**Sabrient Commentary – December 2019** (as of 11/30/2019)
**Scott Martindale, President & CEO, Sabrient Systems, LLC**

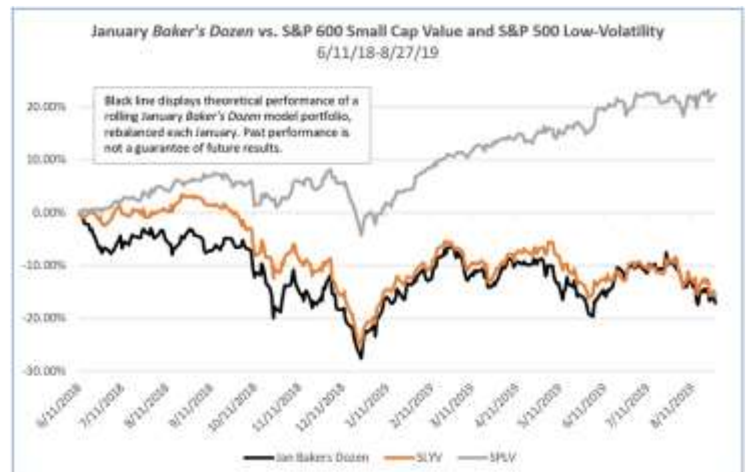
This month's commentary discusses three main topics:

1. Since 8/27/19, investors continue to rotate away from their previous defensive sentiment and back to a more **optimistic outlook and a risk-on preference that better aligns with the actual fundamental outlook**, which has boosted relative performance of Sabrient's *Baker's Dozen* portfolios.
2. We have developed and **introduced a new *Growth Quality Rank (GQR)*** as an enhancement to our growth-at-a-reasonable-price (aka GARP) model. Testing shows that GQR can help reduce volatility during "irrational" times (like the 6/11/18-8/27/19 timeframe) with minimal degradation in upside potential.
3. I give an under-the-hood review of our soon-to-expire **November and December 2018 *Baker's Dozen*** portfolios.

The market all this year has been oscillating between fear and optimism, risk-off and risk-on. Up until 8/27/19, risk-off defensive sentiment was winning, causing an historically-large divergence to build favoring *secular growth, low-volatility and momentum factors, "bond-proxy" defensive sectors, and large caps* (i.e., late-stage economic cycle behavior) over *cyclical growth, high-beta and value factors, cyclical sectors, and small-mid caps* (i.e., expansionary mid-cycle behavior). This divergence had become particularly stark when the trade war with China escalated into actual tariffs in June 2018. But ever since 8/27/19, that divergence began a rapid re-convergence, as fickle investors have regained their optimism about at least a partial resolution to the trade war (including the lifting of tariffs), plus an improving outlook for 2020-21 corporate earnings and capital investment. Investors have moved from displaying tepid and fleeting signs of risk-on rotation to full-blown bullish enthusiasm and reluctance to sell in an apparent *fear of missing out* (aka FOMO).

Last year at that same time of the year, the S&P 500 was marching higher until peaking on 9/20/18, but it was doing so on the backs of defensive sectors and secular-growth Tech mega-caps, and I was opining at the time that the rally would fizzle if there wasn't a rotation into the risk-on cyclicals and small-mid caps. As you know, that rotation didn't happen, leading to the Q4 selloff, and this year was shaping up quite similarly. Indeed, many successful value-tilted fundamentals-based strategies really took it on the chin, including powerhouse quant firm AQR Capital, which performed a 10-year study revealing that the past two years saw abnormal results for their strategies compared to the prior eight due more to "irrational" price moves rather than any change in fundamentals, ostensibly due to fear that a "late-cycle" economy was on the verge of recession. And indeed it was becoming something of a self-fulfilling prophesy, as the dominos seemed to be falling one by one: escalating trade wars created a cloudy outlook, which led to a global manufacturing slowdown, deferred US corporate capital spending, and negative interest rates overseas, which pushed global capital into US debt, *temporarily* inverted the yield curve, which brought out the doomsayers – all of which was beginning to negatively impact the strong consumer sentiment that had been carrying US GDP growth.

