Sabrient Commentary – March 2020 (as of 3/17/2020)

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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 created a historic valuation divergence of large-cap/low-volatility/defensives over small-cap/value/cyclicals. This was unfavorable for Sabrient's *Growth at a Reasonable Price* (GARP) portfolios.
2. **COVID-19 hits a highly-valued stock market in a highly-leveraged economy:** The valuation divergence finally gave way to a nearly 4-month risk-on convergence starting in August 2019 that benefited Sabrient portfolios, but the emergence of COVID-19 in late-December again turned investor sentiment defensive. And as valuations became elevated, the market was ripe for a correction, which was 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 dominance of algorithmic trading. This turn of events hurt Sabrient portfolios.
3. **New process enhancements:** In response to the "new normal" market conditions, Sabrient has 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.
4. **Review of terminating February 2019 and March 2019 *Baker's Dozen* portfolios:** Both portfolios were hindered by allocation tilts toward cyclical sectors, small-mid caps, the value factor and equal weighting. Although these segments typically outperform in a growing economy, cautious investors preferred mega-caps and defensive sectors, giving the cap-weighted S&P 500 benchmark a big advantage.

Market Observations:

From its intraday all-time high on 2/19/20 to the intraday low on 3/17/20 (i.e., less than one month), the S&P 500 fell -30%. This indeed has been the proverbial "waterfall decline" typically associated with a Black Swan event – this time driven primarily by fears that the COVID-19 pandemic will bring the global economy to a standstill, and exacerbated by a crash in oil prices (the largest single-day collapse in crude since 1991 due to the spat between Saudi Arabia and Russia on curtailing production). Moreover, as has become common in recent years, most asset classes have been highly correlated, leaving no place to hide other than in US Treasuries, so high leverage has led to margin calls leading to mass liquidations into the safety of Treasuries and cash. Even gold and cryptocurrencies have largely sold off rather than serve as the safe havens from financial distress they are intended to be, as global traders need cold hard cash, pushing up the US dollar. And, at least initially, neither Financial Crisis-era monetary policies – slashing the fed funds rate to zero (ZIRP), pumping liquidity into the banking system by buying up Treasuries and mortgage-backed securities across the yield curve (QE), and launching a commercial paper funding facility – nor the promise of new fiscal stimulus and an emergency aid package, have done much to staunch the panic.

The market panic led to a massive rotation of capital from stocks into the traditional safe haven of US Treasuries, driving down the 10-year yield below 1.0% for the first time ever, ultimately falling to an unheard-of 0.398% on Monday 3/9/20 (ironically, the 11th anniversary of the low point in US equities before the recovery from the Financial Crisis) before recovering back above 1.0%.

It's worth noting that market conditions were ripe for a correction even before fears of a pandemic began to proliferate. Stock valuations had become quite elevated (with the S&P 500 reaching a forward P/E of 19x) and market internals were showing signs of worry. After a 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 the emerging coronavirus 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.

However, perhaps the extreme selling is reaching a climax and an investable bottom. The past several days have seen the largest percentage losses since Black Monday in 1987. The CBOE Volatility Index (VIX) hit a new all-time closing high on 3/16/20 of 82.69, and an intraday high of 84.83 on 3/17/20 that is second only to the 89.53 reached on 10/24/2008 during the Financial Crisis. Notably, over the past 30 years, outside of the 2008-9 Financial Crisis, there have been *only two days* in which there was an intraday reading higher than 50. So, this is indeed an anomalous time caused by a rare *generational* event. And historically, such an extreme level of fear has been a contrarian indicator of final capitulation (or selling exhaustion), leading to recovery.

