Sabrient Commentary – September 2020 (as of 9/4/2020)

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This month's commentary covers the following talking points, including a discussion of market conditions and their impact on the terminating August 2019 *Baker's Dozen* portfolio, 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 sustained risk-on rotation** into cyclical sectors and smaller caps gave the August 2019 portfolio a great start, but the COVID selloff was painful, causing renewed market bifurcation, with certain secular-growth segments surging higher while most cyclical-growth segments fell into a depression.
3. **Sabrient's longstanding GARP (growth at a reasonable price) model** was never tested in such unusual market conditions in which sentiment was persistently misaligned with forward estimates. So, despite notably strong performance during the 8/27/19-12/19/19 and 3/23/20-6/8/20 "risk-on" timeframes, Sabrient felt it had become untenable to stick with a process that was struggling to provide the consistently good results of the earlier years in this "new normal" of fickle investor sentiment.
4. **This led to new enhancements intended to make Sabrient's quant model more "all-weather"** by: (1) reducing downside volatility versus the S&P 500 benchmark, and (2) placing greater focus on companies with consistent and reliable earnings growth. So, our newer portfolios (starting with December 2019) strike a better balance, which seems to be paying off.
5. **The terminating August 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 GARP 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 Sabrient portfolios selected with our previous (unenhanced) process – as well as most equal-weight, broad-market indexes.

Market observations:

The list of obstacles for the economy remains long – including a relentless pandemic, extreme political polarization (like different planets), unyielding social unrest, rising tensions with China, and massive destruction from historic fires, hurricanes, and rioting. So, it was inevitable that stocks could not continue to rise straight to the sky. September has finally brought about a minor correction. Any market technician would say that the further it rises without a pause, the more severe the inevitable pullback, and indeed many of the investor darlings among the disruptive, secular-growth Tech names that have been surging so strongly suddenly fell hard. But I think it is unlikely that investors are giving up on these names longer term, given massive Federal Reserve liquidity, continued improvement on the pandemic front, an impending election that may finally allow us all to move on, and the expectation of historic economic acceleration no matter who wins.

Despite the pullback, concentration in the S&P 500 is at its highest in decades, with the five dominant mega-cap FAAAM stocks – Facebook (FB), Apple (AAPL), Amazon (AMZN), Alphabet (GOOGL), and Microsoft (MSFT) – now comprising over $7 trillion in market capitalization, or about 26% of the index's total market cap of $27 trillion (versus 16% last year). Led by AAPL's return of +132.3%, FAAAM returned an average of +72.3% and contributed +15.7% towards the *cap-weighted* S&P 500 return of +20.4% since launch of the August 2019 *Baker's Dozen* on 8/20/19 through 9/4/20, which means the other 500 stocks in the benchmark in aggregate contributed only +4.7%. Further illustrating the narrow leadership, the *equal-weight* S&P 500 was up only +8.8% and the equal-weight S&P SmallCap 600 Index was up just +0.7% over the same timeframe. And amazingly, the market cap of AAPL is now over $2 trillion, *which exceeds the total market capitalization of the entire Russell 2000 small cap index!*

Of course, investor sentiment in general and the stock market in particular have been bolstered by unprecedented congressional fiscal programs and Fed monetary support, including zero interest rate policy (ZIRP), open-ended quantitative easing (QE), de facto yield curve control (YCC), and the buying of corporate bonds (including junk bonds and fixed-income ETFs – and perhaps will include equity ETFs at some point). This de facto "Fed put" has induced a speculative fervor, FOMO ("fear of missing out"), and a TINA ("There is No Alternative!") mindset for risk assets – particularly given infinitesimal bond yields and a falling dollar.

On the other hand, we have witnessed extreme bifurcation in this market, with certain secular growth segments performing extremely well, while other segments are quite literally in a depression. And although the pandemic has exacerbated this situation, it has been developing for a while. As I have often discussed, when the trade war with China escalated in June 2018, the market became highly bifurcated to seek the perceived safety of the dominant mega caps over smaller caps, growth over value, and secular-growth Technology over cyclical-growth sectors like Financials, Industrials, Materials, and Energy. It rotated defensive and risk-off into bonds, dividend payers, and mega caps, even pre-COVID when the economic outlook was solid. This is also when the price of gold began to ascend. And with the massive COVID stimulus, gold has evolved from being just a hedge against uncertainty to now boast its own secular growth story, which is why the latest **Q3 2020 *Baker's Dozen*** includes a gold miner.

