Sabrient Commentary – November 2020 (as of 11/6/2020)

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This month's commentary covers the following talking points, including discussion of **market conditions and their impact on the terminating October 2019 *Baker's Dozen***, as well as the impact of process enhancements on new portfolios going forward:

1. **The past 2 years (since the China trade war escalated in June 2018) have been unkind to the value factor**, cyclical sectors, and valuation-based strategies like Sabrient's. This led to an historic market bifurcation with large caps, growth factor, and the secular-growth Technology sector greatly outperforming small caps, value factor, and cyclical growth sectors (like Financial, Industrial, Materials, Energy). In addition, narrow leadership means a handful of stocks thrive, and cap-weighted indexes have greatly outperformed equal-weighted indexes.
2. **The terminating October 2019 *Baker's Dozen* portfolio** launched with equal position weights and overweight allocations (relative to the S&P 500 benchmark) to small/mid-caps, cyclical sectors, and the value factor, as indicated by our quant model. *Each of these four tilts (position weightings, cap sizes, sectors, and value/growth) hurt relative performance versus the benchmark, which is market cap-weighted and dominated by mega-caps, Technology sector, and the growth factor,* giving the benchmark an advantage over the portfolio as well as most equal-weight, broad-market indexes. The portfolio was also hurt by a lack of breakout winners and by holding travel/leisure stocks during the pandemic.
3. However, since mid-May 2020, **market breadth has been improving and small caps, value, and cyclicals have outperformed**. Also, post-election suggests an infrastructure spending bill and higher inflation will further boost these segments. Our expectation is that Value/Growth and Small/Large performance ratios will continue to revert and market leadership will broaden such that strategic beta ETFs, active selection, and equal weighting will thrive once again. This should be **favorable for value, quality, and growth at a reasonable price (GARP) strategies like Sabrient's**, although not to the exclusion of high-quality secular growth stocks – i.e., investors should be positioned for both cyclical and secular growth.
4. Regardless, **Sabrient has implemented process enhancements** to make the stock selection process more "all-weather" by: (a) reducing downside volatility versus the benchmark, (b) focusing more on earnings consistency/reliability to improve the likelihood of meeting earnings estimates by adding our new Growth Quality Rank to the model, and (3) creating a better balance between secular growth and cyclical/value stocks and across market caps. Thus, secular growers like ADBE, ADSK, AMD, APPS, AMZN, CHTR, NVDA, and SEDG became competitive in our model with lower-P/E cyclical growth stocks.
5. The process enhancements were introduced in December 2019, and indeed **our newer portfolios have shown improved performance relative to the benchmark** in the "new normal" market conditions – but are still well-positioned for a broadening market and rotation into value/cyclicals.

Market observations:

With the election mercifully behind us, investors and Corporate America can move forward with a better idea of economic landscape ahead. Add to that the extraordinary results of the Pfizer (PFE) vaccine trials (90% effective!), and you can see how the clouds of uncertainty are quickly lifting. Regardless, Modern Monetary Theory (MMT) seems here to stay, as both sides of the political aisle seem to agree that the only way to prevent a COVID-induced depression in a highly indebted economy is to print even more money and become even more leveraged and indebted. Although there surely will be a day of reckoning at some point, the abundance of fiscal and monetary stimulus – with much more expected to come – should continue to propel stocks higher (along with gold and cryptocurrencies). Of course, certain industries do better than others under a given Administration, but in general I expect greater market breadth and higher prices into year-end and 2021.

Q3 real GDP growth came in at +33.1%, the highest-ever GDP growth rate. Of course, the consumer spending that supported this surge was largely the result of the $5 trillion in fiscal and monetary stimulus (aka, the dollar printing press) rather than organic economic activity. Nevertheless, it helped many at-risk businesses survive. However, the economic recovery has been more "K-shaped" than V-shaped in that segments of the economy have been strong (e.g., technology, WFH, online shopping, homebuilding, home improvement) while other segments either have struggled or have been in an outright depression (e.g., oil & gas, commercial real estate, financials, travel & leisure, dining). As a result, there is a strong push for the next round of fiscal stimulus to target lower income levels, particularly services industries.

