Sabrient Commentary – October 2020 (as of 10/5/2020)

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

1. **Market conditions for much of the past 5 years** have been mostly news-driven and unkind to most valuation-based strategies and the value factor. But especially the past 2 years, starting with escalation in the China trade war in June 2018 and then the pandemic, we saw extreme market bifurcation – with growth greatly outperforming value, secular growth over cyclical growth sectors, and large caps over small-mid caps – due to cautious corporate and investor sentiment and narrow market leadership, even as the major market-cap-weighted indexes continued to hit new highs, mostly on the backs of mega-cap Tech firms.
2. **In late 2019 (8/27/19-12/19/19), a promising increase in breadth and a sustained risk-on rotation** into cyclical sectors and smaller caps helped the September 2019 *Baker's Dozen* get off to a great start. But the pandemic selloff led to renewed market bifurcation and a K-shaped recovery, with many secular-growth market segments surging while many cyclical-growth segments fell into a depression. However, more recently there have been **signs of a renewed rotation into value/cyclicals/small caps**.
3. **The terminating September 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, the Technology sector, and the growth factor,* giving the benchmark an advantage over the Sabrient portfolios [which were selected with our previous (unenhanced) process] as well as most equal-weight, broad-market indexes. The portfolio was also hurt by a lack of big breakout winners.
4. **Sabrient's GARP (growth at a reasonable price) model** was never tested for such unusual and bifurcated market conditions. So, we chose to implement **enhancements intended to make our GARP model more "all-weather"** by: (1) reducing downside volatility versus the S&P 500 benchmark, (2) improving the likelihood that our selected stocks will meet earnings estimates, and (3) creating a **better balance** between secular growth and cyclical/value stocks and across large/mid/small market caps.
5. **The newer *Baker's Dozen* portfolios** (starting with December 2019) selected with our enhanced process have shown **improved performance relative to the benchmark**, led by some big winners from the secular-growth Technology sector, which have helped overcome persistent underperformance among some cyclical growth stocks in this "new normal" market climate.

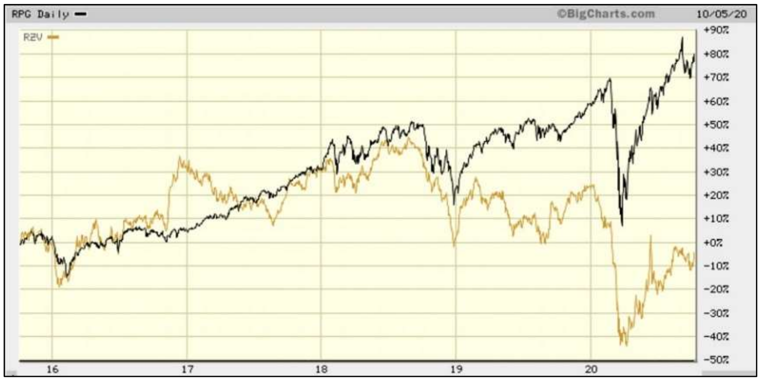
Market observations:

The April-August 5-month stretch was the best 5-month period for the S&P 500 (+35%) since 1938. But any market technician would tell you that the further the market rises without a pause, the more severe the inevitable pullback. And indeed, along came the traditionally challenging month of September and a nasty bout of profit-taking mixed with capital preservation. Many of the investor darlings from among the disruptive, secular-growth Technology companies that had been surging so strongly suddenly fell hard, with the S&P 500 (SPY) pulling back -10.9% from its 9/2/20 intraday high to its 9/24/20 intraday low and the tech-laden Nasdaq 100 (QQQ) falling -14.3% (9/2/20—9/21/20).

Dispersion among individual stocks has been huge, with huge winners and big losers in what many are calling a K-shaped recovery, largely influenced by their industries – e.g., work-from-home (WFH) technology firms have thrived while travel/hospitality/leisure firms have not. No doubt, our economy still faces a long list of obstacles including an unyielding pandemic, extreme political polarization, intractable social unrest, an existential confrontation with China, massive destruction from historic fires, hurricanes, and rioting, and poor corporate earnings visibility. So, it was inevitable that stocks would pullback after going almost straight up in July-August. Q3 earnings reporting season has started, so all eyes are watching the trajectory of earnings recovery and guidance.

