Sabrient Commentary – February 2020 (as of 2/11/2020)
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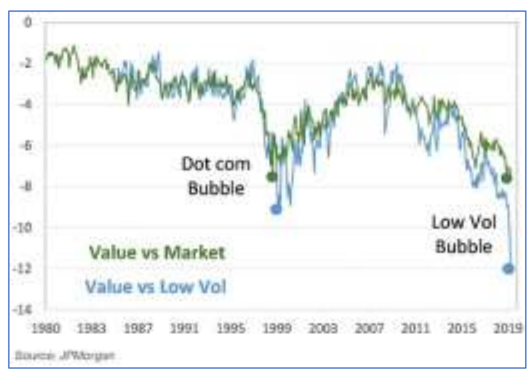
This month's commentary focuses on three main discussion topics:

1. **Impact of populist movement on investor sentiment:** After 6-1/2 years of consistent outperformance for Sabrient's *Baker's Dozen* portfolios since 2009, the rise in popularity of disruptive leaders with a populist message like Donald Trump and Bernie Sanders (and others around the world) starting in mid-2015 changed the character of investor sentiment to be more cautious, defensive, and wary of *cyclical* growth and smaller caps (despite a positive economic outlook) while pushing large-cap *secular* growth companies to elevated P/E multiples. All of this is unlike anything Sabrient had seen or tested on its quantitative model in the past (i.e., since the Internet Bubble burst in 2000), so our portfolios have struggled at times over the past four years.
2. **New process enhancements:** In response to this "new normal" in market conditions, we have introduced two new process enhancements to our long-standing portfolio strategy: 1) a proprietary new *Growth Quality Rank (GQR)* as an alpha factor, which testing suggests will reduce volatility and provide better *all-weather* performance with *minimal reduction to upside potential,* and 2) "guardrails" against extreme sector tilts away from the benchmark's allocations to reduce relative volatility.
3. **Review of terminating Jan 2019 and Feb 2019 *Baker's Dozen* portfolios:** Both portfolios were hindered by allocation "tilts" toward cyclical sectors, small-mid caps, and equal weighting, which typically outperform in growing economy, but cautious investors preferred mega-caps and defensive sectors, giving the cap-weighted S&P 500 large cap benchmark a big advantage.

After 6-1/2 years of consistent outperformance for Sabrient's *Baker's Dozen* portfolios, which first launched as a top picks list on the Sabrient website in 2009, investor sentiment suddenly changed in mid-2015, driven more by the news than by the fundamental outlook. The election campaign rhetoric that year began attacking pharmaceuticals pricing practices, China devalued the yuan, oil prices took another leg down, and the Fed announced its intention to begin raising rates. Moreover, a new populist fervor began to cascade across the world, with "Great Disruptors" like Donald Trump and Bernie Sanders gaining popularity in the US and Boris Johnson (and his successful push for Brexit) in the UK, among others. Investors could no longer count on "politics as usual." As a result, the infamous *FAANG* acronym came into the vernacular due to narrow market breadth, led only by the mega caps Tech names – Facebook, Amazon, Apple, Netflix, and Google. And although stocks saw a "Trump Bump" in anticipation of tax cuts and deregulation throughout 2017 favoring the *risk-on* sectors (like cyclical sectors, small-mid caps, emerging markets, and the high-beta factor), in March 2018 the extreme escalation in the trade war with China threw a monkey wrench into it all and *risk-off* sentiment took hold, ultimately leading to the 4Q2018 selloff and technical bear market (-20% drawdown on the S&P 500).

The 18 months of trade war escalation from March 2018 through August 2019 created an historically large *relative valuation divergence* in Low-volatility/Defensives/Large-mega-caps over Value/Cyclicals/Small-mid caps due to both various macro events (like the China trade war and fluctuating Federal Reserve monetary policy) as well as the rise of *algorithmic trading* (which can amplify and prolong fluctuations in sentiment). Then, even with the rapid recovery from that drawdown, most of 2019 was dominated by investor caution, largely due to concerns about an escalation in the trade war and further contraction in the manufacturing segment, leading to a *self-fulfilling prophesy* of reduced corporate capital spending, an earnings recession, and slower global economic growth. All of this has been challenging for Sabrient's stock selection approach, which is forward-looking and depends upon alignment between investor preferences and the consensus outlook among sell-side analysts for individual companies.