All in all, this year has been a bit deceiving. While the growth-oriented, cap-weighted indexes have been in a strong bull market *thanks to a handful of mega-cap Tech names,* the broader market essentially has been in a downtrend since mid-2018, making it

difficult for any valuation-oriented portfolio or equal-weight index to keep up. To illustrate, below is a 5-year chart (starting 7/1/15) comparing the SPDR S&P 500 (SPY), the Technology Select Sector SPDR (XLK), the highly cyclical Industrials Select Sector SPDR (XLI), the S&P 500 LargeCap Pure Growth ETF (RPG), and the S&P 600 Small-cap Pure Value ETF (RZV). This chart illustrates the stark market bifurcation and relative performance gaps between large vs. small, growth vs. value, and secular-growth vs. cyclical-growth. (Note: Highly cyclical and value-oriented sectors would include Financials, Industrials, Materials, and Energy.)

You can see that after the 2016 election, market breadth and the value factor got a nice but short-lived boost during the "Trump Bump," and then in mid-2018 the trade war with China created a stark and historic market bifurcation due to uncertainty rather than a significant cut to earnings expectations, and the bifurcation has only gotten worse this year due to COVID, economic lockdowns, civil unrest, and a rancorous election campaign. I have highlighted this dynamic with the fan lines tracing the uptrend in RPG versus the downtrend in RZV since mid-2018. The major market-cap-weighted indexes continued to hit new highs, primarily on the backs of the five mega-cap secular-growth Tech stocks – namely Apple (AAPL), Amazon (AMZN), Microsoft (MSFT), Alphabet (GOOGL), Facebook (FB), aka "FAAAM" – while a large swath of the market has been quite weak. As a result, for the past two years plus, valuation-oriented portfolios like Sabrient's underperformed, *as did many broad-market equal-weighted indexes.*

However, since mid-May of this year (and especially since the September lows) we have seen signs of *greater market breadth and a rotation into value/cyclicals/small caps*, which is a bullish sign of a healthy market. To illustrate, the next chart compares the same five ETFs as the previous 5-year chart, but with much different relative performance. You can see that since 5/15/20, the small-cap Pure Value RZV and the highly cyclical Industrial Select Sector SPDR ETF (XLI) have greatly outperformed the Technology Select Sector SPDR (XLK), the large-cap Pure Growth ETF (RPG) and the SPY (which is at the bottom). Continued outperformance of Industrials may indicate the start of a new expansionary phase – fueled at least partly by expectations of an infrastructure spending bill.

Indeed, institutional buyers are back, encouraged by solid Q3 earnings reports, and they are buying the higher-quality stocks. The 5-year TIPS breakeven inflation is up to 1.63%, which is back to pre-pandemic levels. Likewise, a rising 10-year Treasury yield implies increasing confidence in economic recovery. Moreover, history suggests the next leg up for stocks will prod Treasury yields to break out to the upside. Furthermore, as credit markets continue to rally with an ongoing US economic recovery, smaller companies should see better business and credit conditions, facilitating a continued mean reversion for small caps. Market segments like Industrials and small caps typically have greater earnings leverage than large cap Tech, which provides an advantage during an expansionary phase of the economic cycle.

Going forward, our expectation is that Value/Growth and Small/Large relative performance ratios will continue to revert and market leadership will broaden such that active selection, strategic beta, and equal weighting will thrive once again. This should be favorable for value, quality, and growth at a reasonable price (GARP) strategies like Sabrient's, although not to the exclusion of high-quality secular growth stocks – i.e., *investors should be positioned for both cyclical and secular growth*.

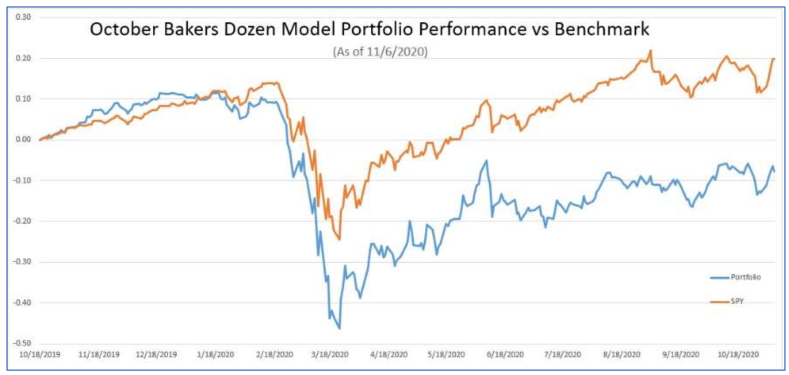
Notably, we have enhanced our GARP strategy by adding our newly developed *Growth Quality Rank (GQR)*, which rewards companies with more consistent and reliable earnings growth, putting secular-growth stocks on more competitive footing in the rankings with cyclical growth (even though their forward valuations are often higher than our GARP model previously rewarded). As a result, our newer *Baker's Dozen* portfolios launched since December 2019 reflect <u>better balance</u> between secular growth and cyclical/value stocks and across large/mid/small market caps. And those portfolios have shown markedly improved performance relative to the benchmark, even with this year's continued bifurcation. Names like Adobe (ADBE), Autodesk (ADSK), Digital Turbine (APPS), Amazon (AMZN), Charter Communications (CHTR), NVIDIA (NVDA), and SolarEdge Technologies (SEDG) became eligible with the addition of GQR, and they have been top performers. But at the same time, our portfolios are *also well-positioned for a broadening or rotation to value, cyclicals, and small caps*.

