Sabrient Commentary – January 2021 (as of 1/6/2020)

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This month's commentary can be summarized by the following talking points, which cover market conditions and their impact on the terminating December 2019 *Baker's Dozen* as well as Sabrient's recent process enhancements for all new portfolios:

1. **The two years following China trade war escalation in mid-2018 were unkind to the value factor**, cyclical sectors, and valuation-based strategies like Sabrient's growth at a reasonable price (aka GARP) approach. 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). Moreover, the COVID-19 pandemic crushed many Consumer Services stocks, particularly travel, leisure, dining, and entertainment. In addition, narrow leadership means a handful of stocks thrived and cap-weighted indexes greatly outperformed equal-weighted indexes.
2. Since mid-May 2020, **market breadth has greatly improved and small caps, the value factor, and cyclical sectors have outperformed** – all in anticipation of a vaccine rollout, reopening of the economy, infrastructure spending, a new expansionary economic phase, and higher inflation. As Value/Growth and Small/Large performance divergences continue to converge while market leadership broadens, my view is that *investors should be positioned for both cyclical and secular growth*. Moreover, I expect fundamental active selection, strategic beta ETFs, and equal weighting will outperform the passive cap-weighted indexes, and we may see a revival in long/short as well. This should be favorable for Sabrient's enhanced GARP approach, which combines value, growth, and quality factors.
3. To make our stock selection process more "all-weather," **Sabrient has implemented process enhancements** to: (a) reduce downside volatility versus the benchmark, (b) increase our focus on earnings consistency & reliability to improve the likelihood of meeting earnings estimates [by adding our new Growth Quality Rank (GQR) to the model], and (c) create a better balance between secular growth and cyclical/value stocks and across market caps. Thus, many top-performing secular growth stocks have become competitive in our model with the more attractively valued cyclical stocks.
4. The process enhancements were introduced in December 2019, and **most of our GARP portfolios since then have shown markedly improved performance relative to the benchmark**. Going forward, we believe our portfolios are positioned for both: (a) narrow leadership with an investor focus on secular growth, and (b) greater market breadth and rotation into value/cyclicals.
5. **The terminating December 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 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 portfolio and most equal-weight, broad-market indexes. Also, the portfolio also was disadvantaged by holding overweight positions in travel/leisure, Industrial, and Energy during the pandemic. ***Nevertheless, the portfolio still has managed to outperform the S&P 500****, thanks to a couple of big winners from the Technology sector.*

Market observations:

As the world bids good riddance to a challenging and often terrifying 2020, it is evident that rapid development of highly effective COVID-19 vaccines and an end to a rancorous election cycle has goosed optimism about the economy and reignited "animal spirits" among investors. Moreover, there are: 1) President-elect Biden's choice of the ultra-dovish former Fed Chair Janet Yellen for Treasury Secretary, 2) a likely thawing in the trade conflict with China (which had wreaked so much havoc on investor sentiment towards small caps, the value factor, and cyclical sectors), 3) apparent Democrat control of the legislative triumvirate: President, House, and Senate, and thus 4) an expectation of big government spending programs targeting things like infrastructure, healthcare, and clean energy, not to mention enhanced stimulus checks.

One might think that such a situation would send stocks plummeting due to fears of higher taxes and regulations, but historically, US stocks since 1948 have averaged +14% annual return since 1948 when Democrats control Congress and the White House (according to DataTrek). Furthermore, I think the likelihood of sweeping changes and increases in tax rates, regulation, and spending are lessened given razor thin majorities and the presence of several moderate Democrats. Given the apparent broad acceptance of once-unthinkable Modern Monetary Theory (MMT) and the willingness of central banks (including our own) to support the economy with unlimited liquidity, investors evidently expect the trend to continue for much of that liquidity to find its way into both financial assets and hard assets alike, including stocks, gold, commodities, and cryptocurrencies.