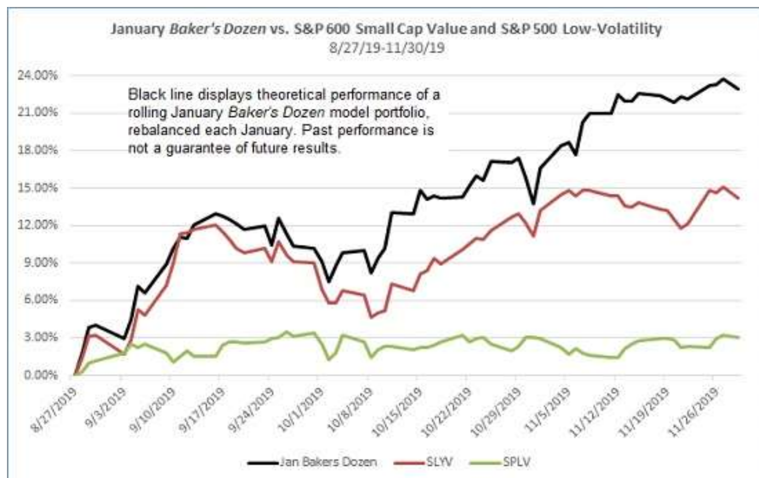
But it was all based on false pretenses, in my view, and investors now seem to be convinced that the bottom is in for the industrial/manufacturing cycle and the corporate earnings recession, and particularly for prices of value/cyclical stocks with solid fundamentals. Corporate earnings results haven't been as bad as feared, macro clouds are parting, and the latest data shows the consumer remains as strong as ever. Ultimately, stock prices are driven by earnings expectations and interest rates (for discounted cash flow valuation), and as the external obstacles hindering the free market are lessened or removed, the outlook brightens. And when investors *focus on the fundamentals* rather than the latest tweet, CNN headline, or a single economic number taken out of context, it generally bodes well for Sabrient's value-tilted "growth at a reasonable price" (aka GARP) portfolios, which of course include our flagship *Baker's Dozen* portfolios.




The chart to the right illustrates the high correlation between a theoretical rolling January *Baker's Dozen* model portfolio (gross performance, no fees) and the risk-on SPDR S&P 600 Small Cap Value ETF (SLYV), as well as the approximately 40 percentage points (pps) underperformance of both strategies versus the Invesco S&P 500 Low Volatility ETF (SPLV), from the start of the market bifurcation on 6/11/18 until the sustained risk-on rotation began on 8/27/19. You also can see the three short-lived rally attempts following the Christmas Eve

capitulation day.

But ever since sentiment turned on 8/27/19 (more than 3 months ago!), the massive performance divergence has been closing rapidly, with our theoretical rolling January *Baker's Dozen* model portfolio significantly outperforming SPLV by about 20 pps (and the SLYV by about 9 pps) through 11/30/19, as shown in the next chart below.




Will this bullish rotation into value/cyclicals/small-mid continue? According to JP Morgan's quant strategist Marko Kolanovic, *"We called for this rotation in July, and after an initial August setback, there was a multi-standard deviation rotation in September. Yet, there was broad skepticism at the time that the rotation was just a blip, so we reiterated that it had only begun and by far the largest part of the rotation was still ahead of us."* I agree, as I have been writing about the same growing divergence since summer 2018 when it was still in an early stage.

Nevertheless, at Sabrient we are always looking for ways to improve our process, so to further sidestep the dreaded "value trap" and better cushion the downside during times when investor sentiment turns "irrational," Sabrient founder David Brown and his team have developed a new **Growth Quality Rank (GQR)** to introduce as an enhancement to our GARP model. In a nutshell, it helps us identify companies with *consistent and reliable* earnings growth that are more likely to achieve their forecasts. Leveraging the competencies and skillsets of our young quant analyst/developers, who employed *Monte Carlo analysis* (rather than just our normal *scientific hypothesis testing*) on a variety of additional fundamental factors to develop and perfect this new *alpha model*, we were pleased to find that a rules-based historical simulation produced much less volatility (particularly during that challenging 2018!) and a higher overall Sharpe Ratio (risk-adjusted performance), with minimal reduction in the upside potential.

Now, let's take a look at the **November 2018 *Baker's Dozen*** portfolio, which we track as a 12-month portfolio ending on 11/20/19. Although it has made several valiant efforts to catch up with the benchmark S&P 500 following the December 2018 selloff, those periods of defensive sentiment have kept knocking it back down (late-January, mid-April, and late-July), as shown in the chart. However, since the bullish rotation began on 8/27/19, it was up +19.4% versus the benchmark total return of +10.1% (through 11/30/19).

The portfolio launched with an overweight 62% allocation (versus only 17% in the benchmark S&P 500) to three highly cyclical sectors of Energy (23.1% vs. 5.3%), Industrials (23.1% vs. 9.2%), and Materials (15.4% vs. 2.7%); an overweight in value/cyclical Financial sector (23.1% vs. 13.3%) and an underweight in Technology (7.7% vs. 24.0%). Moreover, it had an 85% allocation to small-mid caps (vs. the S&P 500 being solely a large cap index). In addition, although we consider all our stocks selections to have solid growth outlooks, our GARP portfolios typically have a Value tilt (based on price/book), so the portfolio officially carried only a 31% allocation to the Growth factor (vs. the benchmark's 59%, which is typical of a cap-weighted index).

