Sabrient Commentary – January 2022 (as of 1/20/2022)

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Key talking points this month include:

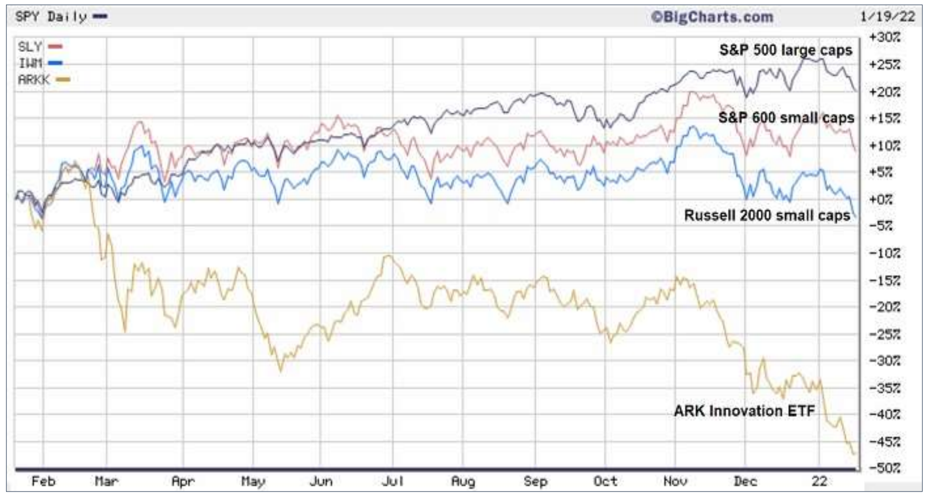
1. Sabrient Systems and subsidiary Gradient Analytics form a **unique collaboration of engineers and forensic accountants** who leverage quantitative models, a **process-driven approach**, and expertise in financial statement analysis.
2. Our portfolios displayed consistently strong performance in 2009–2014, but then market became narrow/news-driven, causing **historic divergences in Growth/Value and Large/Small caps.** But the divergences have shown **notable mean reversion** recently.
3. Sabrient continually implements process enhancements to make our ***Growth at a Reasonable Price*** (aka GARP) model more all-weather, including adding proprietary new alpha factors: *Earnings Quality Rank (EQR)* and *Growth Quality Rank (GQR)*. Thus, our newer GARP portfolios provide diversified exposure to Value & Growth, cyclical & secular growth, and across market caps.
4. **Elevated volatility** is likely to persist given ongoing supply chain disruptions and COVID impacts, midterm elections, divergent global government policy responses, geopolitical tensions, lingering inflationary pressures, and possible slower growth in China.
5. However, **inflation should begin to moderate** in 2022 as supply chains and labor markets gradually recover (reducing the excess demand-versus-supply gap), the US dollar remains strong, the Fed reduces monetary accommodation, and disinflationary structural trends resume (e.g., aging demographics, globalization, technological disruption, automation, productivity).
6. **Interest rates should remain low** in 2022, with the 10-year US Treasury yield likely staying below 2.0% for much of the year due to US dollar strength as a global safe haven, lower rates in most developed markets, moderating inflation, widespread "financialization" of the global economy, regulatory or investor mandates for holding "cash or cash equivalents."
7. **Equity valuations should moderate in 2022**, although current elevated multiples (e.g., P/E ratio) are mostly justified by robust earnings growth, strong earnings leverage, abundant global liquidity, low interest rates, and a lack of good alternatives ("TINA").
8. But given asset inflation and "malinvestments" from massive global liquidity, we expect **broader market leadership, re-emergence of the Quality factor, performance reversion** in Value/Growth and Small/Large, and *greater share price reliance on earnings growth rather than multiple expansion*.
9. Thus, ***we suggest staying long but hedged,*** with a heightened emphasis on quality and a balance between 1) value/cyclicals and 2) high-quality secular growers & dividend payers.
10. Stocks outside of Big Tech may offer **better opportunities for investors** due to lower valuations and higher growth rates. Active selection, strategic beta, equal weighting, and the **Quality factor should thrive**, which also should be favorable for Sabrient's ***Baker's Dozen*****, Small Cap Growth, Dividend, and Forward Looking Value** portfolios.
11. In addition, we have created a ***Sabrient Quality Index Series*** comprising 5 broad-market and 5 sector-specific, rules-based, strategic beta and thematic indexes, which we are pitching to various ETF issuers. (Please tell your favorite ETF wholesaler!)
12. The **Q4 2020** ***Baker's Dozen*** terminates on 1/20/2022 after 15 months of life. It launched on 10/20/20 with equal position weights and a bias toward non-cyclical sectors, small caps, and the growth factor, in accordance with our enhanced model. As of 1/19/2022, the Model Portfolio displays a **gross return of +40.9%** (versus +33.9% for the S&P 500).
13. The new **Q1 2022** ***Baker's Dozen*** launched on 1/20/2022, with equal position weights and a diverse mix of market caps, Value and Growth stocks, and cyclical and secular growth companies.