I have written often about the stark market bifurcation that has developed over the past few years, beginning with the unwinding of the "Trump Bump" reflation trade due to the escalating trade wars. It led to historic extremes in growth over value and large over smaller caps, with the broad-market, cap-weighted indexes hitting new highs as investment capital has favored mega-cap, secular-growth Tech and passive, market-cap-weighted ETFs. But today, although I think it is unlikely that investors will give up on Technology names, their high relative valuations as the economy enters what I see as an early-stage expansionary cycle appear to be opening the door for greater market breadth and some capital rotation into value, cyclicals, and smaller caps.

The divergences in Growth/Value and Large/Small have been stark, as illustrated by the 5-year **chart on the left** of the Invesco S&P LargeCap 500 Pure Growth ETF (RPG) vs. Invesco S&P SmallCap 600 Pure Value ETF (RZV). You can see that the RZV got a brief pop following the 2016 election before falling back in line with RPG, but then RPG began to outperform starting in 2H2018, with a massive bifurcation in 2019 and for much of 2020.



Persistently low inflation offers some explanation as to why value stocks have continued to underperform growth. Historically, there is usually a strong correlation between inflation expectations and the Value/Growth ratio, but the recovery in inflation expectations during the COVID recovery has not followed suit, at least so far. However, as the economy recovers, it seems capital is likely to broaden from a sole focus on the secular-growth Tech firms (that have thrived during lockdowns and WFH) into some of the lagging value-oriented and cyclical sectors, like Industrial and Financial. The **second chart** compares RPG and RZV against the SPDR S&P 500 (SPY), Technology Select Sector SPDR (XLK), and the cyclical Industrial Select Sector SPDR (XLI) since 7/13/20. You can see that RZV and XLI greatly outperformed into mid-August, then gave back some ground, and most recently have begun to pull away again.

I think this trend will continue. Expansionary monetary policy and economic recoveries have historically been beneficial to smaller caps and value stocks. Moreover, the Price/Book (P/B) for Growth versus Value stocks overall is at a record high, and as ProShares recently pointed out, it has been 20 years since the P/B of the S&P MidCap 400 versus the S&P 500 was this low. For Value to continue outperforming in earnest, we likely will need to see more incentive for money growth (i.e., a steeper yield curve) and gradually rising inflation expectations

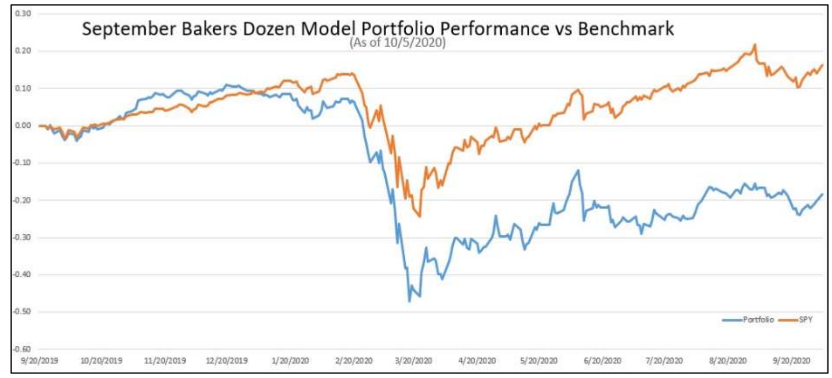
My expectation is that the historic imbalances in Value/Growth and Small/Large performance ratios will gradually revert and market leadership will broaden such that strategic beta ETFs, active selection, and equal weighting will thrive once again. This should be favorable for value, growth-at-a-reasonable-price (GARP), and quality-oriented strategies like Sabrient's, *although <u>not to the exclusion</u> of secular growth industries*. In other words, an investor should be positioned for <u>both</u> cyclical and secular growth.