Although the specific holdings might vary, these allocations are generally representative of most of our portfolios, as cyclicals tend to display the greatest earnings growth in a growing economy, and large caps have been largely "bid up" to high valuations (relative to small-mid, historically), according to our model. Nevertheless, because these allocation "tilts" are quite different from the cap-weighted S&P 500 benchmark's composition (sectors, market caps, value/growth ratio), they have hurt our relative performance during the buildup of this historic relative-valuation "bubble." However, our model continues to tell us that these tilts represent areas in which an investor should want to be positioned – and especially for a re-convergence of the relative-valuation bubble, *which has been underway over the past three months*.

Looking at the individual holdings, the portfolio has benefited from three solid (if not breakout) positions in private mortgage insurer NMI Holdings (NMIH) +75%, building supply/remodel firm American Woodmark (AMWD) +60%, both of which have benefited from the resurgence in housing, and electronic component maker KEMET Corp (KEM) +42%. Notably, all three are classified as *Growth* stocks, while nine of the other ten are considered *Value* stocks. All three reported solid earnings and guidance, and all have seen their forward P/E multiples expand considerably. However, the actual aggregate earnings growth of the overall portfolio so far is only at about half of the estimate upon launch. Nevertheless, an improved outlook has allowed the aggregate forward P/E to expand by 25%.

| Ticker | Company Name | Return | Fwd P/E at Launch | Current Fwd P/E | Est. NTM EPS Growth at Launch | Actual EPS Growth |
|---|---|---|---|---|---|---|
| NMIH | NMI Holdings, Inc. | 74.4% | 9.4 | 10.7 | 47.2% | 63.4% |
| AMWD | American Woodmark Corporation | 59.6% | 7.9 | 12.9 | 39.0% | 18.3% |
| KEM | KEMET Corporation | 41.7% | 4.9 | 16.5 | 61.1% | 50.6% |
| POST | Post Holdings, Inc. | 14.4% | 18.2 | 21.2 | 23.7% | 21.8% |
| XPO | XPO Logistics, Inc. | 9.3% | 18.3 | 18.7 | 37.7% | 25.9% |
| CF | CF Industries Holdings, Inc. | 4.9% | 16.7 | 18.6 | 186.6% | 97.2% |
| AIR | AAR Corp. | 2.9% | 15.6 | 16.4 | 46.0% | 34.9% |
| MPC | Marathon Petroleum Corporation | -1.6% | 8.6 | 8.3 | 45.7% | 11.9% |
| TBK | Triumph Bancorp, Inc. | -2.3% | 12.1 | 14.9 | 62.2% | 20.9% |
| HFC | HollyFrontier Corporation | -11.0% | 7.7 | 10.3 | 64.7% | 35.7% |
| MCY | Mercury General Corporation | -14.3% | 15.6 | 16.9 | 67.4% | -3.6% |
| UFS | Domtar Corporation | -14.7% | 7.8 | 18.5 | 59.0% | 25.1% |
| EOG | EOG Resources, Inc. | -30.8% | 15.3 | 15.1 | 38.6% | -2.6% |
| | **Average** | **10.2%** | **12.2** | **15.3** | **59.9%** | **30.7%** |
| SPY | SPDR S&P 500 ETF Trust | 20.3% | | | | |

The laggards include oil & gas firm EOG Resources (EOG) -31%, paper products maker Domtar (UFS) -15%, P&C insurer Mercury General (MCY) -14%. All three badly missed earnings expectations, and only MCY is anticipating earning growth next year. Note that the best performers are from Technology and Consumer segments (including consumer finance), while the worst performers are from cyclical Energy, Materials, and Financial. Nevertheless, several of the names in this portfolio continue to display sufficiently attractive GARP properties to make them eligible for new portfolios, including NMIH, XPO, CF, MPC, and MCY.

As for the **December 2018 *Baker's Dozen*** model portfolio, it benefited by launching just two days prior to the Christmas Eve capitulation day, so it wasn't hurt too bad coming out of the gate, and it actually got off to a great start before the intermittent defensive sentiment had it essentially fall in line with the benchmark for most of the ensuing several months. However, it has really pulled away to the upside since the bullish rotation began on 8/27/19, showing a total return of +21.4% versus the benchmark total return of +10.1% (through 11/30/19), which accounts for all its outperformance since inception.

The portfolio launched with an overweight 62% allocation (versus only 17% in the benchmark S&P 500) to three highly cyclical sectors of Energy (15.4% vs. 5.3%), Industrials (23.1% vs. 9.2%), and Materials (15.4% vs. 2.7%); a slight overweight in value/cyclical Financial sector (15.4% vs. 13.3%) and an underweight in Technology (7.7% vs. 24.0%). Moreover, it had a 69% allocation to small-mid caps (vs. the S&P 500 being solely a large cap index). In addition, although we consider all our stock selections to have solid growth outlooks, our GARP portfolios typically have a Value tilt (based on price/book), so the portfolio officially carried only a 54% allocation to the Growth factor versus the benchmark's 59% (typical of a cap-weighted index), which is pretty close compared to most of our other portfolios.