So, IMHO, this provides solid justification for an investor to take a fresh look at Sabrient's portfolios today.

Comments on the terminating October 2019 *Baker's Dozen* portfolio:

The GARP strategy employed to select the stocks for the September 2019 *Baker's Dozen* portfolio (prior to the new enhancements) is *forward-looking* in that it relies upon the consensus EPS growth estimates of the sell-side analyst community. For this portfolio, it favored the value factor, small and mid-caps, and cyclical sectors (typical for a growing economy) as our model indicated that the growth factor, large caps, and secular growth Technology were already largely "bid up" to relatively high valuations. However, an investor penchant for those highly valued market segments persisted, so Sabrient's portfolios suffered. Of course, in a concentrated 13-stock portfolio, a few breakout winners can overcome a number of laggards, but the October 2019 portfolio has lagged the benchmark S&P 500 due to a lack of breakout winners, persistently narrow market leadership, and continued expansion of the historic *relative-valuation bubble* of large-cap/growth-factor/secular-growth over small-cap/value-factor/cyclical-growth.

The October 2019 *Baker's Dozen* model portfolio started well as it launched in the midst of the 8/27/19-12/19/19 period of sustained risk-on sentiment, which occurred between the protracted period (March 2018 – August 2019) of trade war uncertainty and the onset of the COVID-19 pandemic. Although the broad market indexes continued to hit new highs this summer (on narrow leadership from secular-growth, mega-cap Technology stocks), many of the attractively valued cyclical sectors and smaller caps have continued to languish in what can be described as a K-shaped recovery, with some market segments doing quite well and others falling into a depression. In aggregate, this portfolio has fallen far short of expected earnings, with only 6 of the 13 names having beat or come close to EPS estimates. Like many of our *Baker's Dozen* portfolios over the past two years, it was challenged by frequent and persistent defensive turns in investor sentiment. Nevertheless, it showed significant outperformance since the 3/23/20 selloff low through current (11/6/20) with a return of **+70.9% versus +58.4% for the S&P 500**. Still, this was not enough to overcome a lack of breakout winners over its full life and unfavorable allocation tilts.



The portfolio launched with a 54% allocation (vs. 30% allocation in the benchmark) to attractively valued "deep cyclical" sectors – Financial (23.1% vs. 13.1%), Industrial (15.4% vs. 9.3%), Energy (0.0% vs. 4.6%), and Materials (15.4% vs. 2.7%) – which hurt relative performance over the period. Also, it had a significant allocation (15.4%) in travel & leisure industries that have seen outsized impact from the pandemic. Furthermore, it was underweight (0.0% vs. 27.5%) the Information Technology sector. Notably, concentration in the S&P 500 remains near its highest in decades as the five dominant mega-cap FAAAM stocks account for about 25% of the total market cap of the S&P 500 (versus 16% last year) and about 50% of the Nasdaq 100. Led by returns of +88.4% in AMZN and +103.2% in AAPL since the 10/18/19 launch of the October 2019 portfolio through current (11/6/20), **FAAAM have returned an average of +71.1% and contributed +16.4% to the *cap-weighted* S&P 500 return of +19.8%**, which means the other 500 stocks in the benchmark in aggregate contributed only +3.4%. Further illustrating the narrow market leadership, the cap-weight Nasdaq 100 ETF (QQQ) is up +54.8%, while the S&P 500 Equal Weight (RSP) is +8.1%, the S&P MidCap 400 Equal Weight (EWMC) is +5.2%, and the S&P SmallCap 600 Equal Weight (EWSC) is *down -1.3%* – more evidence of the historic bifurcation.