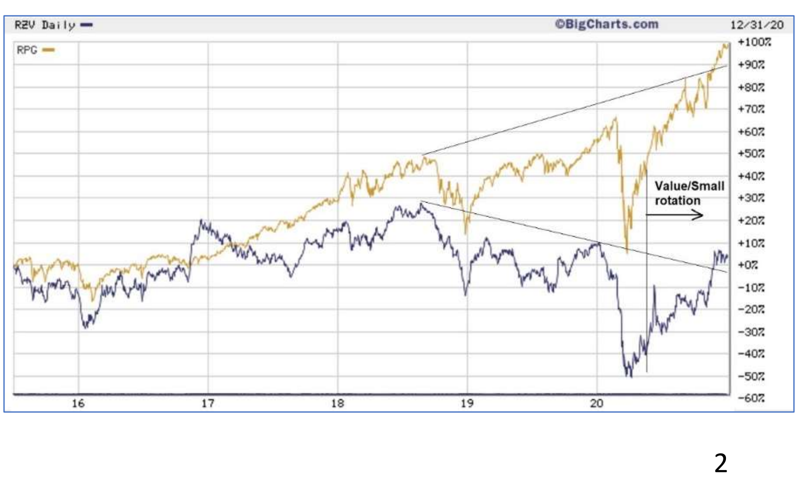
Regrettably, the federal budget deficit was $3.1 trillion in fiscal year 2020 (more than 3x the 2019 deficit) or 15.2% of GDP, which is the *highest since 1945* (the end of WWII), as the Fed's "printing press" kept cranking out dollars at breakneck speed to replace actual organic growth and free market trade. However, on the flipside, the economic rebound has been quite strong, leading many to believe that the spending was necessary to prevent economic collapse. Following record-breaking US GDP growth of +33.4% (annualized) in Q3 2020, the Atlanta Fed's NowCast forecast for Q4 GDP growth indicates a solid +8.9% annualized (although the consensus of economists is only +4.5%). For full-year 2021, GDP is projected to exceed +5.0%, which would be the *highest annual growth rate since 1982.*

In addition, although Wall Street's quarterly earnings estimates are most frequently revised downward heading into an earnings season, revisions for Q4 have moved steadily higher. Bloomberg's consensus S&P 500 earnings growth rate estimates for 2021 and 2022 are +22.2% and +16.9%, respectively (compared to an expected -16.0% for full-year 2020). According to Jefferies, this represents a significant and unusual tailwind for stocks. So, if the S&P 500 aggregate EPS in 2021 ends up closer to $185/share, today's 3,748 price level indicates a forward P/E of 20.3x, which seems reasonable in a "TINA" (There is No Alternative) climate characterized by an expansionary economic cycle, low interest rates, modest inflation, abundant liquidity, healthy banks, strong corporate balance sheets with high cash balances, rising earnings, resumptions in buybacks, and stable (or even rising) dividends.

Given their greater access to capital and wider business "moats," most large companies have survived (and often thrived) in that tumultuous year – with the notable exceptions of the Energy sector and some Consumer Services industries (primarily related to travel, dining, and entertainment). But more recently, Energy has been showing leadership as oil prices rise back above $50. Although small businesses generally took it on the chin due to the shutdowns, the iShares Russell 2000 (IWM) has been rapidly gaining traction and actually surpassed 2020 performance of the SPDR S&P 500 (SPY), +20.0% versus +18.3%. This is all quite healthy behavior. Moreover, most economic reports have been quite promising, capped off by the ISM Manufacturing Index rising to 60.7 in December, easily beating expectations, reflecting broad-based activity with 16 of 18 industries reporting expansion.

Needless to say, Technology was the top performing sector in 2020, buoyed by acceleration in unstoppable secular growth trends and solutions to pandemic-driven disruption (like digitization, WFH, ecommerce, touchless transactions, blockchain, and precision medicine). At nearly 28%, Technology has its highest weighting in the S&P 500 index since the dot-com bubble in 2000 when its weighting was nearly 35%. But if you add back tech-oriented juggernauts Amazon.com (AMZN), Alphabet (GOOGL), Facebook (FB), Netflix (NFLX), and Tesla (TSLA), some of which were previously classified in the Tech sector, today's weighting is actually closer to 40%. Notably, for full-year 2020, the five largest stocks – Apple (AAPL), Microsoft (MSFT), Alphabet, and Facebook, aka FAAAM – returned an average of +53.0% and contributed +10.4% to the *cap-weighted* S&P 500 return of +18.3%, which means the other 500 stocks in the benchmark in aggregate contributed only +7.9%. But that's a big change from just several months ago (before the Value/Growth and Small/Large rotation kicked into gear), when FAAAM accounted for virtually all (or more) of the S&P 500 return (meaning the other 500 stocks in aggregate had a negative return). Further illustrating the narrow market leadership, the cap-weight Nasdaq 100 ETF (QQQ) was up +48.6% in 2020, while the S&P 500 Equal Weight (RSP) was only up +12.7%, the S&P MidCap 400 Equal Weight (EWMC) +15.6%, and the S&P SmallCap 600 Equal Weight (EWSC) +14.9% – providing further evidence of the historic market bifurcation (although it has shown significant recent convergence).