Comments on the terminating September 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) was *forward-looking* in that it relied upon the consensus EPS growth estimates of the sell-side analyst community. It favored the value factor, small and mid-caps, and cyclical sectors (typical for a growing economy) as the 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 has 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 September 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 **September 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 during the

3/23/20-6/8/20 recovery rally with a return of **+68.0% versus +45.0% 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 62% allocation (vs. 30% allocation in the benchmark) to attractively valued "deep cyclical" sectors – Financial (23.1% vs. 13.1%), Industrial (7.7% vs. 9.3%), Energy (7.7% vs. 4.6%), and Materials (23.1% vs. 2.7%) – which hurt relative performance over the period. Also, it had a significant allocation (23.1%) in travel & leisure industries that have seen outsized impact from the pandemic. Furthermore, it was underweight (7.7% vs. 27.5%) the Technology sector. Notably, concentration in the S&P 500 remains near its highest in decades as the five dominant mega-cap FAAAM stocks – Facebook (FB), Apple (AAPL), Amazon (AMZN), Alphabet (GOOGL), and Microsoft (MSFT) – compose over $6.5 trillion in market capitalization. They now 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 +78.3% in AMZN and +116.2% in AAPL since the 9/20/20 launch of the September 2019 portfolio through current (10/5/20), **FAAAM have returned an average of +61.4% and contributed +14.9% to the *cap-weighted* S&P 500 return of +16.1%**, which means the other 500 stocks in the benchmark in aggregate contributed only +1.2%. Further illustrating the narrow market leadership, the *equal-weight* S&P 500 is up only +4.7%, while the S&P MidCap 400 equal-weight index is up just +0.6% and the equal-weight S&P SmallCap 600 Index is *down* -5.6% over the 9/20/20-10/5/20 timeframe.

Moreover, the September 2019 portfolio had a 85% overweight allocation to mid and small 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 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 7.7% allocation 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 a growing economy and ahead of a convergence of the growth/value relative-valuation bubble.

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	21.7%	7.8	10.5	29.8%	43.3%
GDDY	GoDaddy Inc.	15.7%	19.7	18.5	57.7%	32.5%
ANTM	Anthem, Inc.	14.5%	11.8	13.7	27.8%	44.4%
AIZ	Assurant, Inc.	1.0%	13.6	13.2	45.8%	46.2%
VAC	Marriott Vacations Worldwide Corpo	-10.9%	12.3	37.9	37.2%	-58.4%
ALL	The Allstate Corporation	-11.4%	10.8	8.4	31.0%	56.5%
ARNC + HWM	Arconic + Howmet Aerospace	-12.5%				
NMIH	NMI Holdings, Inc.	-26.0%	10.0	10.9	32.3%	26.1%
JBLU	JetBlue Airways Corporation	-30.5%	8.1	NE	25.7%	-176.3%
CF	CF Industries Holdings, Inc.	-33.8%	19.1	21.0	53.7%	5.4%
PPC	Pilgrim's Pride Corporation	-49.4%	13.9	9.5	66.2%	-45.6%
IMAX	IMAX Corporation	-49.4%	17.1	NE	40.9%	-140.0%
PARR	Par Pacific Holdings, Inc.	-68.0%	10.8	NE	84.7%	-198.2%
	Average	**-18.4%**	**12.9**	**16.0**	**44.4%**	**-30.4%**
SPY	SPDR S&P 500 ETF Trust	16.1%				
RSP	S&P 500 equal-weighted index	4.7%				
EWMC	S&P 400 equal-weighted index	0.6%				
EWSC	S&P 600 equal-weighted index	-5.6%				

The **table on the left** shows model portfolio performance for the period 9/20/19-10/5/20. You can see that the average performance of the portfolio's positions is -20.1% versus the S&P 500 cap-weighted performance of +14.1%. But we also should consider performance of the S&P 500 equal-weight index +2.9%, S&P MidCap 400 equal-weight index -1.6%, and S&P SmallCap 600 equal-weight index -7.6%.