I have been discussing this unsettling market divergence since summer 2018, as have other valuation-driven quant firms. Similarly, J.P. Morgan's quant team observed this massive relative valuation divergence between Low-volatility/Defensives and Value/Cyclicals, as shown in this chart from last summer:



Finally, starting on 8/27/2019, the market commenced a sustained risk-on rotation back into cyclical sectors and small-mid caps that one would expect given the real fundamental outlook of rising GDP growth, a strong consumer, record low unemployment, and low interest rates. Perhaps 2020 finally will be the year for small caps. While the S&P 500 forward P/E has risen to 18.5x, the Russell 2000 is at 16.8x and the S&P 600 small cap index is only 16.3x, so the valuations are much more attractive (albeit far less dominated by secular growth Technology and more by cyclical Financial and Industrial sectors).

Nevertheless, it became evident to us at Sabrient that the market could 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 had become capable of displaying persistently "irrational" behavior unlike anything we had seen or tested on our quantitative model in the past (i.e., after the post-Internet Bubble). During those first 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 its 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 those 18 months of the China trade war escalation.

In response, we have implemented <u>two new enhancements</u> to our existing "Growth at a Reasonable Price" (aka GARP) quantitative model and portfolio selection process, which testing suggests will both *reduce relative volatility* versus the benchmark S&P 500 and *provide better "all weather" performance,* even when investor sentiment becomes misaligned with the fundamental outlook, without making dramatic changes to our long-standing strategy that had produced so many high-performing portfolios – and importantly, with *minimal reduction to the upside potential* that investors had come to expect from us.

First, whereas a 30% concentration limit previously had been the only sector constraint, "guardrails" against extreme sector tilts away from the benchmark S&P 500's allocations were introduced to reduce relative volatility. In addition, a proprietary new *Growth Quality Rank (GQR)* was developed as an alpha factor to add to the underlying quantitative model and portfolio selection process. In a nutshell, GQR focuses on *consistency and predictability* of earnings and a company's likelihood of meeting consensus earnings estimates. It also allows for more in the way of *secular* growth companies (even if they display slightly higher forward P/Es) rather than letting the model steer stock selection heavily into lower-P/E *cyclical* growth companies.

We are quite excited about these enhancements, especially given the solid fundamental outlook for the US economy and equities.

Comments on the terminating January 2019 and February 2019 *Baker's Dozen* portfolios:

Many of Sabrient's portfolios that were live during that challenging 18-month period (3/2018-8/2019) indeed absorbed some pain. Of course, with a concentrated 13-stock portfolio, some portfolios will have a few breakout winners that can overcome a number of laggards, as was the case with the October 2018 and December 2018 Baker's Dozen portfolios. But the January 2019 and February 2019 portfolio have lagged the benchmark S&P 500, primarily due to a lack of breakout stars, but also due to the market preferences that favored mega-caps and defensive sectors, giving the market-cap-weighted S&P 500 large cap index a huge advantage (including over the equal-weighted S&P 500).

Our 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-mid caps, as large caps have been largely "bid up" to high valuations. Nevertheless, because these allocation "tilts" are quite different from the cap-weighted S&P 500's composition (sectors, market caps, value/growth ratio), they have hurt our relative performance during the buildup of this historic relative-valuation "bubble." (Note: Our enhanced model should help mitigate this.)

Nevertheless, these tilts represent areas in which an investor typically would want to be positioned in a growing economy – and especially for a convergence of the relative-valuation bubble. Still, as I described in the previous section, we have instituted guardrails against extreme sector tilts away from the benchmark to help reduce relative volatility. 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%).

The **January 2019 *Baker's Dozen*** model portfolio in aggregate has fallen short of expected earnings, but several names have beaten estimates, and over the next 12 months it is expected to grow EPS by 31% overall. As shown in the chart below, it charged out of the gate right after launch, but then ran into various defensive swoons in February, April, and August that were quite daunting. But the sustained risk-on rotation to close out 2019 allowed relative performance to catch up to the benchmark, as solid guidance and improving investor sentiment boosted the value factor and cyclical sectors – leading to a portfolio total return of +24.9% versus the S&P

500 benchmark return of +13.4% (in the 8/27/19-12/31/19 timeframe).

The portfolio launched with an overweight 54% allocation (versus only 17% in the benchmark S&P 500) to three highly cyclical sectors of Industrials (23.1% vs. 9.2%), Energy (15.4% vs. 5.3%), 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 (15.4% vs. 24.0%). Moreover, it had a 75% 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). Also, the cap-weighted S&P 500 (dominated by mega-cap Tech names) has greatly outperformed the equal-weight S&P 500 (+28.0% vs. 20.8%) over the timeframe, illustrating the dominance of mega-cap Technology on overall market performance.

