# **Sabrient Commentary – May 2020** (as of 5/8/2020)

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

This month's commentary discusses these topics:

1. **Investors position for recovery from COVID-19 shutdown:** Although the current forward P/E of the S&P 500 of 20x seems overvalued based on historical valuations, in our view the current rally is justified, with room for *further multiple expansion* before earnings begin to catch up, due to: massive monetary and fiscal stimulus, negative real interest rates that favor long duration, anticipation of deescalating tensions with China, and investor speculation on a strong recovery from the shutdown.
2. **A "new normal" of unpredictable market conditions:** In retrospect, after 6-1/2 years in which the *Baker's Dozen* portfolios consistently outperformed, mid-2015 marked the beginning of a "new normal" in which markets have been dominated by macro events, which changed investor sentiment to be more cautious and defensive, and thus wary of *cyclical* growth and smaller caps (despite a positive economic outlook) while pushing large-cap *secular* growth companies to elevated P/E multiples.
3. **New process enhancements:** In response to this "new normal," Sabrient has enhanced its *Baker's Dozen* selection strategy to *improve all-weather performance and reduce relative volatility* versus the benchmark S&P 500, as well as to put *secular*-growth companies (which often display higher valuations) on more equal footing with *cyclical*-growth firms (which tend to display lower valuations). The two enhancements include: 1) new limits on extreme sector "tilts" versus the benchmark's allocations, and 2) the addition of our new proprietary *Growth Quality Rank* (GQR) as an alpha factor that measures the *consistency and reliability* of a company's earnings and thus its likelihood of meeting estimates.
4. **Review of terminating April 2019 and May 2019 *Baker's Dozen* Model 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 an advantage over Sabrient's portfolios and most broad-market equal-weight indexes.

**Market Observations:**

Optimism reigns for the coronavirus pandemic slowing and the economy reopening. And because stocks tend to be 3-6 months forward looking (and remarkably predictive, at that), April saw the best single-month performance for the S&P 500 in 33 years (+12.7%), while the Nasdaq saw its best month in 20 years (+15.4%). Notably, the S&P 500 Growth Index recorded its highest ever monthly returns, according to S&P Dow Jones Indices. In addition, gold and bitcoin have been rising as a hedge against all sorts of outcomes, including geopolitical instability, trade wars, de-globalization, unfettered monetary & fiscal liquidity, inflation, a weakening dollar, a "toppy" bond market, etc. (plus the periodic bitcoin "halving" event that occurs this week).

This impressive rally off the lows seems justified given: 1) the coronavirus, as bad as it is, falling well short of the dire lethality predictions of the early models and the ability to "flatten the curve," 2) massive monetary and fiscal policy support and the associated reduction in credit risk, 3) household income holding up relatively well, as the main impact has been on lower wage workers who can't work remotely and government support should cover much of their losses, 4) escalation of tensions with China seems to be "all hat and no cattle" for now with a focus on economic recovery, and 5) the growing dominance and consistent performance of the secular-growth Technology sector plus other "near-Tech" names [like Facebook (FB) and Amazon.com (AMZN)]. As further confirmation, the yield curve has been steepening, and if capital indeed continues to rotate out of the "bond bubble," longer-term yields should keep rising, which further validates the rise in equities.

In retrospect, 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" in which markets have been dominated by macro events like the rise of populism and protectionism, Federal Reserve policy, China's unwieldy debt and slowing growth, a highly polarized US electorate, the dominance of secular growth Technology on the market indexes, trade wars, contraction in the manufacturing segment, and reduced corporate capital spending. This has changed the character of investor sentiment to be more cautious and defensive, and thus wary of *cyclical* growth and smaller caps (despite a positive economic outlook) while pushing large-cap *secular* growth companies to elevated P/E multiples. Finally, starting on 8/27/2019, the market saw the sustained risk-on rotation back into the value factor, cyclical sectors, and small-mid caps that one would expect given the positive outlook of rising GDP growth, a strong consumer, record low unemployment, and low interest rates … at least until the coronavirus was unleashed upon us.