Indeed, if we look back over the past 2.5 years since mid-2018, apparent market strength has been somewhat deceiving in that the growth-oriented, cap-weighted indexes have been in a strong bull market *thanks primarily to a handful of mega-cap Technology names,* while most of the rest of the broader market essentially has been in a downtrend, making it difficult for valuation-oriented portfolios or equal-weight indexes to keep up. To illustrate, below is a **5-year chart** (starting 7/1/15) comparing the S&P 500 LargeCap Pure Growth ETF (RPG) and the S&P 600 SmallCap 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 strong but short-lived boost during the "Trump Bump," and then in mid-2018 the trade war with China launched a stark and historic market bifurcation due more to uncertainty rather than a significant cut to earnings expectations. And the bifurcation has only gotten worse this year due to COVID-19, lockdowns, civil unrest, and a tumultuous election. I have highlighted this dynamic on the chart 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 largest FAAAM stocks, while a large swath of the market has been quite weak. As a result, many value-oriented portfolios underperformed, *as did many broad-market equal-weighted indexes.*

However, since mid-May 2020, there has been *improving market breadth and a rotation into value, cyclicals, and smaller caps*, which is a bullish sign of a healthy market. To illustrate, the **chart below** compares the same two ETFs as the previous 5-year chart, but with much different relative performance. You can see that since 5/15/20 the SmallCap Pure Value RZV has greatly outperformed the LargeCap Pure Growth RPG. I continue to believe that a new expansionary economic phase is about to launch.

Indeed, institutional buyers are back, and they are buying the higher-quality stocks (not just the high-flying momentum stocks). The 5-year TIPS breakeven inflation is once again on the rise, recently eclipsing the 2.0% level (compared to 0.16% at the depths of the pandemic selloff). Likewise, a rising 10-year Treasury yield (now around 1.04%) implies increasing confidence in economic recovery and rotation from bonds to stocks (pushing Treasury yields higher). Furthermore, as credit markets continue to improve and spreads fall with the economic recovery, smaller companies should enjoy better business and credit conditions, facilitating a continued recovery in Industrials, Energy, and small caps, which typically have greater earnings leverage than large-cap Technology.

Regardless, we chose to enhance our GARP model at the end of 2019 by adding a new *Growth Quality Rank (GQR)* that rewards companies with consistent and reliable earnings growth, thus allowing secular-growth stocks to score competitively 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 a *better balance 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 last year's continued bifurcation for much of the year.

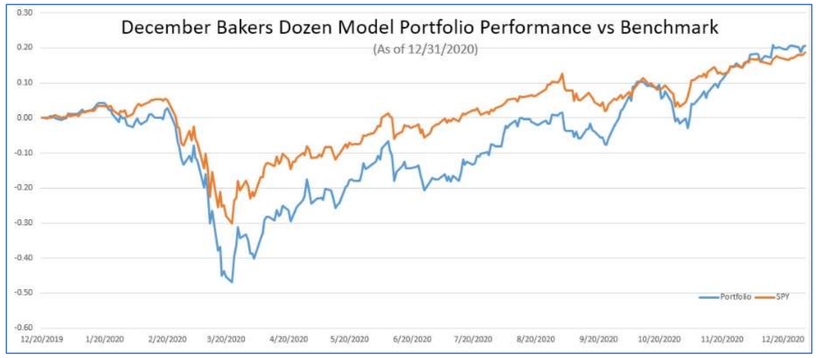
To illustrate, the **table below** shows the performance of the live Baker's Dozen portfolios from their launch dates through 1/6/21, as well as since the selloff bottom on 3/23/20 (if it was live at that time) relative to the benchmark SPDR S&P 500 ETF (SPY). Only the Q2 2020 portfolio is underperforming. As an example, the **Q4 2020 *Baker's Dozen*** (which is still available for investment) holds 4 large caps (versus 9 small/mid), 8 growth stocks (versus 5 value stocks), and includes several higher-P/E secular-growth names to balance the cyclical growth and lower-P/E value stocks. Because of our model enhancements, several Technology names became eligible for consideration (and indeed they are among the best performers), and yet the portfolio also remains *well-positioned for a continued market broadening and rotation into value, cyclicals, and small caps*. In fact, our Small Cap Growth portfolio has been surging over the past few months.