Market bifurcation can be illustrated by the **chart**, which compares the S&P 500 (SPY) against a handful of ETFs representing diverse market segments (YTD performance through 8/31/20). At the top are ARK Innovation ETF (ARKK), which is up about +90% and whose largest holdings are Tesla (TSLA) and Square (SQ). It is followed by Grayscale Bitcoin Trust (GBTC); VanEck Vectors Junior Gold Miners (GDXJ); Invesco Nasdaq 100 (QQQ), which is dominated by the FAAAM stocks; SPDR Gold Shares (GLD); and iShares 20+ Year Treasury Bond (TLT). All are up more than +20% YTD, compared with the SPY at about 10%. Representing the underperforming market segments are Invesco S&P SmallCap 600 Equal Weight (EWSC), US Global Jets (JETS), which of course holds the struggling airlines; VanEck Vectors Oil Services (OIH), and ARK Restaurants ETF (ARKR) – the latter three of which are bunched together at worse than -40% YTD performance. After the recovery rally initially peaked on 6/8/20, those laggards all resumed their downtrends while the leaders continued their uptrends, led by the unlikely bedfellows of disruptive Technology, bitcoin, and gold.

Enhancements to Sabrient's portfolio selection process:

We have implemented 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 new limitations on extreme sector "tilts" versus the benchmark's allocations
2. Put greater emphasis on consistent and reliable earnings growth with the addition of a new alpha factor to the quant model, i.e., our proprietary Growth Quality Rank (GQR)

GQR allows some secular growth names (which tend to display more consistent and reliable earnings growth, albeit at higher valuations) to rank in our model on more competitive footing with the cyclical growth names (which tend to display more attractive 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 newer portfolios (starting with December 2019 when the enhancements were implemented) have been much more balanced among large, mid, and small caps, with a slight growth bias over value, and a better balance between secular growth and cyclical growth, and they are performing better in this unusual market climate.

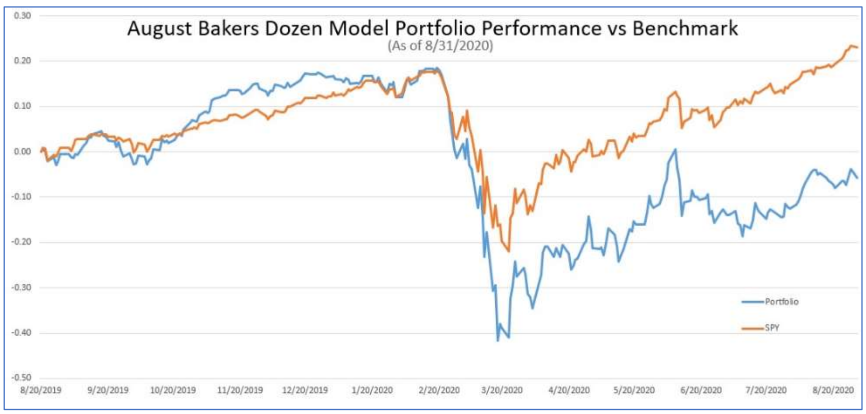
For example, compared with the August 2019 portfolio, the new **Q3 2020 *Baker's Dozen*** holds more large caps (5 of 13), has a growth tilt (8 growth versus 5 value stocks), and includes several higher-P/E secular-growth names (e.g., APPS, AZN, CHTR, QDEL) to balance the cyclical growth and lower-P/E value names. The portfolio also includes a gold miner, given gold's secular growth story in expectation of global devaluation of the major currencies to inflate away massive debt, which likely will create capital rotation into hard assets like gold, silver, and commodities. Furthermore, Sabrient's **2020 *Forward Looking Value*** portfolio (35 holdings) also has a growth bias, approximately equal 1/3 allocations to large, mid, and small caps and a 55% allocation to the Technology and Healthcare sectors – whereas the 2019 FLV portfolio had a value bias, a 50% allocation to small caps, 73% allocation to the cyclical Industrial, Materials, and Energy sectors, and only 15% allocation to Technology and Healthcare, which are dramatic differences.

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

The GARP strategy employed to select the stocks for the August 2019 *Baker's Dozen* portfolio (prior to the new model 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 August 2019 portfolio has lagged the benchmark S&P 500 due to a shortage of breakout stars, 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.

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 sectors, and an overweight in travel & leisure industries (which saw outsized impact from the coronavirus pandemic). In addition, although Sabrient believes all of its stocks have solid growth outlooks, our GARP (growth at a reasonable price) approach often leads to a value tilt, but 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 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 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.

The **August 2019 *Baker's Dozen*** model portfolio launched about five weeks before the end of the protracted period (March 2018 – August 2019) of trade war uncertainty and investor defensive sentiment, and indeed it was nicely outperforming throughout the 8/27/19-12/19/19 period of sustained risk-on sentiment. But the market impact of COVID-19 has been painful, despite the broad market indexes hitting new highs (on narrow leadership) and despite a promising 3/23/20-6/8/20 recovery rally. 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 8/27/19-12/19/19 period of sustained risk-on sentiment with **a total return of +17.0% versus the S&P 500 benchmark total return of +12.4%**, and more recently, during the 3/23/20-6/8/20 recovery rally, **it returned a robust +67.8% versus +45.0% for the S&P 500**. Still, this wasn't enough to overcome a lack of breakout winners and unfavorable allocation "tilts."