The upper chart on the left shows a performance comparison of the cap-weighted S&P 500 versus other broad-market equal-weighted indexes from when the market starkly bifurcated due to the China trade war escalating to actual tariffs on 6/11/18 until the depths of the COVID-19 selloff on 3/23/20. The **cap-weighted S&P 500 (SPY), which is dominated by a handful of mega-cap Tech juggernauts, handily beat most broad-market equal-weight indexes,** including the S&P 500 Equal-Weight (RSP), S&P 400 Mid-Cap Equal-Weight (EWMC), and S&P 600 Small Cap Equal-weight (EWSC), and S&P 500 Equal-Weight Energy (RYE). The lone exception is the NASDAQ 100 Equal Weight (QQEW), which slightly outperformed SPY over the period, but QQEW is 40% Technology, while SPY is 25% Tech!

The lower chart shows the same comparison during the broad-based recovery rally from 3/23/20 through current (5/8/20), with substantial outperformance of those same equal-weight indexes over the SPY.

This illustrates how difficult it has been for cap-diversified equal-weight portfolios (and in fact most active strategies) to keep up with the narrow leadership of the S&P 500. Moreover, according to DataTrek, the average performance from the 2/19/20 market peak through 5/8/20 was -21.8% for *large cap cyclical* sectors and -30.7% for *small cap cyclicals* compared to -13.5% for the SPY.

In any case, it became clear to us of a "new normal" in cautious, news-driven investor sentiment characterized by a penchant for defensive sectors and *secular* growth, and dominated by passive index investing and algorithmic trading, which actually began to develop in mid-2015 when the populist movement gained steam and the Fed announced a desire to begin tightening monetary policy. This "new normal" has severely handicapped risk-on market segments like small-mid caps, value stocks, and cyclical sectors in favor of mega-cap Tech juggernauts, long-term secular growth industries, and "bond proxy" dividend-paying defensive sectors.

In response, Sabrient has enhanced our forward-looking and valuation-oriented *Baker's Dozen* GARP strategy to *improve all-weather performance and reduce relative volatility* versus the benchmark S&P 500, as well as to put *secular*-growth companies (which often display higher valuations) on more equal footing with *cyclical*-growth firms (which tend to display lower valuations). The two enhancements include: 1) new limits on extreme sector "tilts" versus the benchmark's allocations, and 2) the addition of our new proprietary *Growth Quality Rank* (GQR) as an alpha factor that measures the *consistency and reliability* of a company's earnings and thus its likelihood of meeting estimates.

I still think we are in the early stages of a new expansionary cycle that could run for several years, driven by an upswing in manufacturing activity, infrastructure spending, and new technologies like 5G, the Internet of Things (IoT), AI/ML, robotics, clean energy, blockchain, quantum computing, nanotechnology, genomics, and precision medicine – so it was important that our enhanced strategy give solid consideration to players in these market segments.

**Comments on the terminating April 2019 and May 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.

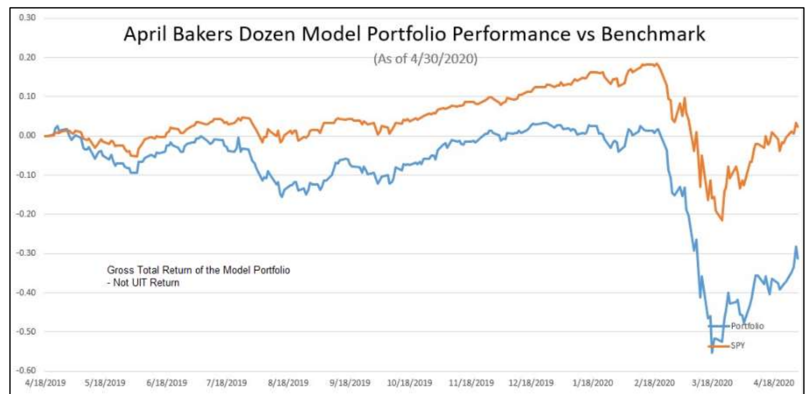
However, an investor penchant for those highly-valued market segments has persisted, especially during that challenging 18-month period (March 2018 – August 2019) of China trade war, and Sabrient's portfolios that were live during that timeframe absorbed pain.

Of course, in a concentrated 13-stock portfolio, a few breakout winners can overcome a number of laggards, but the April 2019 and May 2019 portfolios have lagged the benchmark S&P 500 due to both a shortage of breakout stars and narrow market leadership during most of the subject timeframe, as capital flowed into secular-growth mega-cap Tech and "bond proxy" dividend-paying defensive sectors, creating a *relative-valuation bubble*. 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, further illustrating narrow market leadership.

