factor over the life of the trust. ***Each of these four tilts (position weightings, sectors, cap sizes, and growth/value) hurt the trusts' relative performance versus the market-cap-weighted S&P 500 index, which is dominated by mega-caps, the Technology sector, and the growth factor***, giving the index a big advantage over Sabrient portfolios and *all major market equal-weight indexes* during this timeframe.

Although these tilts represent areas in which an investor typically would want to be positioned in a growing economy (which is expected to resume once COVID-19 has run its course) and ahead of a convergence of the relative-valuation bubble, our enhanced model should help accommodate the desirability of the neglected market segments while mitigating the downside if such investor preferences persist. For example, the S&P 500 has a 2.7% allocation to the Materials sector and 4.5% to Energy, so we will not allow those sectors to reach the 30% maximum previously permitted (so, instead of a maximum of 4 out of 13 stocks from one of those sectors, we might only allow up to 2, or 15%). Moreover, the addition of our new Growth Quality Rank (GQR) helps put secular growth names (that have displayed consistent and reliable earnings growth but higher forward valuations) on more equal footing with the cyclical growth names (that typically display more attractive forward valuations but greater volatility in sales and earnings).

The **March 2019 *Baker's Dozen*** model portfolio launched in the midst of the protracted period (March 2018 – August 2019) of trade war uncertainty and investor defensive sentiment. In aggregate, the portfolio has fallen short of expected earnings, but several names have beaten estimates, and over the next 12 months several are still expected to grow EPS significantly (in spite of COVID-19 disruptions). Like most of our monthly *Baker's Dozen* portfolios, it was challenged by persistent defensive turns in sentiment (like in April and August). But unlike some of the other portfolios, it never got much traction during the risk-on phases due to a lack of breakout winners among its holdings – although **during the 8/27/19-12/31/19 period of sustained risk-on sentiment it showed a total return of +16.4% versus the S&P 500 benchmark total return of +13.4%**. And after the historic selloff, only 5G infrastructure company **Zayo Group (ZAYO)** is still in the green due to being acquired and taken private at $35/share, which locked in its performance in the portfolio at +25.4% (and protected it from the selloff).




The portfolio launched with a 46% allocation (vs. 17% allocation in the benchmark) to attractively valued "deep cyclical" sectors – Industrial (30.8% vs. 9.3%), Energy (0.0% vs. 4.6%), and Materials (15.4% vs. 2.7%) – which hurt relative performance over the period. Furthermore, it had a significant allocation (23.1%) in airlines, hotel, and gaming industries that have seen outsized impact from the Coronavirus pandemic. The portfolio was underweight (15.4%) the Technology sector (versus about 25% in the benchmark). Moreover, it had a 77% allocation to small-mid caps (vs. the S&P 500 benchmark being solely a large cap index), while large caps have greatly outperformed small-mid caps during the life of the portfolio. In addition, although we consider all our stocks selections to have solid growth outlooks, our GARP portfolios typically have a Value tilt by First Trust's definition (primarily based on price/book), and indeed the portfolio carried only a 15.4% allocation to the Growth factor (vs. the benchmark's 59%, which is typical of a cap-weighted index), but the market's Growth factor greatly outperformed the Value factor. Also, the cap-weighted S&P 500 has greatly outperformed the equal-weight S&P 500 (and all other major market equal-weight indexes) over the full timeframe, again illustrating the dominance of mega-cap Technology on market performance.