There is a striking divide between the 7 of the 13 holdings that performed quite well versus the 6 that performed quite poorly. Winners include private mortgage insurer **NMI Holdings (NMIH)**, +71%, trucking company **Saia (SAIA)**, +64.2%, electronic component maker **KEMET Corp (KEM)**, +38.7%, application software firm **SS&C Technologies (SSNC)**, +31.1%, steel maker **Commercial Metals (CMC)**, +25.9%, and casino operator **Boyd Gaming (BYD)**, +22.2%, which has come on strong lately at the expense of those with exposure to Macau (and China's Coronavirus). In addition, **Legacy Texas Bank (LTXB)** was acquired by Prosperity Bancshares (PB) at a nice profit.

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.	71.0%	9.5	11.1	47.1%	63.4%
SAIA	Saia, Inc.	64.2%	13.0	19.2	23.4%	8.8%
KEM	KEMET Corporation	38.7%	4.6	17.2	61.1%	1.7%
SSNC	SS&C Technologies Holdings, Inc.	31.1%	14.0	16.1	39.0%	49.2%
CMC	Commercial Metals Company	25.9%	6.7	9.3	58.7%	60.1%
BYD	Boyd Gaming Corporation	22.2%	15.6	16.4	35.3%	31.1%
LTXB	LegacyTexas (acquired 10/31//19 by PB)	18.9%				
CNC	Centene Corporation	-0.5%	15.0	13.0	24.1%	23.8%
ALK	Alaska Air Group, Inc.	-0.7%	10.3	9.1	37.3%	44.2%
BA	The Boeing Company	-5.5%	20.3	59.6	29.9%	-122.1%
CF	CF Industries Holdings, Inc.	-5.7%	17.4	21.4	165.3%	97.2%
BKR	Baker Hughes Company	-8.2%	21.7	20.4	105.9%	29.7%
MPC	Marathon Petroleum Corporation	-16.7%	9.3	8.7	39.3%	-25.2%
	Average	**18.1%**	**13.1**	**18.5**	**55.5%**	**21.8%**
SPY	S&P 500 cap-weighted index	28.0%				
RSP	S&P 500 equal-weighted index	20.8%				

Of the six underperformers, well-publicized troubles at **Boeing (BA)**, -5.5%, have been a drag on the portfolio despite a favorable climate for its business. Nevertheless, a company like Boeing enjoys a duopoly (along with Airbus) in commercial aircraft manufacturing, and it is expected to make a big comeback next year with over 260% year-over-year EPS growth (i.e., a forward PEG of 0.23). But the biggest disappointments are due to earnings misses from Materials and Energy sector names **Marathon Petroleum (MPC)**, -16.7%, **Baker Hughes (BKR)**, -8.2%, and **CF Industries (CF)**, -5.7%, at least partly due to capital spending postponements from the trade war. MPC is part of a surprisingly weak refining segment despite strong consumer spending. However, the next 12 months look quite solid for MPC and BKR, with over 30% EPS growth expected by the analyst community.

Furthermore, there is the unfortunate situation with health plan provider **Centene (CNC)**, -0.5%, which has seen its forward P/E compress from 15.0x to 13.0x despite showing *better* than expected earnings (and with solid growth expected for the next 12 months). Although it has recovered quite a bit of ground over the past 5 months, investors have largely avoided it due to the political climate (e.g., "Medicare for all") that has created tremendous uncertainty around health plan providers, especially those providing coverage through government-subsidized programs like Medicaid. Similarly, **Alaska Air (ALK)**, -0.7%, is a well-regarded airline that has seen both earnings *beats* and P/E *compression*, which is a frustrating combination for an investor.

Note that several of the holdings still display sufficiently attractive GARP properties today to be considered for new portfolios, including NMIH, BYD, BKR, CNC, ALK, BA, and MPC.

The **February 2019 portfolio** was similarly challenged by defensive market conditions in April, and August, but unlike many of the other monthly Baker's Dozens, it never got much traction during the risk-on phases due to a lack of breakout winners among its holdings. Even in the 8/27/19-12/31/19 period, the portfolio total return was only +14.6% versus the S&P 500 benchmark total return of +13.4%.

It launched with a 38% allocation (versus 17% in the S&P 500) to attractively valued cyclical sectors Industrials (23% vs. 10%), Energy (7.7% vs. 5%), and Materials (7.7% vs. 2%). Moreover, it had a 69% allocation to small-mid caps (vs. the S&P 500 benchmark being solely a large cap index), and of course large caps have greatly outperformed small-mid caps. 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 the August portfolio carried only a 46% allocation to the Growth factor (vs. the benchmark's 59%, which is typical of a cap-weighted index), but the market's Value factor greatly underperformed the Growth factor. Also, the cap-weighted S&P 500 has greatly outperformed the equal-weight S&P 500 (+22.5% vs. 14.3%) over the full timeframe, again illustrating the dominance of mega-cap Technology on overall market performance.