Relative to the benchmark S&P 500, Sabrient's portfolios launched with equal weights (vs. market cap weights) on all positions, an overweight allocation to small and mid-caps, an overweight aggregate allocation to the highly cyclical industrials, energy, and materials sectors, and an overweight in travel/leisure/hospitality 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 often leads to a value tilt; however, the growth factor significantly outperformed the value factor over the life of the portfolio. ***Each of these four tilts (position weights, sectors, cap sizes, and growth/value) hurt the portfolio's relative performance versus the market-cap-weighted S&P 500 index***, which is dominated by the mega-caps, Technology sector, and growth factor preferred by cautious investors amid rancorous trade wars, impeachment, electioneering, and pandemic. As such, the benchmark enjoyed a big advantage over the *Baker's Dozen* portfolios *as well as most 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 **April 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. Like most of our recent *Baker's Dozen* portfolios, it was challenged by frequent and persistent defensive turns in sentiment. Nevertheless, it showed significant outperformance during the 8/27/19-12/19/19 period of sustained risk-on sentiment with **a total return of +21.4% versus the S&P 500 benchmark total return of +12.4%**, and more recently, during the 3/23/20-4/29/20 recovery rally, **it returned +51.2% versus +31.6% for the S&P 500**. Still, this wasn't enough to overcome a shortage of breakout winners 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. Moreover, it had a significant allocation (30.8%) in airlines, hotel, restaurant, and gaming industries that have seen outsized impact from the Coronavirus pandemic. In addition, 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 while the benchmark has a large-cap size focus that is further exaggerated by its market-cap weighting. In addition, although we consider all our stocks selections to have solid growth outlooks, our GARP portfolios typically have a Value tilt (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 through Friday, 5/8/20. The average performance of the portfolio's positions is **-31.0%** versus the S&P 500 cap-weighted performance of +2.9%. **But when you consider the S&P 500 equal-weight index at -8.3%, and S&P 600 small-cap equal-weight index at -22.4%, the relative performance picture is a little different.**

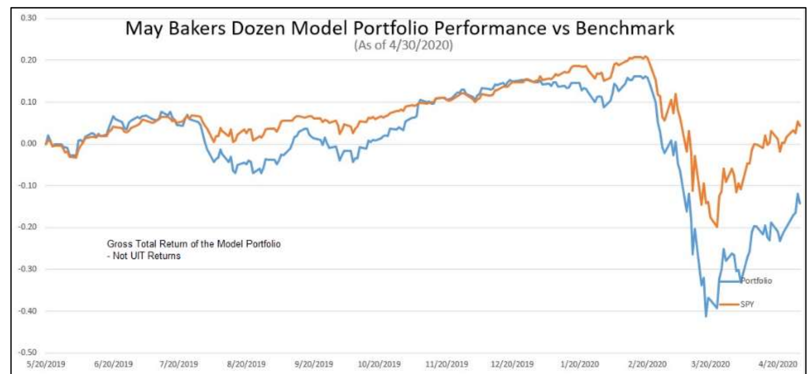
| Ticker | Company Name | Return | Fwd P/E at Launch | Current Fwd P/E | Est. NTM EPS Growth at Launch | Actual EPS Growth |
|---|---|---|---|---|---|---|
| PCRX | Pacira BioSciences, Inc. | 14.3% | 24.9 | 23.9 | 41.5% | 59.7% |
| CMC | Commercial Metals Company | -1.4% | 7.5 | 9.1 | 52.0% | 72.3% |
| SSNC | SS&C Technologies Holdings, Inc. | -8.1% | 16.9 | 15.0 | 30.9% | 20.8% |
| URI | United Rentals, Inc. | -12.1% | 6.5 | 10.2 | 18.0% | 17.3% |
| VAC | Marriott Vacations Worldwide Corpo | -19.7% | 13.6 | 27.3 | 30.7% | 33.1% |
| CVLT | Commvault Systems, Inc. | -26.6% | 27.7 | 30.1 | 37.7% | 0.6% |
| TRV | The Travelers Companies, Inc. | -28.3% | 12.3 | 10.5 | 23.6% | 0.9% |
| CF | CF Industries Holdings, Inc. | -33.9% | 20.1 | 17.4 | 92.1% | 65.0% |
| BYD | Boyd Gaming Corporation | -39.2% | 17.1 | NE | 31.3% | -2.2% |
| NMIH | NMI Holdings, Inc. | -45.5% | 12.1 | 7.7 | 35.0% | 48.9% |
| DIN | Dine Brands Global, Inc. | -49.5% | 12.2 | 36.4 | 33.2% | 5.4% |
| GLOG | GasLog Ltd. | -71.9% | 17.3 | 12.1 | 64.8% | -52.2% |
| SAVE | Spirit Airlines, Inc. | -81.2% | 9.1 | NE | 38.7% | -29.4% |
| | **Average** | **-31.0%** | **15.2** | **18.2** | **40.7%** | **18.5%** |
| SPY | SPDR S&P 500 ETF Trust | 2.9% | | | | |
| RSP | S&P 500 equal-weighted index | -8.3% | | | | |
| EWSC | S&P 600 equal-weighted index | -22.4% | | | | |

