Baker's Dozen Commentary – December 2022

December 5, 2022

Scott Martindale, President & CEO

Key talking points this month include:

1. Sabrient Systems and subsidiary Gradient Analytics form a **unique collaboration of engineers and forensic accountants** who leverage quantitative models, a **process-driven approach** (led by founder and former NASA engineer David Brown), and **expertise in financial statement analysis** (through subsidiary Gradient Analytics, led by Brent Miller, CFA).
2. Our portfolios displayed **consistently strong performance** in 2009–2014, but then the market became narrow & news-driven, dominated by mega caps and passive index investing, leading to **historic divergences** in Growth versus Value factors and Large versus Small caps, which was challenging for our value-oriented *Growth at a Reasonable Price* (aka GARP) portfolio strategies.
3. In December 2019, we implemented **process enhancements** to make our approach more all-weather, including proprietary new alpha factors *Earnings Quality Rank v2* and *Growth Quality Rank*. Our GARP portfolios now provide diversified exposure to Value & Growth factors, cyclical & secular growers, and across market caps, leading to **significant improvement in performance** relative to the benchmarks for all Sabrient's portfolios … *while maintaining the potential for significant outperformance*.
4. **18 of our 19 live portfolios (and 32 of the 39 launched since enhancements were implemented) are outperforming** or staying even (within 1% of) their benchmarks (based on gross total return as of 12/2)—despite depressed sentiment and market volatility. These portfolios include ***Baker's Dozen*, Forward Looking Value, Small Cap Growth, and Dividend.**
5. Our **Dividend portfolios have performed particularly well**. Rather than a pure income orientation, it employs a GARP + Income strategy that seeks quality companies selling at an attractive price and displaying a strong EPS growth forecast, a history of raising dividends, a solid coverage ratio, and an aggregate dividend yield approaching 4% or more. *Notably, the **Dividend 41** portfolio launched with overweights in Energy, Financials, and REITs, and it currently offers a robust **5% dividend yield***.
6. The **Q4 2021 *Baker's Dozen*** (that is the next to terminate next month) is outperforming by a wide margin all relevant market benchmarks (including various mid- and small-cap indexes, both cap-weighted and equal-weight). As of 12/2, it showed a gross total return of +5.7% versus -8.7% for the S&P 500, which is a ***+14.4% active return***.
7. Massive liquidity in response to pandemic led to speculation and asset inflation, but now tighter monetary policy and an end to "helicopter money" has led to an investor rotation back to Quality and Value factors, which is **favorable for active selection, strategic beta, equal weighting** *… and for Sabrient's portfolios.*
8. **Inflation and bond yields have been receding** while recession expectations have grown, setting up a potential neutral Fed pivot—perhaps leading to further upside in stocks. Equity valuation multiples have risen with recent dovish signals from the Fed, despite ongoing concerns about recession and lower corporate earnings. Forward P/E for S&P 500 and S&P 600 small caps are now 18.1x and 13.6x (as of 12/2). The **Energy sector** remains atop our SectorCast rankings.
9. Stock-bond correlation surged in 2022 along with interest rates, likely due to the predominance of aggressive-growth Tech stocks in the major indexes (and their sensitivity to rising rates), which led many observers to declare the classic 60/40 portfolio allocation model dead. But as rates recede and capital rotates into value stocks and cyclicals, the 60/40 portfolio may regain its luster.
10. We continue to suggest investors ***stay long but hedged,*** with a heightened emphasis on quality and a balance between value/cyclicals and high-quality secular growers & dividend payers. However, passive index returns may be uninspiring in this macro climate, so **the time may be ripe for active selection that can exploit the performance dispersion among stocks**, which should continue to be *favorable for Sabrient's portfolios*.
11. Sabrient's latest portfolios—including the new **Q4 2022 *Baker's Dozen*** (launched on 10/20), **Forward Looking Value 10** (launched on 7/15), **Small Cap Growth 36** (launched on 11/14), and **Sabrient Dividend 41** (launched on 9/12 and offering a ***5% current yield***)—are positioned to outperform passive benchmarks, in our view. Each holds a diverse mix across market caps, Value and Growth factors, and cyclical and secular growth exposures, plus an overweight allocation to the strong Energy sector. If indeed inflation is on the wane and the Fed is soon to pivot, ***this seems like a great buying opportunity for our portfolios***.

