Sabrient Commentary – January 2020 (as of 1/9/2020)

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This month's commentary discusses three main topics:

1. **The risk-on rotation continues:** The historically large divergence between low-volatility/defensive/large cap companies versus value/cyclical/small-mid cap has been converging, which better aligns with the positive fundamental outlook – boosting the relative performance of Sabrient's *Baker's Dozen* portfolios.
2. **New process enhancements:** In response to the persistent and (what we see as irrational) defensive investor sentiment in the face of a generally positive outlook – unlike any behavior we have seen or tested before – we are adding:
   a. "Guardrails" against extreme sector tilts away from the benchmark, to reduce relative volatility
   b. Our newly developed *Growth Quality Rank (GQR)* that focuses on consistency and predictability of earnings and a company's likelihood of meeting consensus earnings estimates. Testing suggests GQR can help reduce volatility during "irrational" times (like the 6/11/18-8/27/19 timeframe) with minimal degradation in upside potential.
3. **Under-the-hood reviews:** Summaries of our soon-to-terminate December 2018 and January 2019 *Baker's Dozen* portfolios.

As I have been discussing for nearly 18 months now, a stark market bifurcation commenced in June 2018 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, value and high-beta factors, cyclical sectors, and small-mid caps (i.e., expansionary cycle behavior). It persisted longer than the analyst consensus used in our quantitative GARP (growth at a reasonable price) model suggested, with only fleeting glimpses of risk-on rotation whenever promising news about the trade war came out. Until 8/27/19, risk-off defensive sentiment was dominating, and it was worryingly looking a lot like *deja vu* from 2018. As you recall, small caps peaked on 8/31/18 while the S&P 500 was able to march a bit higher before peaking on 9/20/18, but it was doing so on the backs of defensive sectors along with secular-growth Tech mega-caps, and I was opining at the time that the rally would fizzle if there wasn't some rotation into the risk-on cyclicals and small-mid caps – which as you know didn't happen, leading to the Q4 selloff.

But this year has played out quite differently. Since 8/27/19, a bullish risk-on rotation has been persisting in which investors have shifted away from their previous defensive risk-off sentiment and back to more optimistic behavior that better aligns with the solid fundamental expectations of Wall Street analysts and Corporate America. We have seen glimpses of this off and on whenever the Fed said something dovish or the Administration said something encouraging about China trade negotiations. But it wasn't until late August that the risk-on rotation stuck. So, instead of peaking and selling off like 4Q18, stocks seem to have put in a bottom, as investors have become optimistic about the trade negotiations, a dovish Fed, improving corporate earnings in 2020-21, and resurgent capital spending – *to the notable benefit of Sabrient's various GARP portfolios.*

To illustrate, the charts below compare a theoretical rolling January *Baker's Dozen* portfolio versus the SPDR S&P 500 (SPY), Invesco S&P 500 Low Volatility (SPLV), which performed so well during the period of defensive sentiment, and SPDR S&P 600 Small Cap Value (SLYV) for two timeframes: Christmas Eve 2018 "capitulation day" to present and 8/27/19 to present.

This certainly has been a welcome development, and of course, Sabrient has long been proud of the impressive theoretical back-test history (post-Internet Bubble) of our underlying GARP (growth at a reasonable price) model as well as the solid actual performance of our *Baker's Dozen* portfolios since launch in 2009. But it has become evident to us that more recently *the market has displayed persistently irrational behavior unlike anything we have seen (or tested) in the past* – largely due to various macro events (like the China trade war and Federal Reserve monetary policy), but perhaps also due to the rise of algorithmic trading (which can amplify and prolong fluctuations in sentiment). In any case, investor sentiment has been skewed even given a sound fundamental outlook. And in response, **we have chosen to implement new enhancements** to our existing quantitative GARP model and portfolio selection process *with the goal of achieving better "all weather" performance relative to the benchmark* S&P 500.

As a reminder, David Brown and his team here at Sabrient don't *force* cyclicals and small caps to be in our GARP portfolios, but rather our quantitative model identifies stocks having good earnings quality and less-aggressive accounting practices that are expected to achieve solid earnings growth while still selling at an attractive price – and those names tend to come from the cyclical sectors *when the economy is growing*. And of course, we limit exposure to any one sector to a maximum of 30%. But macro uncertainty, algo-driven trading, and fickle investor behavior have been common for much of the past 4.5 years – essentially since mid-2015 when the last presidential campaign commenced and the Fed began signaling its intentions to tighten (with the main exception being the 15 months of post-election risk-on rally from November 2016 until the February 2018 correction). Such behavior has allowed many quality companies with solid earnings growth expectations to fall to single-digit forward P/Es.