Gross performance thru 1/6/2021:

Portfolio	Launch Date	Portfolio Gross Return Since Launch	SPY Return Since Launch	Portfolio Gross Return Since 3/23/20	SPY Return Since 3/23/20	Portfolio Gross Return Since 10/30/20	SPY Return Since 10/30/20
Dec 2019 BD	12/20/19	**22.8%**	18.6%	**132.5%**	69.6%	**25.0%**	14.8%
Q1 2020 BD	1/17/20	**23.4%**	14.6%	**112.0%**	69.6%	**24.1%**	14.8%
Q2 2020 BD	4/20/20	**21.0%**	34.3%	**N/A**		**9.3%**	14.8%
Q3 2020 BD	7/20/20	**23.0%**	16.1%	**N/A**		**21.9%**	14.8%
Q4 2020 BD	10/20/20	**15.7%**	9.2%	**N/A**		**21.1%**	14.8%

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

The December 2019 *Baker's Dozen* portfolio 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. For this portfolio, it mostly favored the value factor, small and mid-caps, and cyclical sectors due to their more attractive valuations. However, even though narrow market leadership and an investor penchant for the more highly valued market segments persisted, the portfolio was well-positioned with some top performers from Technology and Communications Services sectors, due to the balance between secular and cyclical growth that our enhanced model allows. Of course, in a concentrated 13-stock portfolio, a few breakout winners can help to offset a number of laggards, and this portfolio was well-served by breakout performances from SolarEdge Technologies (SEDG) and Advanced Micro Devices (AMD) despite extreme impacts of the pandemic on the value/cyclical stocks from travel, industrial, financial, and energy.



The December 2019 model portfolio launched on 12/20/19, which happened to coincide with the exact end of the 4-month period of sustained risk-on sentiment (8/27/19-12/19/19) that had given value investors so much hope after about 15 months of trade war uncertainty. Although the broad market indexes continued to hit new highs last summer during the post-selloff recovery (led by narrow leadership from secular-growth, mega-cap Technology stocks), many of the attractively valued cyclical sectors and smaller caps continued to languish in what could be described as a "K-shaped" recovery, with some market segments doing quite well and others falling into a depression. In aggregate, most of the portfolio has lived up to earnings expectations, with 7 of the 13 names having beat or come close to EPS estimates, and it has shown significant outperformance since the 3/23/20 selloff low through 1/6/21 with a return of **+132.5% versus +69.6% for the S&P 500**. Moreover, the last two months of the year (with the value rotation and "reopening trade") was good for the portfolio as it grew **+25.0% versus +14.8% for the SPY** (10/30/20-1/6/21).

The portfolio launched with a 46% allocation (vs. 29% allocation in the benchmark) to attractively valued "deep cyclical" sectors – Financial (15.4% vs. 13.0%), Industrial (23.1% vs. 9.1%), Energy (7.7% vs. 4.3%), and Materials (0.0% 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 (15.4% vs. 23.2%) the Information Technology sector. Notably, those two names making up the 15.4% InfoTech allocation turned out to be the two biggest winners in the portfolio (SEDG and AMD).

Moreover, the December 2019 portfolio had a 30.8% underweight allocation (4 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 23.1% allocation (3 positions) to the growth factor (vs. the benchmark's 60%), 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. Thus, the benchmark enjoyed a big advantage versus the *Baker's Dozen as well as versus 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. ***Nevertheless, the December 2019 Baker's Dozen still has managed to outperform the benchmark****, thanks to a couple of big winners from the Technology sector.*