Market commentary:

In my October commentary, I discussed the relative performance of various asset classes (including the S&P 500, bonds, dividend stocks, REITs, gold, the dollar, and crypto), and how all were down with the exception of the US dollar. Since the October lows, however, the dollar has pulled back and all other asset classes have regained some ground. In addition, on one hand, the historic divergences in Growth over Value factor and Large over Small caps have been converging (or "mean reverting") over the past couple of years, but on the other hand, 2022 has brought about an historic disconnect in the traditional correlation between stocks and bonds that so many investors and their advisors have long relied upon—often employing the classic 60/40 stock/bond allocation.

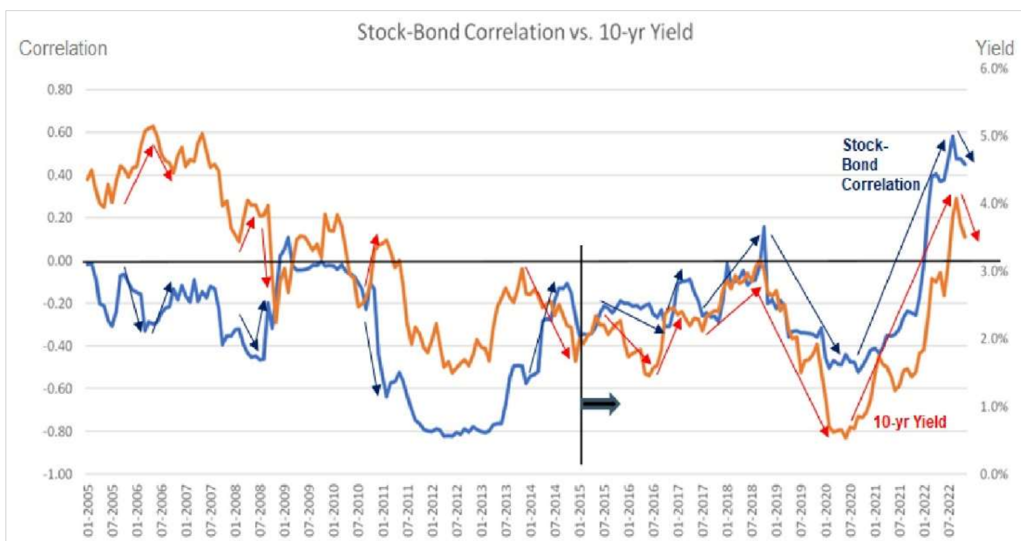
Whereas stock and bonds historically have been *inversely* correlated during volatile times, this year they have fallen in concert to an extent that hasn't been seen in over 60 years, as bonds have failed to serve as a safe haven. Instead, it has been dividend-paying equities (aka "bond proxies") that have held up relatively well. In addition, of course, oil and commodities have done well thanks to extraordinary performance during the first half of the year, and stocks within the Energy sector continue to be especially strong (albeit with significant volatility).

However, I have been expecting this anomalous behavior to change. In October, the 10-year Treasury yield spiked to over 4.3% (its highest since the Financial Crisis) primarily due to ultra-hawkish Fed jawboning. But it seemed unsustainably high given the S&P 500's dividend yield of only 1.7% and its earnings yield (inverse of 16.5x P/E) of 6.0%—which implied an equity risk premium of only 3.4% (versus a "typical" ERP of 5.0%). So, bonds had become highly attractive relative to stocks, suggesting that either yields had to recede (bond prices rise) or stocks would fall further. But with recession on the horizon and investors hungry for safe yield and given that capital markets are forward discounting (expectant of a Fed pivot), it was logical that idle cash would soon flow into bonds, which it has done. So, as the 10-year yield has tumbled back down to 3.5% (as of 12/2), stocks have risen and the P/E multiple on the S&P 500 has risen to 18.1x (implying an earnings yield of 5.5%), which has kept the equity risk premium stable at about 3.5%.