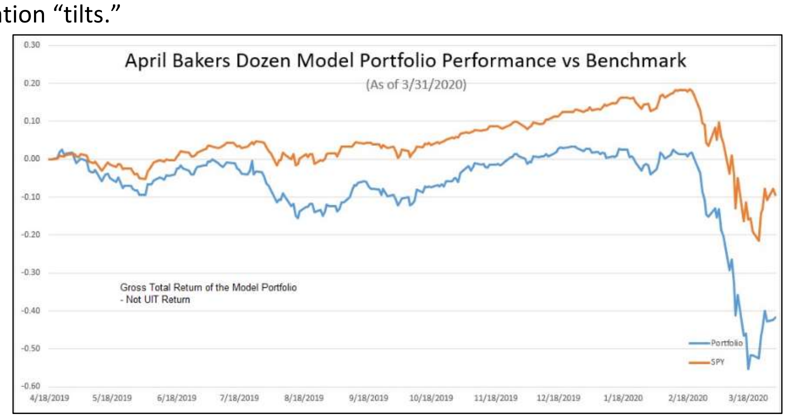
The table below shows March 2019 model portfolio performance as of 3/31/20. You can see that the average performance of the portfolio's positions is -29.9% versus the S&P 500 cap-weighted performance of -6.6%. **But when you also compare it to the S&P 500 equal-weight index, -16.9%, and the S&P 600 small-cap equal-weight index, -33.6%, the relative performance picture changes**.

| Ticker | Company Name | Return | Fwd P/E at Launch | Current Fwd P/E | Est. NTM EPS Growth at Launch | Actual EPS Growth |
|---|---|---|---|---|---|---|
| ZAYO | Zayo Group Holdings, Inc. | 25.4% | | | | |
| AME | AMETEK, Inc. | -10.3% | 20.0 | 17.5 | 23.3% | 27.4% |
| URI | United Rentals, Inc. | -11.4% | 6.3 | 5.2 | 18.0% | 20.2% |
| HLT | Hilton Worldwide Holdings Inc. | -19.1% | 22.2 | 23.7 | 37.2% | 39.1% |
| TRV | The Travelers Companies, Inc. | -22.5% | 11.9 | 9.5 | 24.7% | 7.4% |
| ANTM | Anthem, Inc. | -24.1% | 16.1 | 9.2 | 20.1% | 22.1% |
| SSNC | SS&C Technologies Holdings, Inc. | -28.9% | 16.6 | 10.0 | 30.8% | 32.5% |
| AGCO | AGCO Corporation | -29.8% | 14.5 | 11.2 | 19.7% | 14.1% |
| CF | CF Industries Holdings, Inc. | -32.8% | 18.1 | 15.4 | 101.4% | 66.6% |
| VST | Vistra Energy Corp. | -36.1% | 11.9 | 6.7 | 211.9% | 69.9% |
| BYD | Boyd Gaming Corporation | -47.4% | 15.8 | 10.7 | 33.5% | 34.8% |
| ATI | Allegheny Technologies Incorporated | -67.3% | 13.8 | 9.8 | 24.8% | -19.9% |
| SAVE | Spirit Airlines, Inc. | -75.5% | 8.1 | NE | 49.8% | 15.7% |
| | **Average** | **-29.2%** | **14.6** | **11.7** | **49.6%** | **27.5%** |
| SPY | SPDR S&P 500 ETF Trust | -6.6% | | | | |
| RSP | S&P 500 equal-weighted index | -16.9% | | | | |
| EWSC | S&P 600 equal-weighted index | -33.6% | | | | |

Unlike our stronger-performing portfolios that have enjoyed at least one big breakout performer, the March 2019 portfolio never had a big winner other than ZAYO. No other positions were safe from the selloff, although **AMETEK (AME)**, -10.9%, and **United Rentals (URI)**,-11.4%, held up better than the others. AME is a specialty industrial electronics maker, and URI is an industrial equipment rental company operating primarily in North America. Both have exceeded EPS expectations, as have hotel/resort company **Hilton Worldwide (HLT)**, -19.6%, health plan provider **Anthem (ANTM)**, -25.1%, **SS&C Technologies (SSNC)**, -29.5%, and casino operator **Boyd Gaming (BYD)**, -47.8%, although of course the next 12 months' outlook for most of these firms is expected to take a hit. The exception is ANTM, which maintains a solid growth forecast, but it has been hobbled by the political threat of single-payer "Medicare for All," although more recently it has shown some relative strength with the fading prospects of Bernie Sanders as a contender for the Democratic presidential nomination.