Moreover, the October 2019 portfolio had a 23.1% underweight allocation (3 positions) to large caps (vs. the S&P 500 benchmark being solely a large cap index), but large caps have greatly outperformed small-mid caps during the life of the portfolio. In addition, although we consider all our stocks to have solid growth outlooks, our GARP portfolios typically have a value tilt (primarily based on price/book), and indeed the portfolio carried only a 15.4% allocation (2 positions) to the growth factor (vs. the benchmark's 59%, which is typical of a cap-weighted index), but the growth factor greatly outperformed the value factor.

Each of these four tilts (position weights, sectors, cap sizes, and value/growth) hurt the portfolio's relative performance versus the market-cap-weighted S&P 500 index, which is dominated by mega-caps, the Technology sector, and the growth factor preferred by cautious investors amid trade wars, impeachment, electioneering, pandemic, and social unrest. As such, the benchmark enjoyed a big advantage over the *Baker's Dozen* as well as most other broad-market, equal-weight indexes during this timeframe, even though these tilts represent areas in which an investor typically would want to be positioned in an expansionary economy and ahead of a convergence of the growth/value relative-valuation bubble.

The **table below** shows model portfolio performance for the period 10/18/19-11/6/20. You can see that the average performance of the portfolio's positions is -7.7% versus the S&P 500 cap-weighted performance of +19.8%. But we also should consider the aforementioned performance of equal-weight indexes, particularly EWSC at -1.3%.

Ticker	Company Name	Return	Fwd P/E at Launch	Current Fwd P/E	Est. NTM EPS Growth at Launch	Actual EPS Growth
ANTM	Anthem, Inc.	27.3%	11.6	14.2	27.2%	32.1%
RCII	Rent-A-Center, Inc.	21.3%	11.0	8.4	31.9%	53.7%
CI	Cigna Corporation	20.8%	9.2	10.9	22.9%	26.4%
CMC	Commercial Metals Company	6.2%	8.1	10.1	26.0%	27.4%
VAC	Marriott Vacations Worldwide Corpo	5.8%	12.9	36.6	33.7%	-102.0%
KBH	KB Home	-5.4%	11.0	7.8	30.5%	34.6%
ARNC + HWM	Arconic + Howmet Aerospace	-6.6%	- Merger -			
RNR	RenaissanceRe Holdings Ltd.	-11.3%	14.6	12.9	45.5%	-68.9%
ALL	The Allstate Corporation	-14.2%	10.6	7.8	32.9%	41.0%
NMIH	NMI Holdings, Inc.	-20.9%	10.2	10.7	33.1%	2.2%
PPC	Pilgrim's Pride Corporation	-40.7%	13.6	9.4	58.3%	-40.6%
CF	CF Industries Holdings, Inc.	-40.8%	18.4	24.8	54.8%	-23.3%
ALK	Alaska Air Group, Inc.	-42.1%	10.0	NE	33.3%	-207.2%
	Average	**-7.7%**	**11.8**	**14.0**	**35.9%**	**-18.7%**
SPY	SPDR S&P 500 ETF Trust	19.8%				
RSP	S&P 500 equal-weighted index	8.1%				
EWMC	S&P 400 equal-weighted index	5.2%				
EWSC	S&P 600 equal-weighted index	-1.3%				

The best performers have been Anthem (ANTM), a health benefits plan provider, Rent-A-Center (RCII), which offers lease-to-own household durable goods, Cigna (CI), which provides healthcare plans and services, and Commercial Metals (CMC), a specialty steelmaker focused on proprietary rebar and a major recycling operation. But again, there was a lack of breakout performers. And of course, the pandemic shutdown crushed many EPS reports and clouded forward guidance.

The worst performers have been regional airliner Alaska Air Group (ALK), fertilizer maker CF Industries (CF), Pilgrim's Pride (PPC), a chicken processor/distributor that contended with a serious chicken virus plus assorted other challenges; and private mortgage insurer NMI Holdings (NMIH).

Enhancements to Sabrient's portfolio selection process:

Rather than continuing to wait for the Value/Growth performance gap to converge, Sabrient instead chose to develop and implement two enhancements to our forward-looking and valuation-oriented portfolio selection process that aim to *preserve the market-beating potential* investors had come to expect from us while improving "all-weather" performance:

1. Reduce downside volatility versus the S&P 500 benchmark with limits on extreme sector tilts versus the benchmark's allocations
2. Add a metric for consistency and reliability of earnings growth – i.e., our proprietary *Growth Quality Rank (GQR)*

GQR allows some secular growth names (which tend to display more consistent earnings growth, albeit at higher valuations) to rank in our model on more competitive footing with the cyclical growth names (which tend to display lower valuations, albeit with more volatility in earnings growth). So, while Sabrient's portfolios over the past two years have been dominated by smaller caps, the value factor, and cyclical sectors – to their detriment in this highly bifurcated market – our more recent portfolios (starting with December 2019) have been much *more balanced across market caps, with a slight growth bias over value, and with a better balance between secular and cyclical growth.* Thus, relative performance to the benchmark in these bifurcated market conditions is greatly improved.