Market observations:

Elevated volatility has continued into the new year. High stock valuations are based upon ongoing economic recovery and corporate earnings exceeding expectations, so it's understandable that investors have been spooked primarily by: 1) fears of an economic slowdown due to persistent COVID variants that have perpetuated supply chain disruptions and renewed lockdowns in China and other major economies, and 2) unyielding inflationary pressures that have led the Federal Reserve and other central banks to suddenly shift to a hawkish narrative and a stepped up timetable for QE tapering and interest rate hikes (aka "normalization").

Nevertheless, stocks enjoyed another stellar year in 2021, with the S&P 500 up +28.7% in 2021, making it the third year in a row following returns of +31.2% in 2019 and +18.4% in 2020. In fact, since the Financial Crisis recovery began in 2009, there has been only one slightly negative year for the S&P 500, which was in 2018 (-4.4%) when sentiment turned defensive primarily due to the trade war with China. However, focusing on the major cap-weighted indexes can distort what's happening in the broader market. For example, the top 10 largest stocks by market cap (AAPL, MSFT, GOOG, AMZN, TSLA, FB, NVDA, BRK.B, JPM, UNH) compose more than 1/3 of the S&P 500 index. The big recovery rally in 2020 off the pandemic lows was great for the many high-potential but highly speculative/low-quality names that you find in the ARKK Innovation ETF (ARKK), but now the Quality factor is back in vogue as investors are demanding that companies justify their elevated valuations with strong top and bottom-line growth and forward guidance.

To illustrate, the chart shows a 1-year chart (thru 1/19/22) of the S&P 500 (SPY) versus the S&P 600 small caps (SLY), Russell 2000 small caps (IWM), and the ARKK. While the S&P 500 index was up roughly 20% over the past year, ARKK is down about 47%. Many of the Nasdaq's high-fliers have fallen precipitously from their 52-week highs – with some down 50-90%, including names like WKHS, TLRY, SFIX, PTON, FCEL, HOOD, TDOC, and ZM. Notably, ARKK (and others of the speculative ARK fund family) rank at or near the bottom of Sabrient's GARP and quality-oriented SectorCast rankings. I also included both the SLY and IWM to highlight the renewed focus on Quality and Value, as membership in the S&P 600 requires a history of 4 consecutive quarters of positive earnings whereas the Russell 2000 is solely based on market cap. Although they have historically performed similarly, the higher-quality SLY has significantly outperformed the IWM over the past year. Furthermore, while the SPY has a forward P/E of 21.5x, the IWM is at 16.7x and the SLY is at only 15.5x.



The key point here is that not all stocks are overvalued, and although Big Tech likely will continue to be treated as "safe and defensive" by investors (largely through passive investing), I think that high-quality stocks outside of the Big Tech favorites and speculative growth names will offer better opportunities for investors this year, with lower valuations and higher growth rates.

As for inflation, my view is a bit different from the dire narratives dominating the airwaves. As shown in the chart, money supply has risen rapidly since the late 1990's while velocity of money has fallen such that CPI inflation remained low. The pandemic-induced emergency response brought massive new liquidity injections that caused a big spike in money supply but a big fall in velocity, as the all the freshly printed cash exceeded the hobbled economy's real demand for capital and its ability to absorb it – leading to accelerated asset inflation and unproductive capital allocation (aka "malinvestments"). The upshot is that consumer demand quickly returned to pre-COVID levels while supply chains have been slow to recover, leading to a spike in excess demand (the gap between demand and supply) and elevated CPI inflation until supply chains (factories, transport, logistics, energy, labor) fully mend.

All the Fed can do with monetary tightening tools is depress demand and economic growth when the economy is still well below full capacity. Also, "financialization" of the global economy (e.g., leverage, capital markets, derivatives, short-term corporate governance) means that even small changes in interest rates have widespread impacts. So, I believe the Fed is trying to "talk down" inflation. Indeed, the "taper tantrum" we have seen of late has happened without the Fed actually doing much of anything yet beyond starting to reduce emergency stimulus. I believe we will see lessening inflationary pressures and only modest increases in long-term Treasury yields in 2022, particularly as high YoY comps kick in. Nevertheless, elevated volatility is likely to continue, which reinforces our view that investors should stay *long but hedged*, with a balance between 1) value/cyclicals and 2) high-quality secular growers & dividend payers and with a greater focus on quality.