The best performer in the portfolio by far has been **Pacira BioSciences (PCRX)**, a specialty drug maker focused on non-opioid pain management and regenerative health solutions. No other positions ducked the selloff, although specialty steel firm **Commercial Metals (CMC)** and application software maker **SS&C Technologies (SSNC)** held up a little better than the others.

The worst performers in the portfolio are **Spirit Airlines (SAVE)**, Greek liquefied natural gas (LNG) carrier **GasLog (GLOG)**, restaurant operator **Dine Brands Global (DIN)**, and private mortgage insurer **NMI Holdings (NMIH)**, all of which were down well over 40%. Other double-digit underperformers include industrial equipment rental firm **United Rentals (URI)**, hotel/resort operator **Marriott Vacations Worldwide (VAC)**, data protection software firm **Commvault Systems (CVLT)**, insurer **The Travelers (TRV)**, fertilizer maker **CF Industries (CF)**, and casino operator **Boyd Gaming (BYD)**. Of course, airlines, restaurants, hotels, and casinos have been decimated by the pandemic and associated travel restrictions and social distancing, while LNG prices have fallen hard along with oil.

Notice that the top performers either beat or came close to meeting EPS estimates, while the laggards typically badly missed EPS expectations. The one exception is NMIH, which has handily *beat* earnings expectations in a robust real estate market but still sold off in the face of an uncertain housing outlook. (Note: NMIH was a top performer in previous portfolios.)

The **May 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, this portfolio has fallen only a little short of expected earnings, and 9 of the 13 names have beaten or come close to EPS estimates. Like most of our recent *Baker's Dozen* portfolios, it was challenged by frequent and persistent defensive turns in sentiment. Nevertheless, it showed significant outperformance during the 8/27/19-12/19/19 period of sustained risk-on sentiment with **a total return of +23.7% versus the S&P 500 benchmark total return of +12.4%**, and more recently, during the 3/23/20-4/29/20 recovery rally, **it returned +45.6% versus +31.6% for the S&P 500**. Still, this wasn't enough to overcome a shortage of breakout winners and unfavorable allocation "tilts."




The portfolio launched with a 31% allocation (vs. 17% allocation in the benchmark) to attractively valued "deep cyclical" sectors – Industrial (7.7% 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 (15.4%) in 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 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 (primarily based on price/book), and indeed the May 2019 portfolio carried only a 30.8% 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. And again, 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 through Friday, 5/8/20. You can see that the average performance of the portfolio's positions is **-14.1%** versus the S&P 500 cap-weighted performance of +5.1%. **But when you consider the S&P 500 equal-weight index, -5.5%, and S&P 600 small-cap equal-weight index, -18.8%, the relative performance picture is quite different.**