The best performers have been Commercial Metals (CMC), a specialty steelmaker focused on proprietary rebar and a major recycling operation; GoDaddy (GDDY), a cloud-based technology firm offering domain registration and websites; Anthem (ANTM), a health benefits plan provider, and Assurant (AIZ), which provides specialty insurance solutions like extended warranties and cell phone coverage. But again, there was a lack of breakout performers. And of course, the pandemic shutdown crushed many EPS reports.

The worst performers have been Par Pacific Holdings (PARR), which operates domestic oil refining and marketing facilities in Hawaii and the Northwest; Pilgrim's Pride (PPC), a chicken processor/distributor that contended with a serious chicken virus plus assorted other challenges; IMAX Corp (IMAX), which provides digital motion picture technologies and premium theater systems; private mortgage insurer NMI Holdings (NMIH); and regional airliner JetBlue Airways (JBLU).

Enhancements to Sabrient's portfolio selection process:

Rather than continuing to wait for the Value/Growth performance gap to converge, we instead chose to develop and implement two process enhancements to our forward-looking and valuation-oriented portfolio selection process that aim to *preserve the market-beating potential* investors had come to expect 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 a better balance between secular and cyclical growth.* As a result, performance in these "new normal" 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 September 2019 portfolio, the new **Q3 2020 *Baker's Dozen*** holds more large caps (5 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. The portfolio also includes a gold miner, given gold's secular growth story amid expectations of rising inflation. Since launch on 7/20/20, the top performer is application software firm Digital Turbine (APPS) at +167.9% while the worst performer is the gold miner SSR Mining (SSRM) at -19.0%.

Gross performance thru 10/5/2020:

	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
	Sep 2019 BD	9/20/19	**-19.2%**	16.1%	0.1%	**50.5%**	53.7%	63.2%
↑	Oct 2019 BD	10/18/19	**-10.9%**	16.2%	0.7%	**68.6%**	53.7%	63.2%
old process	Nov 2019 BD	11/20/19	**-5.9%**	11.4%	-2.0%	**87.1%**	53.7%	63.2%
new process	Dec 2019 BD	12/20/19	**4.8%**	7.5%	-6.0%	**100.5%**	53.7%	63.2%
↓	Q1 2020 BD-B	1/30/20	**5.5%**	5.2%	-4.1%	**81.0%**	53.7%	63.2%
	Q2 2020 BD	4/20/20	**16.5%**	21.7%	31.3%	**N/A**		
	Q3 2020 BD	7/20/20	**10.2%**	5.2%	6.6%	**N/A**		

Final thoughts:

Looking ahead, the Fed has committed to remain dovish for the foreseeable future, which is negative for the dollar and long-term yields but positive for stocks. This likely will encourage more risk-taking, leading to further multiple expansion and quite likely a post-COVID economic surge for 2021 (and beyond). I continue to believe that we are in the early stages of a new expansionary economic phase and bull market that could run for several years. It would be driven by an upswing in manufacturing activity, infrastructure spending, and new technologies like 5G cellular, the Internet of Things (IoT), e-commerce, cloud computing, AI/ML, autonomous technology, robotics, 3-D printing, clean energy, blockchain, quantum computing, nanotechnology, genomics, precision medicine, and even space travel. Moreover, my expectation is that, as the economy continues its gradual reopening from the COVID shutdown, supported by an imminent vaccine and effective therapeutics, the market's advance will broaden out to include value stocks, cyclical sectors, and smaller caps. And because *passive* flows into the broad market indexes primarily benefit the largest companies, I think **investors soon will show renewed interest in *strategic beta* ETFs and old-fashioned *active* selection**.

In any case, the performance of our more recent portfolios appears to confirm that Sabrient's latest enhancements to our portfolio selection approach are indeed boosting all-weather performance by: 1) reducing relative volatility versus the benchmark, 2) improving the likelihood that our selected stocks will meet earnings estimates, and 3) striking a better balance between secular-growth and cyclical-growth companies and across large/mid/small market caps.

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.