Among the worst performers are **Spirit Airlines (SAVE)**, -75.5%, and BYD as the travel/entertainment industry has been crushed by the Coronavirus pandemic and the associated travel restrictions and social distancing measures. Other laggards include **Allegheny Technologies (ATI)**, -67.3%, and **Vistra Energy (VST)**, -37.7%. ATI is a metal fabricator selling high-performance materials and advanced alloys that saw dramatic reductions in sales due to troubles at Boeing and the airline industry. VST is an independent power producer that would normally seem immune to challenges across the broader economy, but it has missed earnings estimates and more recently was caught up in the broader utilities sector valuation reset (from historically high P/Es).

The **April 2019 *Baker's Dozen*** model portfolio also launched in the midst of the protracted period (March 2018 – August 2019) of trade war uncertainty and investor defensive sentiment. In aggregate, the portfolio has fallen somewhat short of expected earnings, but several names have beaten estimates, and over the next 12 months several are still expected to grow EPS (in spite of COVID-19 disruptions). Like most of our monthly *Baker's Dozen* portfolios, it was challenged by persistent defensive turns in sentiment (like in April and August). And although **it showed significant outperformance during the 8/27/19-12/31/19 period of sustained risk-on sentiment with a total return of +20.9% versus the S&P 500 benchmark total return of +13.4%**, it ultimately suffered from a lack of breakout winners among its holdings and unfavorable allocation "tilts."




The portfolio launched with a 39% allocation (vs. 17% allocation in the benchmark) to attractively valued "deep cyclical" sectors – Industrial (15.4% vs. 9.3%), Energy (7.7% vs. 4.6%), and Materials (15.4% vs. 2.7%) – which hurt relative performance over the period. Furthermore, it had a significant allocation (30.8%) in airlines, hotel, restaurant, and gaming industries that have seen outsized impact from the Coronavirus pandemic. The portfolio was underweight (15.4%) the Technology sector (versus about 25% in the benchmark). Moreover, it had a 92% allocation to small-mid caps (vs. the S&P 500 benchmark being solely a large cap index), while large caps have greatly outperformed small-mid caps during the life of the portfolio. In addition, although we consider all our stocks selections to have solid growth outlooks, our GARP portfolios typically have a Value tilt by First Trust's definition (primarily based on price/book), and indeed the April 2019 portfolio carried only a 23.1% allocation to the Growth factor (vs. the benchmark's 59%, which is typical of a cap-weighted index), but the market's Growth factor greatly outperformed the Value factor. Also, the cap-weighted S&P 500 has greatly outperformed the equal-weight S&P 500 (and all other major market equal-weight indexes) over the full timeframe, again illustrating the dominance of mega-cap Technology on market performance.

The table below shows April 2019 model portfolio performance as of 3/31/20. You can see that the average performance of the portfolio's positions is -41.8% versus the S&P 500 cap-weighted performance of -9.3%. But when you also compare it to the S&P 500 equal-weight index, -19.7%, and the S&P 600 small-cap equal-weight index, -34.5%, the relative performance picture changes.

| Ticker | Company Name | Return | Fwd P/E at Launch | Current Fwd P/E | Est. NTM EPS Growth at Launch | Actual EPS Growth |
|---|---|---|---|---|---|---|
| CMC | Commercial Metals Company | -8.5% | 7.5 | 9.0 | 52.0% | 72.3% |
| PCRX | Pacira BioSciences, Inc. | -8.9% | 24.9 | 16.0 | 41.5% | 60.6% |
| URI | United Rentals, Inc. | -24.3% | 6.5 | 5.2 | 18.0% | 20.2% |
| TRV | The Travelers Companies, Inc. | -26.8% | 12.3 | 9.5 | 23.6% | 7.4% |
| SSNC | SS&C Technologies Holdings, Inc. | -31.2% | 16.9 | 10.0 | 30.9% | 32.5% |
| CVLT | Commvault Systems, Inc. | -33.9% | 27.7 | 25.1 | 37.7% | 0.6% |
| CF | CF Industries Holdings, Inc. | -38.1% | 20.1 | 15.4 | 92.1% | 66.6% |
| VAC | Marriott Vacations Worldwide Corpo | -45.9% | 13.6 | 6.7 | 30.7% | 33.1% |
| BYD | Boyd Gaming Corporation | -51.2% | 17.1 | 10.7 | 31.3% | 34.8% |
| NMIH | NMI Holdings, Inc. | -56.2% | 12.1 | 4.1 | 35.0% | 57.2% |
| DIN | Dine Brands Global, Inc. | -65.2% | 12.2 | 4.0 | 33.2% | 29.2% |
| GLOG | GasLog Ltd. | -75.6% | 17.3 | 12.4 | 64.8% | -49.1% |
| SAVE | Spirit Airlines, Inc. | -77.1% | 9.1 | NE | 38.7% | 15.7% |
| | **Average** | **-41.8%** | **15.2** | **10.7** | **40.7%** | **29.3%** |
| SPY | SPDR S&P 500 ETF Trust | -9.3% | | | | |
| RSP | S&P 500 equal-weighted index | -19.7% | | | | |
| EWSC | S&P 600 equal-weighted index | -34.5% | | | | |