Ticker	Company Name	Return	Fwd P/E at Launch	Current Fwd P/E	Est. NTM EPS Growth at Launch	Actual EPS Growth
SEDG	SolarEdge Technologies, Inc.	266.5%	19.2	82.6	43.0%	39.8%
AMD	Advanced Micro Devices, Inc.	104.6%	40.1	51.6	166.9%	172.5%
CHTR	Charter Communications, Inc.	31.1%	41.7	31.9	106.3%	139.9%
VAC	Marriott Vacations Worldwide Corpo	12.8%	14.6	40.5	28.1%	-102.0%
ANTM	Anthem, Inc.	9.8%	13.5	14.4	22.8%	32.1%
ENVA	Enova International, Inc.	7.0%	5.3	6.4	31.6%	74.0%
AZN	AstraZeneca PLC	-1.1%	19.0	15.6	-4.3%	-8.4%
KBH	KB Home	-1.9%	10.0	8.4	30.6%	34.6%
CMRE	Costamare Inc.	-9.5%	8.6	7.2	54.3%	46.6%
ALK	Alaska Air Group, Inc.	-25.3%	10.1	NE	19.6%	-207.2%
HII	Huntington Ingalls Industries, Inc.	-31.1%	14.0	13.1	24.7%	5.1%
NMIH	NMI Holdings, Inc.	-31.5%	11.4	11.0	31.7%	2.2%
VLO	Valero Energy Corporation	-34.5%	10.0	NE	74.4%	-98.9%
	Average	**22.8%**	**16.7**	**25.7**	**48.4%**	**10.0%**
SPY	SPDR S&P 500 ETF Trust	18.6%				
RSP	S&P 500 Equal-Weight	14.9%				
EWMC	S&P 400 MidCap Equal-Weight	19.8%				
EWSC	S&P 600 SmallCap Equal-Weight	22.9%				

The **table to the left** shows Model Portfolio performance of the December 2019 *Baker's Dozen* for the period 12/20/19-1/6/21. You can see that the gross average return of the 13 holdings is +22.8% versus the S&P 500 cap-weighted performance of +18.6%. The portfolio's outperformance versus the benchmark is entirely attributable to three stocks from Technology and Communications Services sectors, namely SolarEdge Technologies (SEDG), a provider of solar power solutions, chipmaker Advanced Micro Devices (AMD), and cable operator Charter Communications (CHTR). Even though 7 of the 13 names either exceeded or came close to meeting their earnings expectations, some were still ignored if they were from a neglected industry.

Notably, although SEDG came close but fell somewhat short of its EPS forecast, its forward P/E ballooned from 19.2x at launch to 71.7x, further illustrating the speculative investor fervor, particularly involving innovative/disruptive technologies like clean energy. Also, Marriott Vacations Worldwide (VAC) lagged for much of the life of the portfolio but gained roughly 50% during the late-year value rotation (since 10/30/20) in anticipation of a resurgence in pent-up travel demand, despite badly missing its earnings estimates for the past year. As a result, its forward P/E ballooned from 14.6x at launch to 40.5x.

The worst performers have been oil & gas refiner Valero Energy (VLO), private mortgage insurer NMI Holdings (NMIH), military shipbuilder Huntington Ingalls Industries (HII), and regional airliner Alaska Air Group (ALK), as travel, industrial, financial, and energy suffered outsized impacts from the COVID-19 pandemic and economic disruption.

Final thoughts:

Going forward, absent another exogenous shock (like a resurgent pandemic), the “reopening trade” seems sustainable and the historic divergences in Value/Growth and Small/Large performance ratios will continue to gradually converge as market leadership broadens, which is good for the long-term health of the market. Thus, in my view, *investors should be positioned for both cyclical and secular growth* – including exposure to small caps, emerging markets, and hard assets like gold, commodities, and cryptocurrencies.

Moreover, I expect fundamental active selection, strategic beta ETFs, and equal weighting will outperform the passive cap-weighted indexes, and we may see a revival in long/short as well. This should be favorable for Sabrient’s enhanced GARP approach, which combines value, growth, and quality factors while providing for a more “all-weather” portfolio with balance between secular growth and cyclical/value stocks and across market caps.

Our outlook for the economy and stocks continues to look bright, primarily due to:

1. Economic reports and forward guidance continue to strengthen, bolstered by the vaccine rollout.
2. Q3 corporate earnings were much better than expected, and Q4 earnings expectations are being revised steadily upward.
3. The Fed has committed to ultra-low interest rates for the foreseeable future, which makes equities attractive by comparison in at least three ways:
   a) discounting future earnings streams at a low discount rate means higher present value
   b) a lower cost of capital boosts EPS
   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 as government seems determined to continue to borrow and spend at an unprecedented rate. This also makes rising inflation more likely (although likely not as much as many expect).
5. Strong corporate balance sheets and expectations of rising earnings, buybacks, dividends, and Capex.
6. An unflagging entrepreneurial spirit keeps bringing innovation, disruption, and productivity gains of rapidly advancing technologies (which are inherently disinflationary).

Thus, unleashing pent-up demand and abundant cash on the sidelines should make both the economy and stock market 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.