Inflation continues to show encouraging signs of retreating due to both demand destruction and mending supply chains. Although the midterm election results (and lack of the expected "red wave") mean we are unlikely to see greater support for domestic oil & gas production, there may be sufficient gridlock to prevent new profligate spending bills. Longer term, productivity-enhancing technologies continue to proliferate along with other disinflationary structural trends, which I believe will reverse the troublesome recent trend in labor productivity and help to contain costs and boost profitability—leading to rising corporate earnings and real wages, which together would suggest a healthy and sustainable economy and stock market.

Moreover, I do not believe our political leaders will allow the economy (and especially the working class) to be crushed, no matter how hawkish the Fed's rhetoric has been, so I have been predicting a Fed pause (or neutral pivot) sometime after the December FOMC meeting, likely in early 2023, to at least allow the tightening enacted thus far some time to take full effect, which typically takes 9-12 months for each action to show its impact. I believe the Fed will not only be willing to live with inflation somewhat above its 2% goal, but it may become an intentional tactic within a coordinated global monetary policy (a la the 1985 "Plaza Accord") that seeks to weaken the dollar and gradually "inflate away" the massive debt loads across the world.

Let me comment on the 60/40 stock/bond allocation model…and perhaps assuage fears about its demise. The chart below shows correlation (blue line) of the SPDR S&P 500 Trust (SPY) and iShares 20+ Year Treasury Bond ETF (TLT). Historically, this correlation has been low and usually inverse (i.e., below the black zero line)—until 2022 when stocks and bonds became highly (and undesirably) correlated. Also shown on the chart is the 10-year yield (red line).



Prior to 2015, the yield sometimes moved with stock-bond correlation and sometimes opposite stock-bond correlation (as denoted by the arrows).

But starting in 2015, my observation is that there has been a visible correlation between rising (or falling) yields and rising (or falling) stock-bond correlation.

Why? Well, historically, the major indexes were dominated by oil companies and large industrial conglomerates. But as money

flowed heavily into growth stocks, the market became narrowly focused on mega-cap Tech (giving rise to the "FAANG" acronym). Thus, the stock-bond correlation has been more correlated with bond yield (as denoted by the arrows), likely due to the *predominance in the index of growth stocks*, whose valuations are highly sensitive to rising interest rates (on a discounted cash flow basis) compared to value stocks and dividend payers. This suggests that as interest rates fall and capital rotates into value stocks and cyclicals, stock-bond correlations should fall…and the 60/40 model just might regain its luster.

I think this is achievable so long as the Fed can refrain from pumping up the money supply well beyond the rate of GDP growth, which tends to induce speculative investing. Furthermore, it seems likely that passive index returns may be less than inspiring. So, the time may be ripe for active strategies that can exploit the performance dispersion among individual stocks. On that note, Sabrient's new portfolios—including the ***Q4 2022 Baker's Dozen, Small Cap Growth 36,*** *and* ***Dividend 41*** ***(sporting a 5% current yield)***—leverage our enhanced model-driven selection approach (which combines Quality, Value, and Growth factors) to provide exposure to both longer-term secular growth trends and shorter-term cyclical growth and value-based opportunities. By the way, each portfolio reflects an overweight allocation to the Energy sector, which continues to top our quantitative SectorCast rankings.

Performance Update:

Sabrient's GARP model combines growth, value, and quality factors while searching across all market caps to find opportunities. Our portfolios include the quarterly *Baker's Dozen*, Dividend, and Small Cap Growth portfolios, and the annual Forward Looking Value portfolio. As I have explained in the past, market divergences in 2018-19 (especially due to the trade war with China) were different from anything we had seen in developing our longstanding high-performing model and portfolio selection process, and it severely impacted our performance as well as most other value-biased strategies. In response, we implemented new process enhancements in December 2019 to produce portfolios displaying a better balance between cyclical and secular growth companies and across market caps, lower volatility relative to the benchmarks, and greater portfolio resiliency (i.e., "all weather"). Indeed, the enhanced process has improved relative performance across all our portfolios, as has the market's rotation away from speculative growth toward a preference for value and quality.