Unlike our stronger-performing portfolios that have enjoyed at least one big breakout performer, the April 2019 portfolio never had a big winner. No positions were safe from the selloff, although **Commercial Metals (CMC)**, -8.5%, and **Pacira BioSciences (PCRX)**,-8.9%, held up better than the others. CMC is a manufacturer of specialty steel products (like rebar) with a major recycling operation, and PCRX is specialty drug maker best known for its non-opioid pain solutions. Both have exceeded EPS expectations, as have industrial equipment rental firm **United Rentals (URI)**, -24.3%, application software maker **SS&C Technologies (SSNC)**, -31.2%, hotel/resort operator **Marriott Vacations Worldwide (VAC)**, -45.9%, casino operator **Boyd Gaming (BYD)**, -51.2%, and private mortgage insurer **NMI Holdings (NMIH)**, -56.2%, which by the way was one of our top performers in several previous portfolios. Of course, the next 12 months' outlook for most of these firms is expected to take a hit. The three worst performers include **Spirit Airlines (SAVE)**, -77.1%, and restaurant company **Dine Brands Global (DIN)**, -65.2%, as the travel/entertainment industry has been crushed by the Coronavirus pandemic and the associated travel restrictions and social distancing measures, as well as Greek LNG shipper **GasLog (GLOG)**, -75.6%, which has fallen in concert with natural gas prices.

**Final Thoughts:**

Sabrient's model-driven approach seeks companies with strong growth expectations and good earnings quality that are selling at a reasonable forward valuation, but it doesn't predict fickle investor behavior…and of course it can't foresee a Black Swan event that sends investors into a panic and renders obsolete the forward guidance on which we based our rankings. Nevertheless, we expect our new process enhancements to help cushion the blow whenever defensive sentiment suddenly arises, with minimal reduction to the upside potential during more rational times when investor sentiment and the consensus outlook are aligned.

A deep Q2 recession seems inevitable now (with some estimates as bleak as a -30% fall in GDP), as the COVID-19 pandemic has become a generational event that has temporarily paralyzed much of the US and global economies. But the good news is that the market seems to be trying to hammer out a technical bottom, and valuations today appear to be pricing in a relatively short recession with recovery in H2. Once the economy can open again, tailwinds will include massive monetary and fiscal stimulus, sound fundamentals (especially the strong labor market before the pandemic hit), and new trade deals (Phase 1 with China and the USMCA with Mexico and Canada). Moreover, there is plenty of cash on the sidelines (including over $4 trillion in US money market funds), lofty valuations in Treasuries vs. more attractive valuations in equities, and a deluge of new central bank liquidity to fuel a rally.

As a reminder, we post on our public website my commentaries and presentation slide deck on the Marketing Materials tab at http://bakersdozen.sabrient.com, which also includes performance information on all current and historical *Baker's Dozen* portfolios. In addition, I go into greater detail on market conditions and outlook in my monthly Sector Detector newsletter and blog post, which you can find (and subscribe to for free) on the Sabrient.com homepage.