Let's take a closer look at the past 12 months, which roughly corresponds to the life of the March 2019 *Baker's Dozen* portfolio. As shown in the chart below, the portfolio's default benchmark, the cap-weighted S&P 500, which of course is dominated by a handful of mega-cap Tech secular growth juggernauts, handily outperformed its equal-weighted brethren, including the S&P 500 Equal-Weight (RSP), the Russell 1000 Equal-Weight (EQAL), and the S&P 600 Small Cap Equal-Weight (EWSC), through the market top on 2/29/20. And even during the waterfall selloff, the outperformance continued. This has made it quite difficult for any cap-diversified, equal-weight portfolio to keep up with the narrow leadership of the S&P 500.

Moreover, the Value factor and small-mid caps have lagged the Growth and Momentum factors and large caps throughout, according to S&P Dow Jones Indices, and the historic performance divergence of large caps and low-volatility/defensives over small caps and value/cyclicals keeps widening. Billionaire quant hedge fund manager Cliff Asness of AQR Capital recently observed that, even as the market was hitting new highs on 2/19/20, the 2020 YTD large cap Value relative performance to Growth is in the zeroth percentile of all observations since 2010 (when Growth began to consistently outperform Value), which means that the first 6 weeks of 2020 was *the worst 6-week period for value investing in the past 10 years*. And although Sabrient doesn't employ a strict value strategy (which is why we were able to outperform for most of the past 10 years), our GARP approach does have a strong value bent.

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-mid caps, as secular-growth Technology companies and large caps in general have been 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 through August 2019) of the China trade war escalation.

Thus, it has become evident to us at Sabrient 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 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).

So, we have implemented two new enhancements to our existing "Growth at a Reasonable Price" (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.

These enhancements include guardrails against extreme sector tilts away from the benchmark S&P 500's allocations and our proprietary new *Growth Quality Rank (GQR)*, which was developed as an alpha factor to add to the quant model. 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).

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

Many of Sabrient's portfolios that were live during that challenging 18-month period (March 2018 – August 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 February 2019 and March 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 had become 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 **February 2019 *Baker's Dozen*** model portfolio in aggregate has fallen well short of expected earnings, but several names have beaten estimates, and over the next 12 months are expected to grow EPS significantly. Like most of our monthly *Baker's Dozen* portfolios, it was challenged by a defensive turn in sentiment in April and August, but unlike many of the other portfolios, 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 risk-on recovery period, the portfolio total return was only +14.6% versus the S&P 500 benchmark total return of +13.4%.

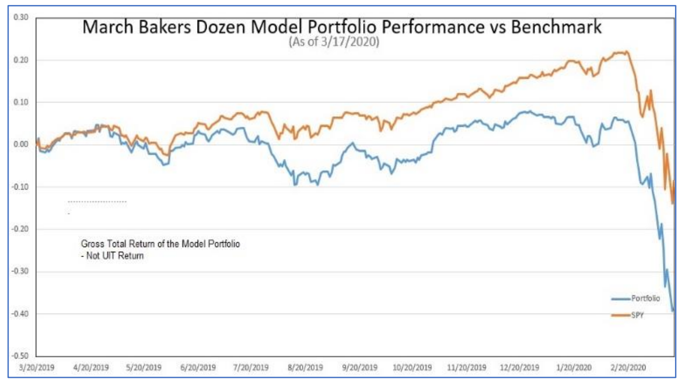
It launched with a 38% allocation (versus 17% in the S&P 500) to attractively valued cyclical sectors Industrials (23% vs. 10%), Energy (7.7% vs. 4.5%), and Materials (7.7% vs. 2.7%). Moreover, it had a 69% allocation to small-mid caps (vs. the S&P 500 benchmark being solely a large cap index), and large caps have greatly outperformed small-mid caps over 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 the 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 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.	36.0%				
MLNX	Mellanox Technologies, Ltd.	6.5%	16.4	14.7	23.9%	42.8%
CNC	Centene Corporation	-11.2%	15.2	12.3	19.1%	23.8%
TRV	The Travelers Companies, Inc.	-25.7%	11.6	9.3	24.3%	7.4%
SSNC	SS&C Technologies Holdings, Inc.	-33.7%	15.9	9.5	31.4%	32.5%
URI	United Rentals, Inc.	-40.2%	7.0	4.1	18.0%	20.2%
SYF	Synchrony Financial	-45.1%	7.3	4.4	16.4%	14.4%
CF	CF Industries Holdings, Inc.	-45.8%	17.9	12.7	102.7%	66.6%
ALK	Alaska Air Group, Inc.	-48.6%	9.6	6.5	50.1%	44.2%
CVLT	Commvault Systems, Inc.	-55.3%	30.7	18.5	38.7%	0.6%
BYD	Boyd Gaming Corporation	-60.8%	17.0	5.5	35.5%	34.8%
BA	The Boeing Company	-70.6%	20.6	29.9	26.0%	-122.1%
DK	Delek US Holdings, Inc.	-71.4%	6.7	13.5	50.5%	-25.7%
	Average	**-35.8%**	**14.7**	**11.7**	**36.4%**	**11.6%**
SPY	S&P 500 cap-weighted index	-7.5%				
RSP	S&P 500 equal-weighted index	-17.9%				