Baker's Dozen & FLV - Gross return thru: 12/2/2022

Portfolio	Launch	Close	Gross Return (FTP website)	SPY Return	Active Return
Q4 2021 BD	10/20/21		5.7%	-8.7%	14.4%
Q1 2022 BD	1/20/22		1.0%	-7.9%	8.9%
Q2 2022 BD	4/20/22		3.6%	-7.7%	11.4%
FLV 10	7/15/22		17.7%	6.1%	11.6%
Q3 2022 BD	7/20/22		11.4%	3.5%	7.9%
Q4 2022 BD	10/20/22		5.6%	11.4%	-5.7%

Sabrient Dividend - Gross return thru: 12/2/2022

Portfolio	Launch	Close	Gross Return	SPY Return	Active
Div 34	12/21/20		27.0%	13.4%	13.7%
Div 35	3/19/21		7.5%	6.7%	0.8%
Div 36	6/22/21		10.7%	-2.1%	12.8%
Div 37	9/20/21		18.6%	-4.8%	23.4%
Div 38	12/20/21		10.7%	-9.5%	20.2%
Div 39	3/18/22		-1.6%	-7.7%	6.0%
Div 40	6/15/22		7.6%	8.2%	-0.6%
Div 41	9/12/22		2.3%	-0.6%	2.8%

Small Cap Growth - Gross return thru: 12/2/2022

Portfolio	Launch	Close	Gross Return	IWM Return	Active
SCG 31	9/8/21		13.4%	-14.7%	28.1%
SCG 32	12/6/21		-2.8%	-13.0%	10.3%
SCG 33	3/4/22		-3.3%	-4.4%	1.2%
SCG 34	6/1/22		3.6%	2.9%	0.7%
SCG 35	8/29/22		3.6%	1.0%	2.6%
SCG 36	11/14/22		NEW!		

In fact, as shown in the table, **18 of our 19 live portfolios (and 32 of the 39 launched since enhancements were implemented in December 2019) are outperforming** or staying even (within 1% of) their benchmarks (based on gross total return as of 12/2)—despite depressed sentiment and elevated market volatility. [Note: Benchmarks are the S&P 500 (SPY) and Russell 2000 (IWM). Gross total returns come from the ftportfolios.com website (without transactional sales charge).]

Notably, our **Sabrient Dividend Portfolio** is different from most high-yielding dividend products in that it seeks both capital appreciation and reliable income by identifying quality companies selling at an attractive price with a solid growth forecast, a history of raising dividends, a good coverage ratio, and a target dividend yield in of 4% or more.

Update on the next-to-terminate Q4 2021 *Baker's Dozen* Portfolio:

The **Q4 2021 *Baker's Dozen*** terminates next month on 1/20/2023. Like all our portfolios, it was selected based on Sabrient's *forward-looking* GARP selection approach that relies upon the consensus EPS growth estimates of the sell-side analyst community.

It launched on 10/20/2021 with an overweight (54% vs. 24% in the benchmark) in attractively valued "deep cyclical" sectors (Energy, Financials, Industrials, Materials), i.e., 7 positions out of 13, plus 3 from Consumer Discretionary. It was slightly underweight (23% vs. 40% in the SPY) secular growth Technology and Healthcare (3 positions). As for Value vs. Growth exposure, the portfolio launched with 46% allocation (6 positions) to the Growth factor, versus the benchmark's 60% weight (as the cap-weighted index is dominated by mega-cap Growth stocks). Lastly, it had a small-mid cap bias relative to the S&P 500 large cap benchmark, with 5 large, 6 mid, and 2 small caps.