Update on the terminating Q4 2020 *Baker's Dozen* portfolio:

The **Q4 2020 *Baker's Dozen*** launched on 10/20/2020 and terminates on 1/20/2022, at which time the new Q1 2022 *Baker's Dozen* will launch. Like all our portfolios, the Q4 2020 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. However, unlike most of our prior portfolios that were typically overweight value and cyclical stocks, it launched with a heavily *underweight* allocation (15% vs. 24% in the benchmark) to attractively valued "deep cyclical" sectors (Financial, Industrial, Materials, and Energy), i.e., 2 positions out of 13. This was because companies in these sectors still had relatively poor forward visibility when the portfolio was selected, even though investors were buying them on recovery speculation (rather than sound fundamentals). Instead, the initial portfolio approximately matched (31% vs. 27%) the benchmark weighting in the Information Technology sector and was overweight both Healthcare (23% vs. 13%) and Communications Services (15 vs. 11%). As for value vs. growth exposure, the portfolio launched with a 69% allocation (9 of the 13 positions) to the *growth* factor, which approximately matches the benchmark's 60%. Lastly, it had a small-cap bias relative to the S&P 500 large cap benchmark, with 4 large, 2 mid, and 7 small caps.

Q4 2020 Baker's Dozen Model Portfolio						
Ticker	**Company Name**	**Return**	**Fwd P/E at Launch**	**Current Fwd P/E**	**Est. NTM EPS Growth at Launch**	**Actual EPS Growth**
VECO	Veeco Instruments Inc.	124.6%	13.8	18.8	88.8%	97.0%
BCC	Boise Cascade Company	91.9%	10.3	8.4	61.7%	218.9%
TPX	Tempur Sealy International, Inc.	77.5%	14.1	11.2	38.8%	88.3%
GTN	Gray Television, Inc.	76.9%	4.9	NE	43.9%	15.2%
OMI	Owens & Minor, Inc.	76.7%	9.4	14.4	295.7%	249.6%
ABBV	AbbVie Inc.	69.9%	7.4	10.0	22.7%	25.6%
AMD	Advanced Micro Devices, Inc.	57.3%	58.0	41.2	64.3%	120.2%
APPS	Digital Turbine, Inc.	21.0%	78.1	25.6	66.7%	226.3%
MDC	M.D.C. Holdings, Inc.	13.6%	8.6	5.3	39.7%	75.1%
CHTR	Charter Communications, Inc.	-4.4%	37.1	19.5	53.0%	64.8%
GDDY	GoDaddy Inc.	-5.2%	18.6	23.5	32.3%	-15.3%
FDX	FedEx Corporation	-11.1%	18.3	11.3	36.5%	29.6%
QDEL	Quidel Corporation	-55.0%	10.2	11.2	426.6%	118.7%
	Average	**41.1%**	**22.2**	**16.7**	**97.7%**	**101.1%**
SPY	SPDR S&P 500 ETF Trust	33.9%				

Despite challenges from the pandemic, most of the holdings have lived up to expectations, with 10 of the 13 beating or coming close to EPS estimates. Over the life of the portfolio so far (10/20/2020-1/19/2022), **the gross average return of the Model Portfolio's equal-weighted holdings is +41.1% versus +33.9% for the S&P 500 cap-weighted index**. The table on the left shows each of the holdings. Of course, in a concentrated 13-stock portfolio, a few breakout winners can help offset several laggards, and indeed, you can see that the portfolio has 7 positions that have outperformed the benchmark, led by a highly diverse group: **Veeco Instruments (VECO)**, a maker of thin film process equipment for semiconductors and electronic devices (including for data storage and 5G), **Boise Cascade (BCC)**, which provides lumber and building products for home construction, **Tempur Sealy International (TPX)**, a manufacturer of bedding products (like the Tempur-Pedic brand), **Gray Television (GTN)**, owner/operator of TV stations, and **Owens & Minor (OMI)**, a provider of medical supplies and healthcare solutions.

The biggest laggard is medical diagnostics firm **Quidel Corp (QDEL)**, which not only missed EPS estimates by a country mile but also is showing significantly lower forward guidance on earnings for the next 12 months. Other underperformers include air freight & logistics powerhouse **FedEx Corp (FDX)**, web services firm **GoDaddy (GDDY)**, and cable operator **Charter Communications (CHTR)**. CHTR and FDX suffered seemingly unwarranted weakness (and significant P/E compression) despite beating or coming close to earnings estimates and displaying solid forward estimates for this year. Notably, top performer VECO and worst performer QDEL essentially canceled each other out (+7% and -8% impact on the portfolio, respectively).