Looking at the individual holdings, the portfolio has enjoyed strong performance from private mortgage insurer NMI Holdings (NMIH) +98%, trucking company Saia (SAIA), biopharma Celgene (CELG) +62% [which got a nice bump when it was acquired by Bristol Myers (BMY)], electronic component maker KEMET Corp (KEM) +60%, casino operator Boyd Gaming (BYD), health plan firm WellCare Health Plans (WCG) +43%, and steel maker Commercial Metals (CMC) +32%, which seeks to corner the market in rebar, of all things, while boasting a large recycling operation. All seven have outperformed the S&P 500 benchmark, and all have come close to or exceeded their earnings estimates while seeing their forward P/E multiples expand considerably. Although the actual aggregate earnings growth of the overall portfolio has fallen short of expectations upon launch, a solid outlook has allowed the aggregate forward P/E to expand by 26%. Notably, its top five performers are all classified as *Growth* stocks, while six of the eight lesser performers are considered *Value* stocks.

Among the six laggards that have not outperformed the benchmark, five of them failed to meet earnings expectations [with the lone exception being Delta Air Lines (DAL)]. The only two names that failed to achieve a double-digit total return were both from the Energy sector: oil & gas firm Pioneer Natural Resources (PXD), which was down -1% as of 11/30/19, and refiner/marketer Marathon Petroleum (MPC), which was up +6%. Both badly missed earnings estimates but are expected to achieve more than 20% EPS growth next year. Several of the names in this portfolio continue to display attractive GARP properties, including NMIH, BYD, CMC, CF, MPC, and PXD.

| Ticker | Company Name | Return | Fwd P/E at Launch | Current Fwd P/E | Est. NTM EPS Growth at Launch | Actual EPS Growth |
|---|---|---|---|---|---|---|
| NMIH | NMI Holdings, Inc. | 97.9% | 8.0 | 10.7 | 47.1% | 63.4% |
| SAIA | Saia, Inc. | 72.4% | 12.4 | 18.6 | 24.6% | 27.0% |
| CELG | Celgene (acquired 11/20/19 by BMY) | 62.2% | | | | |
| KEM | KEMET Corporation | 60.1% | 4.4 | 16.5 | 61.1% | 50.6% |
| BYD | Boyd Gaming Corporation | 43.5% | 12.5 | 15.1 | 36.7% | 31.1% |
| WCG | WellCare Health Plans, Inc. | 43.4% | 17.9 | 20.3 | 30.5% | 54.2% |
| CMC | Commercial Metals Company | 32.0% | 8.4 | 9.2 | 30.4% | 36.5% |
| TBK | Triumph Bancorp, Inc. | 23.3% | 9.7 | 14.9 | 61.8% | 20.9% |
| AIR | AAR Corp. | 23.1% | 13.9 | 16.4 | 30.4% | 20.2% |
| CF | CF Industries Holdings, Inc. | 11.9% | 16.2 | 18.6 | 172.7% | 97.2% |
| DAL | Delta Air Lines, Inc. | 11.5% | 8.2 | 8.2 | 20.8% | 31.5% |
| MPC | Marathon Petroleum Corporation | 6.0% | 8.3 | 8.3 | 39.7% | 11.9% |
| PXD | Pioneer Natural Resources Company | -1.4% | 14.3 | 14.7 | 46.0% | 10.2% |
| | **Average** | **37.4%** | **11.2** | **14.3** | **50.1%** | **37.9%** |
| SPY | SPDR S&P 500 ETF Trust | 28.6% | | | | |

Looking ahead, much of the resurgence in investor optimism is due to expectations of an imminent trade deal with China. I think even an interim ("Phase 1") resolution would lift business confidence, juice capital spending, reinforce jobs growth, and perpetuate the economic expansion. And once that dam breaks, given the large stores of corporate cash and ongoing enhanced corporate cash flow from tax reform, a surge in capex, buybacks, and M&A should be quite stimulative to revenue and earnings growth, and ultimately to stock prices. In addition, forward stock valuations remain in-line with historical norms (considering the low interest rate environment, on a discounted cash flow basis), while investor optimism is growing as the yield curve steepens, leading to capital rotating out of pricey bonds and into riskier assets like stocks. And with hedge funds and individual investors still under-allocated to equities, there seems to be plenty of fuel to feed a continued rally.

Note that we post on our public website my commentaries and presentation slide deck. You can find them all on the Marketing Materials tab on **http://bakersdozen.sabrient.com**, which also includes performance information on all of our 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. As a reminder, I am always happy to take time for individual conversations with financial advisors about market conditions, outlook, and Sabrient's portfolios.

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