Q4 2021 Baker's Dozen Portfolio							
Ticker	Company Name	Sector	Return	Fwd P/E at Launch	Current Fwd P/E	Est. NTM EPS Growth at Launch	Actual EPS Growth
DVN	Devon Energy Corporation	Energy	67.3%	9.8	7.1	321.6%	277.5%
ACGL	Arch Capital Group Ltd.	Financials	42.1%	12.4	11.3	38.8%	38.1%
FANG	Diamondback Energy, Inc.	Energy	30.9%	8.2	5.7	121.4%	164.5%
TJX	The TJX Companies, Inc.	Consumer Discretionary	25.6%	20.1	23.3	41.7%	29.1%
NTR	Nutrien Ltd.	Materials	20.9%	13.0	8.2	140.1%	239.0%
KLAC	KLA Corporation	Information Technology	17.7%	17.1	18.1	33.7%	46.0%
WLK	Westlake Corporation	Materials	6.8%	7.7	10.1	76.4%	80.5%
TMHC	Taylor Morrison Home Corporation	Consumer Discretionary	8.1%	4.6	4.1	64.0%	120.5%
AMAT	Applied Materials, Inc.	Information Technology	-20.4%	16.8	15.9	29.8%	12.4%
WRK	WestRock Company	Materials	-22.7%	9.6	9.4	75.1%	41.7%
HRI	Herc Holdings Inc.	Industrials	-29.5%	20.7	9.3	63.2%	60.9%
BLD	TopBuild Corp.	Consumer Discretionary	-31.3%	18.8	9.7	30.6%	60.4%
MRNA	Moderna, Inc.	Health Care	-45.2%	7.5	25.5	452.6%	69.5%
		Average =	+5.7%	12.8	12.1	114.5%	95.4%
SPY	SPDR S&P 500 ETF Trust		-8.7%				
RSP	S&P 500 Equal-Weight		-4.0%				
MDY	SPDR S&P MidCap 400 ETF Trust		-6.1%				
IWM	iShares Russell 2000 ETF		-16.2%				
EWMC	S&P 400 MidCap Equal-Weight		-4.7%				
EWSC	S&P 600 SmallCap Equal-Weight		-9.4%				

As shown in the table below, 9 of the 13 holdings have met or exceeded EPS estimates. Overall, the portfolio outperformed (by a wide margin) all relevant large cap, mid-cap, and small-cap benchmarks (including both cap-weight and equal-weight). Over the life of the portfolio so far (10/20/2021-12/2/2022), the gross total return of the model portfolio is **+5.7% versus -8.7%** for the S&P 500 index and **-16.2%** for the Russell 2000, led by energy companies and other cyclical names that offset a variety of laggards from biotech, construction, and packaging.

Top performers include oil & gas production firms **Devon Energy (DVN)** and **Diamondback Energy (FANG)**, insurer/reinsurer **Arch Capital Group (ACGL),** and retailer **The TJX Companies (TJX)**. Laggards have been biopharma/vaccine maker **Moderna (MRNA)**, construction suppliers **TopBuild (BLD)** and **Herc Holdings (HRI)**, and packaging maker **WestRock (WRK)**. Notably, some of the losers like HRI and BLD met or exceeded EPS estimates with solid forward guidance *but still sold off*, with their forward P/Es cut in half. We have heard this story before, when fearful investors apparently don't believe (or care about) Wall Street's consensus estimates.

Overview of the latest Q4 2022 *Baker's Dozen* Portfolio:

The **Q4 2022 *Baker's Dozen*** just launched on 10/20. Its 13 holdings are shown in table below, along with statistics on forward valuation, consensus next-12-months (NTM) EPS growth expectations, forward PEG ratio (P/E divided by EPS growth) and two key scores: Earnings Quality Rank (EQR, 1-5 scale, with 5 the best) and Growth Quality Rank (GQR, 1-10 scale, with 10 the best).

The portfolio has a diverse mix across market caps, with 6 large caps, 6 mid-caps, and just 1 small cap; a 6/7 split between value and growth stocks; and a 7/6 split between cyclical and secular growers. As for sectors, there are 4 Energy names, 2 Industrials, 2 Materials, 2 Financials, 1 Healthcare, 1 InfoTech, and 1 from Consumer Staples. Some are familiar names like **Deere & Co (DE)** and **Alaska Air Group (ALK)**, while others are more "under the radar," like industrial packaging maker **Graphic Packaging (GPK)** and medical diagnostics firm **Lantheus Holdings (LNTH)**.