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.	35.7%	34.9	53.3	49.0%	53.1%
MLNX	Mellanox Technologies, Ltd.	16.1%	16.4	16.1	23.9%	42.8%
BYD	Boyd Gaming Corporation	14.9%	17.0	16.4	35.5%	31.1%
URI	United Rentals, Inc.	10.6%	7.0	7.4	18.0%	20.2%
SSNC	SS&C Technologies Holdings, Inc.	8.0%	15.9	16.1	31.4%	28.7%
TRV	The Travelers Companies, Inc.	5.0%	11.6	13.1	24.3%	7.4%
SYF	Synchrony Financial	4.7%	7.3	8.3	16.4%	14.4%
ALK	Alaska Air Group, Inc.	1.7%	9.6	9.1	50.1%	44.2%
CNC	Centene Corporation	-3.5%	15.2	13.0	19.1%	23.8%
CF	CF Industries Holdings, Inc.	-6.5%	17.9	21.4	102.7%	67.4%
BA	The Boeing Company	-18.2%	20.6	59.6	26.0%	-122.1%
DK	Delek US Holdings, Inc.	-22.5%	6.7	11.9	50.5%	46.8%
CVLT	Commvault Systems, Inc.	-26.4%	30.7	30.5	38.7%	0.6%
	Average	**1.5%**	**16.2**	**21.3**	**37.4%**	**19.9%**
SPY	S&P 500 cap-weighted index	22.5%				
RSP	S&P 500 equal-weighted index	14.3%				

Unlike our stronger-performing portfolios that have enjoyed at least one big breakout performer, the Feb 2019 portfolio doesn't yet have a big winner, and 6 of the holdings were also in the January portfolio. The top gainer is 5G infrastructure company **Zayo Group (ZAYO)**, which signed a deal last May to be acquired for $35/share, which has capped its performance at +35.7%. Other solid performers include semiconductor/networking firm **Mellanox (MLNX)**, +16.1%, **Boyd Gaming (BYD)**, +14.9%, **United Rentals (URI)**, +10.6%, and application software firm **SS&C Technologies (SSNC)**, +8.0%. Each of these four companies has come close to or exceeded EPS expectations, with additional solid growth expected over the next 12 months, but again, no big price breakouts.

The worst performer has been cybersecurity firm **Commvault Systems (CVLT)** at -26.4%, which has failed miserably to meet expectations, and its next 12 months expectations remain uninspiring. So, that's a name I wish we could take back. Oil refiner **Delek US (DK)**, -22.5% came close to meeting EPS expectations but has sold off with its brethren in the refining segment (and Energy as a whole) even though consumer spending has been strong. The other three holding with negative returns were also in the January portfolio, including fertilizer maker **CF Industries (CF)**, -6.5%, which has lagged like many in the Materials sector, **Boeing (BA)**, -18.2%, which of course has been the name most in the news after its issues with the 737 MAX, and health plan provider **Centene (CNC)**, -3.5%, which has beat expectations but still suffered due to the political climate around health plan providers.

Final Thoughts:

Sabrient's model-driven approach simply seeks companies with strong growth expectations and good earnings quality that are selling at a reasonable price, but it doesn't predict fickle investor behavior. Nevertheless, as I mentioned earlier, we expect our new process enhancements to help cushion the blow if such a climate persists, with minimal reduction to the upside potential.

Let me close by saying that we see no recession in sight, and investor sentiment finally may be ignoring the fearmongers and moving from risk-averse to risk-embracing, which better matches the positive fundamental outlook for the US economy that is reflected in our model. For 2020, optimism has replaced what I termed a self-fulfilling prophecy about a recession, but now that the forward P/E on the S&P 500 has been flirting with 19x, we'll need to see a revival in capital spending and earnings growth rather than further multiple expansion to drive stocks higher (which is what happened last year).

Tailwinds include ongoing monetary stimulus in the form of low interest rates and easy access to credit, ongoing fiscal stimulus such as low tax rates and deregulation, record low unemployment, low inflation, lofty consumer confidence, improving business confidence, and of course, those signed trade deals (Phase 1 with China and the USMCA with Mexico and Canada). Moreover, there is plenty of idle cash still on the sidelines – including $500 million in global household wealth seeking higher returns, $3.6 *trillion* sitting in US money market funds, and margin debt at its lowest level since 2005. Instead of a recession, we may well see a rotation out of those wildly popular growth/momentum stocks of recent years and into the vast sea of overlooked names (especially many among the small and mid-caps) that still sport attractive valuations.

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.