It can be frustrating when our stocks meet earnings estimates and still sell off to much lower forward valuations due to cautious investor sentiment about the future, which is pretty much what happened during 2018. However, we felt that 2019 exposed a vulnerability in our process that we really hadn't seen before in a sustained way, which is that cautious corporate sentiment led to a *slowdown in capital spending plans*, which made many companies from cyclical sectors like Industrials and Materials *miss estimates*.

Of course, we didn't want to make any *dramatic* changes to Sabrient's long-standing GARP model and portfolio selection process, which work quite well when investor preferences align with fundamentals and favor undervalued growers (rather than bidding up large caps and defensive "bond proxy" sectors). However, we are always looking for ways to improve performance, which can include both enhancing our quantitative model and reducing relative volatility versus the cap-weighted S&P 500 benchmark (which of course is dominated by mega-caps and passive investing, and can retain capital even as it rotates among sectors).

So, we have done a couple of things to enhance our portfolio selection process:

1. We have implemented **additional sector constraints** to reduce relative volatility versus the benchmark. Whereas we previously limited sectors to a max allocation of 30%, without regard to the benchmark's allocations, we found that more recently as the Tech sector that is more heavily weighted in the benchmark has been bid up to higher valuations, our model has pushed us more toward the cyclical sectors (like Industrial/Materials/Energy). And indeed, allowing those sector tilts toward the more attractive valuations has been beneficial at times in the past, but it cuts both ways, such as when those sectors are shunned (however irrational it may be). So, we now have "guardrails" against going too far astray of the benchmark's sector allocations.
2. We set about to enhance our GARP model to better focus on consistency and predictability of earnings and a company's likelihood of meeting consensus earnings estimates, in addition to the factors on which we have always focused (like strength of growth, relative valuation, recent sell-side revisions to estimates, and quality of earnings). This effort has culminated in our new ***Growth Quality Rank (GQR)*** as a new alpha factor. The goal was to provide better "all-weather" performance, even when investor sentiment seems irrational, with *minimal reduction to the upside potential* that investors seek from the *Baker's Dozen*. It also allows for more in the way of *secular* growth companies (even if they display higher forward P/Es) rather than letting the model push us so heavily into lower P/E *cyclical* growth companies, which often can become proverbial "value traps" that have been so impacted by the disconnect between persistently defensive investor sentiment and the positive economic outlook.

|<- 50-stock algorithmic simulations ->|

	Theoretical Historical Rolling Annual January *Baker's Dozen* Portfolio	GARP-Aggressive	**New GARP-GQR Model**	SPY
2009	38.60%	53.68%	**25.03%**	26.46%
2010	23.07%	25.21%	**25.75%**	15.06%
2011	7.40%	-0.82%	**11.68%**	2.11%
2012	49.82%	31.75%	**19.42%**	16.00%
2013	60.90%	61.26%	**37.94%**	32.39%
2014	26.28%	20.86%	**13.09%**	13.69%
2015	-3.56%	-5.69%	**8.34%**	1.38%
2016	5.00%	16.63%	**12.90%**	11.96%
2017	26.33%	25.84%	**30.81%**	21.83%
2018	-17.64%	-20.97%	**-1.77%**	-4.38%
2019 YTD*	20.10%	20.68%	**24.22%**	21.67%
** Through 10/15/19*				
Cumulative Return	605.66%	546.99%	**538.65%**	317.37%
Avg Annual Return	19.85%	18.89%	**18.75%**	14.16%
Standard Deviation	16.60%	19.94%	**15.17%**	13.53%
Simple Sharpe Ratio	1.20	0.95	**1.24**	1.05

Note: Both the existing **GARP-Aggressive Model** and the **New GARP-GQR Model** performance are based on 100% rules-based back-test simulations, which may or may not be indicative of future performance. They employ 50-stock portfolios, rebalanced quarterly with sector concentration limits. On the other hand, the **Theoretical Rolling January *Baker's Dozen*** assumes end-of-day closing prices for the actual published 13-stock January portfolios, rebalanced annually.
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The table to the left shows the strong correlation between a theoretical rolling annual portfolio of our actual published January *Baker's Dozen* model portfolios since inception in 2009 and the underlying "GARP-Aggressive" model (as run in a 50-stock quant simulation with a quarterly rebalance), as you might expect. Likewise, the new GARP-GQR model historical simulation is also correlated during most years but is significantly less volatile. While displaying a similar cumulative return (over the nearly 11-year test), it has a much lower standard deviation and thus a higher Sharpe Ratio versus the existing model.