The portfolio launched with a 54% allocation (vs. 30% allocation in the benchmark) to attractively valued "deep cyclical" sectors – Financial (30.8% vs. 13.1%), Industrial (15.4% vs. 9.3%), Energy (0.0% vs. 4.6%), and Materials (7.7% vs. 2.7%) – which hurt relative performance over the period. Furthermore, it had a significant allocation (23.1%) in travel & leisure industries that have seen outsized impact from the pandemic. Relative to the benchmark, the portfolio was underweight (7.7% vs. 27.5%) the Technology sector. Moreover, it had a 77% overweight 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 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 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 most 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 the August 2019 model portfolio performance from 8/20/19 launch through Friday, 9/4/20. You can see that the average performance of the portfolio's positions is -5.3% versus the S&P 500 cap-weighted performance of +20.4%. But we also should consider performance of the S&P 500 equal-weight index +8.8%, S&P MidCap 400 equal-weight index +4.0%, and S&P SmallCap 600 equal-weight index +0.7%.

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	29.6%	6.8	9.9	31.0%	43.3%
GDDY	GoDaddy Inc.	25.8%	18.9	19.1	57.7%	32.5%
BYD	Boyd Gaming Corporation	17.5%	12.5	49.0	29.4%	-107.6%
CI	Cigna Corporation	10.9%	9.2	9.8	22.2%	33.4%
ANTM	Anthem, Inc.	5.0%	12.7	13.2	27.7%	44.4%
VAC	Marriott Vacations Worldwide Corpo	-0.4%	10.4	33.2	37.2%	-58.4%
RNR	RenaissanceRe Holdings Ltd.	-3.8%	12.9	13.4	64.4%	-36.9%
ALL	The Allstate Corporation	-6.8%	10.5	7.4	29.8%	56.5%
ARNC + HWM	Arconic + Howmet Aerospace	-8.4%				
ENVA	Enova International, Inc.	-26.1%	6.5	6.5	29.4%	26.1%
JBLU	JetBlue Airways Corporation	-32.4%	8.3	NE	30.8%	-176.3%
NMIH	NMI Holdings, Inc.	-33.2%	10.2	9.6	32.3%	26.1%
PPC	Pilgrim's Pride Corporation	-46.7%	13.1	10.2	65.9%	-45.6%
	Average	**-5.3%**	**11.0**	**16.5**	**38.2%**	**-13.5%**
SPY	SPDR S&P 500 ETF Trust	20.4%				
RSP	S&P 500 equal-weighted index	8.8%				
EWMC	S&P 400 equal-weighted index	4.0%				
EWSC	S&P 600 equal-weighted index	0.7%				

The best performers have been **Commercial Metals (CMC)**, a steelmaker focused on proprietary rebar and a major recycling operation. Others that have held up relatively well include cloud-based technology firm **GoDaddy (GDDY)**, healthcare plan provider **Cigna Corp (CI)**, casino operator **Boyd Gaming (BYD)**, and healthcare plan provider **Anthem (ANTM)**. But again, there was a lack of breakout performers.

Chicken processor/distributor **Pilgrim's Pride (PPC)** has been the worst performer as it suffered from all sorts of maladies, including a chicken virus, so it has badly missed estimates. Like in the July portfolio, one of the worst performers has been private mortgage insurer **NMI Holdings (NMIH)**, which is surprising given it has come quite close to meeting its earnings expectations but still sold off given an uncertain housing outlook. Other laggards are from value-oriented industrial, financial, and travel/leisure industries, including **JetBlue Airways (JBLU)**, credit services and analytics firm **Enova International (ENVA)**, and specialty aluminum products maker **Arconic (ARNC)**.

Final thoughts:

Looking ahead, 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 its COVID shutdown, supported by an imminent vaccine and/or an effective treatment (or both), the stock market 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, investors will show renewed interest in *strategic beta* ETFs and old-fashioned *active* selection.

Although the current forward P/E of the S&P 500 of 21.7x seems overvalued based on historical valuations, I continue to see room for *further multiple expansion* before earnings begin to catch up – due to: (1) massive global monetary and fiscal stimulus, (2) ultra-low interest rates that favor long duration on a discounted cash flow basis, (3) a TINA ("There Is No Alternative") mindset, as bonds offer little income or appreciation potential in a strong economic recovery, (4) technological breakthroughs that are rapidly revolutionizing our workplace and way of life, and (5) the larger allocation within broad-market cap-weighted indexes to the higher-multiple, secular-growth Technology sector (as opposed to the lower-multiple cyclical and capital intensive industries of the past).

In any case, let me reiterate that Sabrient's enhancements to our portfolio selection approach have helped our new portfolios strike a better balance between cyclical and secular growers as well as cap sizes, and thus we expect our new process enhancements to boost 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) creating a better balance between secular-growth and cyclical-growth companies and across large/mid/small cap sizes.

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.