Unlike our stronger-performing portfolios that have enjoyed at least one big breakout performer, the February 2019 portfolio never had a big winner. The top gainer is 5G infrastructure company **Zayo Group (ZAYO)**, which signed a deal last May to be acquired for $35/share, which capped its performance at about 36% (and also insulated against the big selloff – the one silver lining). The only other positive performer was semiconductor / networking firm **Mellanox (MLNX)**, +6.5%. Others like casino operator **Boyd Gaming (BYD)**, industrial equipment rental firm **United Rentals (URI)**, and application software firm **SS&C Technologies (SSNC)** fell precipitously from positive returns to deeply negative.

Of the worst underperformers, **Boeing (BA)**, -70.6%, has been the name most in the news due to its issues with the 737 MAX, and then the pandemic's impact on airlines and canceled orders has pushed the firm to the edge of bankruptcy such that a federal bailout may be necessary given its critical role as a duopoly (along with Airbus) in aircraft manufacturing and all the suppliers and contractors that rely upon it. If it survives, analyst expectations call for a big comeback next year in EPS growth. But it is not even the worst performer as oil refiner **Delek US (DK)**, -71.4%, has sold off with the refining segment (and Energy as a whole) even though consumer spending has been strong. Cybersecurity firm **Commvault Systems (CVLT)**, -55.3%, failed to meet expectations and its next 12 months expectations remain uninspiring. And of course, **Alaska Air (ALK)**, -48.6%, has been slammed by a huge cutback in travel. Health plan provider **Centene (CNC)**, -11.2%, has held up relatively well. Although it has shown better than expected earnings and analysts forecast solid growth over the next 12 months, investors were avoiding it due to the political climate threatening to adopt "Medicare for All." But with Joe Biden seemingly destined for the Democratic nomination over Bernie Sanders, the threat has waned.

Similarly, the **March 2019 *Baker's Dozen*** model portfolio in aggregate has fallen short of earnings expectations, but several names have beaten estimates, and over the next 12 months the aggregate forecast still shows nearly 10% EPS growth (although that might change as the sell-side analyst community reruns its models. Strikingly, *the forward P/E has fallen from 14.6x at launch to only 9.2x today.* The portfolio launched shortly before investor sentiment turned defensive in April, although it fared somewhat better than the February portfolio during the 8/27/19-12/31/19 risk-on period, with a total return of +16.4% versus the S&P 500 benchmark total return of +13.4%. Nevertheless, it also was hobbled by a lack of breakout winners, with only 5G infrastructure company **Zayo Group (ZAYO)** in the green due to having been acquired and taken private at $35/share, which locked in its performance in the portfolio at +25.4%.