The ramifications of this are quite promising for our future *Baker's Dozen* portfolios. Of course, this is not the first enhancement to our original model from 2008. For example, we developed and introduced an *Earnings Quality Rank (EQR)* back in 2013, with expert assistance from the Gradient Analytics forensic accounting team, to help us focus on companies with less aggressive accounting practices relative to their industry peers. Similarly, the new GQR will help us focus on those companies with more *consistent and reliable earnings growth trends* that are more likely to achieve their growth forecasts.

And importantly, our simulations suggest that the down years should be significantly softened. Indeed, the horrid performance shown in the table during 2018 for both the rolling *Baker's Dozen* and the underlying GARP-Aggressive model is *greatly improved* in the new GARP-GQR model (and it even beats the benchmark S&P 500). [Note: The gross hypothetical *back-tested* performance shown in the table does not represent the results of actual trading and does not consider transaction costs or fees. Actual returns from live portfolios may differ materially from hypothetical returns.]

Next, let's look at the soon-to-terminate *Baker's Dozen* portfolios. The **December 2018 *Baker's Dozen***, which we track as a 12-month model portfolio ending on 12/20/19, benefited from launching just two days before the Christmas Eve capitulation day, so it wasn't too badly hurt coming out of the gate, and actually got off to a great start before relentlessly defensive sentiment caused it to essentially track the benchmark for most of the ensuing several months. However, since the latest bullish rotation began, the portfolio has nicely pulled away to the upside, showing a total return of +23.2% versus the benchmark's +13.4% in the 8/27/19-12/31/19 timeframe.

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.	95.2%	8.0	10.5	47.1%	63.4%
CELG	Celgene (acquired 11/20/19 by BMY)	79.2%				
SAIA	Saia, Inc.	75.2%	12.4	19.2	24.6%	27.0%
KEM	KEMET Corporation	61.3%	4.4	16.7	61.1%	50.6%
WCG	WellCare Health Plans, Inc.	47.8%	17.9	20.8	30.5%	54.2%
BYD	Boyd Gaming Corporation	45.9%	12.5	15.1	36.7%	31.1%
CMC	Commercial Metals Company	34.8%	8.4	9.6	30.4%	60.1%
TBK	Triumph Bancorp, Inc.	30.1%	9.7	16.2	61.8%	20.9%
AIR	AAR Corp.	28.4%	13.9	16.4	30.4%	22.2%
PXD	Pioneer Natural Resources Company	22.9%	14.3	18.2	46.0%	10.2%
DAL	Delta Air Lines, Inc.	13.3%	8.2	8.1	20.8%	31.5%
CF	CF Industries Holdings, Inc.	12.7%	16.2	19.3	172.7%	97.2%
MPC	Marathon Petroleum Corporation	1.4%	8.3	8.1	39.7%	11.9%
	Average	**42.2%**	**11.2**	**14.9**	**50.1%**	**40.0%**
SPY	SPDR S&P 500 ETF Trust	34.2%				

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 (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 46% allocation to the Growth factor versus the benchmark's 59% (typical of a cap-weighted index). These various allocations are quite different from the cap-weighted S&P 500 benchmark's composition (sectors, market caps, and value/growth ratio), and in fact they have generally hurt our relative performance attribution during the buildup of the historically large defensive/aggressive relative-valuation "bubble" – although this particular portfolio was able to overcome it with some stellar individual performers.

Looking at the holdings, the portfolio has enjoyed strong performance from private mortgage insurer NMI Holdings (NMIH) +95%, biopharma Celgene (CELG) +62% [which got a nice bump when it was acquired by Bristol Myers (BMY)], trucking company Saia (SAIA) +75%, electronic component maker KEMET Corp (KEM) +61%, health plan firm WellCare Health Plans (WCG) +48%, casino operator Boyd Gaming (BYD) +46%, and steel maker Commercial Metals (CMC) +35%, 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 a bit short of the expectations upon launch, a solid forward outlook today has enabled the aggregate forward P/E to expand by 33% (from 11.2x to 14.9x). Notably, its top six performers are all classified as *Growth* stocks, while all seven of the 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 name that failed to achieve a double-digit total return was from the Energy sector, refiner/marketer Marathon Petroleum (MPC), which recently fell in response to the spike in oil prices following the US assassination of Iran's notorious military leader. Although MPC badly missed earnings estimates, it is expected to achieve 26% EPS growth over the next four quarters, and it still displays quite attractive GARP properties (e.g., forward PEG of 0.31), as does NMIH, BYD, CF, and PXD.