Introducing the Q1 2022 *Baker's Dozen* portfolio:

The new **Q1 2022 *Baker's Dozen*** launched on 1/20/2022. 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 comprises a diverse mix across market caps, with 4 large caps, 4 mid-caps, and 5 small caps; a Value/Growth mix of 8 value and 5 growth stocks; and a 7/6 split between cyclical and secular growth companies. As for sectors, holdings are quite diversified, including 3 Information Technology names, 3 Industrials, 2 Financials, 1 from Healthcare, 1 Energy, 1 from Consumer Staples, 1 from Consumer Discretionary, and 1 from Communications Services. Some – like Charter Communications (CHTR) and KLC Corp (KLAC) – are familiar names that have appeared in several previous Baker's Dozen portfolios, while others – like semiconductor equipment maker Axcelis Technologies (ACLS) and insurer American Equity Investment Life (AEL) – are new faces.

Ticker	Company Name	Sector	Industry	Mkt Cap ($B)	NTM EPS Growth	Fwd PE	Fwd PEG	Div Yield	EQR	GQR
ACGL	Arch Capital Group	Financials	Property and Casualty Insurance	17.7	45.1%	11.0	0.24	0.0%	3	10
ACLS	Axcelis Technologies	Information Technology	Semiconductor Equipment	2.1	64.7%	16.8	0.26	0.0%	5	10
AEL	American Equity Investment Life	Financials	Life and Health Insurance	4.2	51.0%	9.2	0.18	0.8%	3	8
ARCB	ArcBest	Industrials	Trucking	2.3	36.0%	10.2	0.28	0.3%	5	9
CHTR	Charter Communications	Communication Services	Cable and Satellite	104.2	37.3%	19.4	0.52	0.0%	4	7
DAR	Darling Ingredients	Consumer Staples	Agricultural Products	10.8	50.9%	13.0	0.26	0.0%	4	8
DVN	Devon Energy	Energy	Oil & Gas Exploration and Production	33.1	146.2%	9.3	0.06	6.7%	5	9
HRI	Herc Holdings	Industrials	Trading Companies and Distributors	4.7	61.4%	15.3	0.25	1.3%	3	10
KLAC	KLA Corp	Information Technology	Semiconductor Equipment	59.6	35.5%	18.0	0.51	1.0%	4	10
PFE	Pfizer	Health Care	Pharmaceuticals	300.5	56.2%	9.1	0.16	3.0%	4	9
TEX	Terex	Industrials	Construction Machinery and Heavy Trucks	3.0	31.2%	12.0	0.39	1.0%	3	10
TOL	Toll Brothers	Consumer Discretionary	Homebuilding	7.3	53.2%	5.9	0.11	1.1%	4	10
WDC	Western Digital	Information Technology	Technology Hardware, Storage, Peripherals	19.3	32.2%	7.4	0.23	0.0%	3	7
			Average:	43.8	53.9%	12.0	0.22	1.2%	3.8	9.0

You can find more detail 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.

Final thoughts:

Looking ahead, equity valuations remain lofty even after the latest spike in volatility, although they are bolstered by robust corporate earnings growth, ongoing government policy support, negative real interest rates, and a lack of good alternatives to stocks (commonly called "TINA," as in, *there is no alternative*) – which should persist unless the Federal Reserve turns overly hawkish (the classic policy mistake by which all recessions are born).

I expect inflation is on course to moderate this year as supply chains recover, temporary bottlenecks and labor shortages resolve, manufacturing decentralizes across different regions, money supply growth levels off, velocity of money supply remains low, the US dollar stays strong, capital utilization remains below the critical 80% threshold, and disinflationary structural trends resume, e.g., aging demographics, slowing global population growth, accelerating disruptive innovation, automation, rising productivity, and re-globalization of supply chains (albeit with some domestic "onshoring" of manufacturing to reduce dependency on adversarial countries).

As a reminder, in response to the "new normal" market conditions characterized by persistently narrow market leadership and Growth/Value and Large/Small performance divergences, Sabrient developed and implemented (in mid-December 2019) **process enhancements** that reduce volatility relative to the benchmark and allow companies that display *consistent and reliable earnings growth* to score more competitively in our GARP model, even if they display somewhat higher valuations. The enhanced process allows for exposure to both the *longer-term secular* growth trends and the *shorter-term cyclical* growth opportunities *without sacrificing strong performance potential.* In addition, Sabrient continues to have the forensic accounting team from subsidiary Gradient Analytics review every candidate for each portfolio.

Thus, we believe Sabrient's portfolios – including the new **Q1 2022 *Baker's Dozen* that launched on 1/20/2022, Small Cap Growth 32 that launched on 12/6/2021, and Sabrient Dividend 38 that launched on 12/20/2021** – are positioned for any growth scenario.

Please be sure to download my accompanying slide deck as well, which is available on the *Baker's Dozen website:* **https://bakersdozen.sabrient.com/bakers-dozen-marketing-materials**. 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 **http://Sabrient.com** homepage.