The portfolio launched with a 46% allocation (versus 17% in the S&P 500) to attractively valued cyclical sectors Industrials (30.8% vs. 10%), Energy (0% vs. 4.5%), and Materials (15.4% vs. 2.7%). 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 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) while 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 over the full timeframe, again illustrating the dominance of mega-cap Technology on 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.	25.4%				
AME	AMETEK, Inc.	-18.5%	20.0	15.4	23.3%	27.4%
ANTM	Anthem, Inc.	-21.3%	16.1	10.6	20.1%	22.1%
HLT	Hilton Worldwide Holdings Inc.	-23.7%	22.2	15.3	37.2%	39.1%
TRV	The Travelers Companies, Inc.	-26.6%	11.9	9.3	24.7%	7.4%
URI	United Rentals, Inc.	-29.9%	6.3	4.1	18.0%	20.2%
AGCO	AGCO Corporation	-33.0%	14.5	9.2	19.7%	14.1%
SSNC	SS&C Technologies Holdings, Inc.	-36.7%	16.6	9.5	30.8%	32.5%
CF	CF Industries Holdings, Inc.	-41.9%	18.1	12.7	101.4%	66.6%
VST	Vistra Energy Corp.	-49.6%	11.9	5.5	211.9%	69.9%
BYD	Boyd Gaming Corporation	-59.7%	15.8	5.5	33.5%	34.8%
ATI	Allegheny Technologies Incorporated	-67.0%	13.8	10.5	24.8%	-19.9%
SAVE	Spirit Airlines, Inc.	-77.7%	8.1	2.3	49.8%	15.7%
	Average	**-35.4%**	**14.6**	**9.2**	**49.6%**	**27.5%**
SPY	SPDR S&P 500 ETF Trust	-8.9%				
RSP	S&P 500 equal-weighted index	-17.6%				

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. Despite being deeply in the negative, specialty industrial electronics maker **AMETEK (AME)**, -18.5%, health plan provider **Anthem (ANTM)**, -21.3%, and hotel/resort company **Hilton Worldwide (HLT)**, -23.7%, have each exceeded EPS expectations. Like Centene in the February portfolio, Anthem has been hobbled for quite a while by the political threat of adoption of Medicare for All, but more recently has shown greater investor confidence.

Among the worst performers, **Spirit Airlines (SAVE)**, -77.7%, has been hit hard by the woes of airlines and travel industry, casino operator **Boyd Gaming (BYD)**, -59.7%, has been hit by travel and crowd-control measures, and Materials firms like specialty materials and components maker **Allegheny Technologies (ATI)**, -67.0%, and fertilizer maker **CF Industries (CF)**, -41.9%, have been struggling with global industrial weakness and falling oil and commodities prices due to the trade war followed by the pandemic threat. Even independent power producer **Vistra Energy (VST)**, -49.6%, from the normally defensive Utilities sector has succumbed to the latest market turmoil.

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. Nevertheless, as I mentioned earlier, we expect our new process enhancements to help cushion the blow whenever defensive sentiment arises in contrast to a positive outlook, with minimal reduction to the upside potential during more rational times when sentiment and outlook are aligned.

Looking ahead, we can no longer claim that there is no recession in sight, as the COVID-19 pandemic has become a *generational event* that, at least for the next several weeks, will completely shut down much of the US and global economies. But the good news is that, after a -30% correction, valuations today may be largely pricing in a short recession, and stocks may be in the process of bottoming (perhaps after a successful retest of the 12/24/2018 lows). Tailwinds include massive monetary and fiscal stimulus, sound fundamentals (especially the labor market) before the pandemic, and new trade deals (Phase 1 with China and the USMCA with Mexico and Canada), which are expected to lead a robust recovery in H2. Moreover, there was already plenty of idle cash still on the sidelines, including trillions of dollars sitting in money market funds, and with all the recent asset liquidations and new central bank liquidity flooding the market, there is even more that may eventually flow back into equities in risk-on fashion once COVID-19 is under control.

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.