As for the **January 2019 *Baker's Dozen*** model portfolio, which we track as a 12-month portfolio ending on 1/20/20, the 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. It charged out of the gate right after launch, but then ran into swoons in February, April, and August that were quite daunting. But the sustained risk-on rotation has allowed relative performance to improve markedly over the past four months, as solid guidance and improving investor sentiment has boosted the value factor and cyclical sectors, with a portfolio total return of +24.9% versus the benchmark total return of +13.4% in the 8/27/19-12/31/19 timeframe.

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.	61.1%	9.5	10.5	47.1%	63.4%
SAIA	Saia, Inc.	55.2%	13.0	19.2	23.4%	27.0%
KEM	KEMET Corporation	41.6%	4.6	16.7	61.1%	50.6%
CMC	Commercial Metals Company	30.1%	6.7	9.6	58.7%	60.1%
SSNC	SS&C Technologies Holdings, Inc.	26.4%	14.0	15.6	39.0%	49.2%
LTXB	LegacyTexas (acquired 10/31//19 by PB)	18.9%				
BYD	Boyd Gaming Corporation	11.3%	15.6	15.1	35.3%	31.1%
BKR	Baker Hughes Company	5.8%	21.7	21.7	105.9%	54.7%
CF	CF Industries Holdings, Inc.	4.1%	17.4	19.3	165.3%	97.2%
ALK	Alaska Air Group, Inc.	2.7%	10.3	9.7	37.3%	26.0%
CNC	Centene Corporation	-0.4%	15.0	13.6	24.1%	30.2%
BA	The Boeing Company	-8.5%	20.3	22.7	29.9%	-68.6%
MPC	Marathon Petroleum Corporation	-11.9%	9.3	8.1	39.3%	11.9%
	Average	**18.2%**	**13.1**	**15.2**	**55.5%**	**36.1%**
SPY	SPDR S&P 500 ETF Trust	23.8%				

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).

Well-publicized troubles at Boeing (BA, -8.5%) have been a major drag on the portfolio despite a favorable climate for its business, as have earnings misses from Materials and Energy names like Marathon Petroleum (MPC), Baker Hughes (BKR), and CF Industries (CF). Other laggards include Centene (CNC), which hit its numbers but still saw its forward P/E fall as investors avoided government-sponsored health plans, and Alaska Air (ALK). 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 200% year-over-year EPS growth (i.e., a forward PEG of 0.11).

The top four performers were all also in the December 2018 portfolio, including private mortgage insurer NMI Holdings (NMIH) +61%, trucking company Saia (SAIA) +55%, electronic component maker KEMET Corp (KEM) +42%, and steel maker Commercial Metals (CMC) +35%. In addition, application software firm SS&C Technologies (SSNC, +26%) has come on strong after a big fall last summer. And Legacy Texas Bank (LTXB) was acquired by Prosperity Bancshares (PB). Several names still display sufficiently attractive GARP properties today to be considered for new portfolios, including NMIH, BYD, BKR, CF, ALK, BA, and MPC.

Looking ahead, although we may well see a correction to test bullish conviction, there is no recession in sight, and investor sentiment is starting to ignore the fearmongers and move from risk-averse to risk-embracing, which better matches the positive fundamental outlook for the US economy. Tailwinds for 2020 include ongoing monetary stimulus (low interest rates and easy access to credit), ongoing fiscal stimulus (low tax rates and deregulation), record low unemployment, low inflation, lofty consumer confidence, improving business confidence, and solutions to the trade wars. Moreover, there is plenty of idle cash still on the sidelines, and although investor confidence is growing more optimistic, most investors are still far from "exuberant." Instead of a recession, I think we are likely to see a continued rotation out of wildly popular growth/momentum stocks of recent years and into the vast sea of overlooked names (especially many in the small and mid capitalizations) 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. Please feel free to contact me directly anytime!