| 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 | 15.8% | 6.5 | 9.1 | 53.6% | 72.3% |
| AIZ | Assurant, Inc. | 4.9% | 10.6 | 10.4 | 44.3% | 44.6% |
| ANTM | Anthem, Inc. | 4.3% | 13.0 | 12.0 | 23.3% | 20.2% |
| SSNC | SS&C Technologies Holdings, Inc. | 2.2% | 15.0 | 15.0 | 19.8% | 20.8% |
| GDDY | GoDaddy Inc. | 1.1% | 22.2 | 19.4 | 56.2% | 29.5% |
| PCRX | Pacira BioSciences, Inc. | -2.9% | 26.1 | 23.9 | 35.3% | 59.7% |
| URI | United Rentals, Inc. | -3.6% | 6.5 | 10.2 | 16.6% | 17.3% |
| VAC | Marriott Vacations Worldwide Corpo | -11.7% | 12.0 | 27.3 | 35.3% | 43.6% |
| AXTA | Axalta Coating Systems Ltd. | -20.8% | 14.4 | 22.4 | 31.1% | 30.1% |
| BYD | Boyd Gaming Corporation | -30.2% | 14.1 | NE | 36.1% | -2.2% |
| MCY | Mercury General Corporation | -32.4% | 15.0 | 12.9 | 42.6% | 7.7% |
| NMIH | NMI Holdings, Inc. | -47.9% | 11.1 | 7.7 | 31.1% | 48.9% |
| BOOM | DMC Global Inc. | -62.3% | 20.0 | 124.7 | 37.8% | 17.6% |
| | **Average** | **-14.1%** | **14.3** | **24.6** | **35.6%** | **31.5%** |
| SPY | SPDR S&P 500 ETF Trust | 5.1% | | | | |
| RSP | S&P 500 equal-weighted index | -5.5% | | | | |
| EWSC | S&P 600 equal-weighted index | -18.8% | | | | |

The best performer in the portfolio by far has been **Commercial Metals (CMC)**, a specialty steel maker (especially proprietary rebar) with a major recycling operation. Others in the black include **Assurant (AIZ)**, a specialty insurer known for its cell phone protection plans and extended contracts for consumer electronics, health benefits firm **Anthem (ANTM)**, application software maker **SS&C Technologies (SSNC)**, and **GoDaddy (GDDY)**, which provides domain registration and website hosting.

Not surprisingly, the worst performer in the portfolio is **DMC Global (BOOM)**, which provides oil & gas equipment and services, primarily for fracking. Other double-digit losers were from value-oriented financial, hospitality, and chemicals industries, including private mortgage insurer **NMI Holdings (NMIH)**, P&C insurer **Mercury General (MCY)**, casino operator **Boyd Gaming (BYD)**, specialty chemical maker **Axalta Coating Systems (AXTA)**, and hotel/resort operator **Marriott Vacations Worldwide (VAC)**. Others that are slightly in the negative as of 5/8/20 include industrial equipment rental firm **United Rentals (URI)** and **Pacira BioSciences (PCRX)**, which makes specialty drugs focused on non-opioid pain management and regenerative health solutions.

Again, like in the April 2019 portfolio, the better performers generally either beat or came close to meeting EPS estimates, while the worst performers typically badly missed expectations, with the most obvious exception being NMIH, which has handily *beat* earnings expectations but still sold off given an uncertain housing outlook. (Note: NMIH was a top performer in previous portfolios.)

**Final Thoughts:**

Looking ahead, even as the economy reopens and corporate earnings begin to recover, I don't envision a full reopening and a return to "normalized" earnings until well after there is both a COVID-19 vaccine and an effective treatment, which could take years. Moreover, I expect the Fed will maintain low rates and accommodative policies until the *average* worker is seeing benefits – and there will be more stimulus to come if necessary.

Therefore, although the current forward P/E of the S&P 500 of 20x seems overvalued based on historical valuations, I think in today's unprecedented climate there is room for *further multiple expansion* to perhaps 23-25x or even more, before earnings begin to catch up. Why? Because of: 1) the far-reaching monetary and fiscal stimulus and massive liquidity injections, 2) negative real interest rates that favor long duration on a discounted cash flow basis, and 3) investor speculation on a strong recovery phase in the economy, a rejuvenation in corporate capital spending, and a gradual improvement in corporate earnings, with leadership driven by *secular growth* in Technology, Comm Services, and Healthcare sectors, as well as onshoring of supply chains and manufacturing operations and increased infrastructure spending that should also boost *cyclical growth* sectors – although with elevated volatility.

Sabrient's model-driven portfolio selection 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. Nevertheless, we expect our new process enhancements to help boost all-weather performance by: 1) reducing relative volatility versus the benchmark, 2) improving the likelihood that selected stocks will meet their earnings estimates, and 3) boosting the rankings of many secular growth companies that tend to maintain investor enthusiasm and putting them on more equal footing with the cyclical growth companies that typically display the best GARP qualities in a growing economy.

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.

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