Ticker	Company Name	Sector	Industry	Mkt Cap ($B)	NTM EPS Growth	Fwd PE	Fwd PEG	Div Yield	EQR	GQR
ALK	Alaska Air Group	Industrials	Airlines	5.3	91.1%	8.5	0.09	0.0%	4	6
BOX	Box Inc.	Information Technology	Application Software	3.9	35.0%	20.9	0.60	0.0%	4	10
DAR	Darling Ingredients	Consumer Staples	Agricultural Products	12.0	49.7%	11.7	0.24	0.0%	4	9
DE	Deere & Co.	Industrials	Agricultural & Farm Machinery	112.1	40.0%	13.7	0.34	1.2%	4	6
DVN	Devon Energy	Energy	Oil & Gas Exploration & Production	47.1	41.3%	7.3	0.18	8.9%	5	10
EWBC	East West Bancorp	Financials	Regional Banks	10.0	35.3%	8.0	0.23	2.2%	5	9
GPK	Graphic Packaging	Materials	Paper Packaging	6.5	32.1%	9.3	0.29	1.9%	5	6
HAL	Halliburton	Energy	Oil & Gas Equipment & Services	29.0	65.6%	13.0	0.20	1.6%	3	7
IMO	Imperial Oil	Energy	Integrated Oil & Gas	31.0	57.8%	6.9	0.12	2.1%	5	8
LNTH	Lantheus Holdings	Health Care	Health Care Supplies	4.8	66.4%	19.4	0.29	0.0%	5	10
MUR	Murphy Oil	Energy	Oil & Gas Exploration & Production	7.0	128.0%	6.0	0.05	2.3%	3	8
NTR	Nutrien Ltd.	Materials	Fertilizers & Agricultural Chemicals	44.0	32.4%	6.8	0.21	2.4%	3	8
PGR	The Progressive Corp.	Financials	Property & Casualty Insurance	70.9	70.9%	20.0	0.28	1.6%	5	9

By the way, the table to the right shows our latest *SectorCast* ETF rankings of the 10 US sector iShares. You can see that the current rankings favor cyclical sectors—with **Energy** by far leading the pack.

Sabrient SectorCast ETF Rankings (as of 12/2/2022)		
Dow Jones U.S. Sector	Tracking ETF	Outlook Score
ENERGY	IYE	96
TECHNOLOGY	IYW	62
CONSUMER STAPLES	IYK	61
HEALTHCARE	IYH	51
CONSUMER DISCRETIONARY	IYC	49
FINANCIALS	IYF	48
INDUSTRIALS	IYJ	42
BASIC MATERIALS	IYM	27
TELECOMMUNICATIONS	IYZ	19
UTILITIES	IDU	11

You can find more detail on this portfolio by downloading the full Holdings report on the *Baker's Dozen* website: https://bakersdozen.sabrient.com/bakers-dozen-marketing-materials. The report describes each of the 13 stock picks in greater detail, including a brief description of each company and what makes them attractive. You also can download my latest slide deck and market commentary. In addition, I go into greater detail on market conditions and outlook in my periodic **Sector Detector newsletter** and blog post, which you can find (and subscribe to for free) on the **http://Sabrient.com** homepage.

Final Comments:

As a reminder, Sabrient implemented **process enhancements** in December 2019 to our *Growth-at-a-Reasonable Price* (GARP) model and *"quantamental"* portfolio selection methodology (which uses the quantitative model as a prescreen and then uses a fundamental review and final selection approach that includes forensic accounting analysis by our Gradient Analytics subsidiary).

This has made our portfolios more "all weather" by reducing volatility relative to the benchmark and allowing companies that display *consistent and reliable earnings growth* to score more competitively in our value biased GARP model, even if they display somewhat higher valuations. The enhanced process seeks to provide exposure to both the *longer-term secular* growth trends and the *shorter-term cyclical* growth opportunities … *without sacrificing the potential for significant outperformance.*

Indeed, with relative performance looking good once again, we believe Sabrient's portfolios – including the new **Q4 2022 *Baker's Dozen*** (launched on 10/20), **Forward Looking Value 10** (launched on 7/15), **Small Cap Growth 36** (launched on 11/14, and **Sabrient Dividend 41** (launched on 9/12, and today offers a ***5.0% current yield***)—are positioned to outperform passive benchmarks.

[Note: **Dividend 42** launches on 12/9.]

If indeed the market has seen its lows, inflation is retreating, and the Fed is soon to pivot to neutral (or even dovish), ***this may be a great buying opportunity for our portfolios***.

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