To illustrate, the **table below** shows the performance of the live Baker's Dozen portfolios from their launch dates through current (10/5/20), as well as since the selloff bottom on 3/23/20 (if it was live at that time) relative to both the S&P 500 (SPY) and the S&P MidCap 400 Equal Weight ETF (EWMC). For example, compared with the underperforming October 2019 portfolio, the new **Q4 2020 *Baker's Dozen*** holds more large caps (4 out of 13), has a growth tilt (8 growth versus 5 value stocks), and includes several higher-P/E secular-growth names to balance the cyclical growth and lower-P/E value names.

Gross performance thru 11/6/2020:

	Portfolio	Launch Date	Portfolio Gross Return Since Launch	SPY Return Since Launch	EWMC Return Since Launch	Portfolio Gross Return Since 3/23/20	SPY Return Since 3/23/20	EWMC Return Since 3/23/20
↑	**Oct 2019 BD**	10/18/19	**-9.7%**	19.8%	4.9%	**70.9%**	58.4%	70.0%
old process	**Nov 2019 BD**	11/20/19	**-4.0%**	14.9%	2.1%	**90.8%**	58.4%	70.0%
new process	**Dec 2019 BD**	12/20/19	**2.6%**	10.7%	-2.1%	**96.2%**	58.4%	70.0%
↓	**Q1 2020 BD-B**	1/30/20	**5.0%**	8.4%	-0.2%	**80.3%**	58.4%	70.0%
	Q2 2020 BD	4/20/20	**18.6%**	25.4%	36.8%	**N/A**		
	Q3 2020 BD	7/20/20	**15.6%**	8.4%	11.0%	**N/A**		

Final thoughts:

The S&P 500 forward P/E multiple for 2021 sits at 21x as of 11/6/20 (based on FactSet consensus of $167.10/share), while the equal-weight versions of the S&P 500, MidCap 400, and SmallCap 600 clock in at 17.3x, 15.5x, and 14.8x, respectively. My view is that, rather than another correction to bring valuations down further, more likely there will be continued rotation from the liquidity-driven investing of the past several years to profit-driven investing, which would favor cyclical/value-oriented sectors (e.g., industrial, financial, materials, energy), and commodity-oriented industries, supported by a weaker dollar.

Again, this is <u>not</u> to the exclusion of the unstoppable secular growth trends. But I expect a continued market broadening away from the narrow investor focus on mega-cap Tech. *This should be favorable for Sabrient's GARP portfolios, especially given our recently enhanced quant model and selection approach that allows for a more "all-weather" portfolio with better balance between secular growth and cyclical/value stocks and across large/mid/small market caps.*

All in all, despite a recent surge in COVID cases, the outlook for the economy and stocks continues to look good, primarily due to:

1. Economic reports continue to strengthen.
2. Q3 corporate earnings have been much better than expected, with accelerated upside forecasted.
3. The Fed has committed to ultra-low interest rates for the foreseeable future, which makes equities attractive by comparison in 3 ways: (a) discounting future earnings streams at a low discount rate means higher present value, (b) a lower cost of capital boosts EPS, and (c) bonds as an alternative to stocks have less upside for capital appreciation and lower current yields for income, i.e., TINA (there is no alternative).
4. Massive fiscal and monetary stimulus should continue to grow, which makes rising inflation more likely. No matter who is elected, our government will continue to borrow and spend at an unprecedented rate.

Furthermore, with the latest news of an effective vaccine, expectations that fiscal and monetary policies will not see significant change, ultra-low interest rates for the foreseeable future, and an unflagging entrepreneurial spirit bringing innovation/disruption with rapidly advancing technologies, stocks remain the place to be. But we cannot afford to go back to widespread lockdowns of our schools and businesses. A reined-in economy is spilling over and ready to burst the dam that has been the COVID lockdown. We just need to unleash the pent-up demand and abundant cash on the sidelines, and the economy and stock market should soar.

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.