Sabrient Systems

Baker's Dozen Commentary – January 2023 (updated)

January 20, 2023

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. **20 of our 21 live (or recently terminated) portfolios (and 34 of the 41 launched since process enhancements were implemented) are outperforming** or staying even with (within 1% of) their benchmarks (based on gross total return as of 1/19)—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 42** portfolio launched with overweights in Energy, Financials, and REITs, and it currently offers a robust **4.8% dividend yield***.

6. The **Q4 2021 *Baker's Dozen*** just terminated, and it outperformed by a wide margin all relevant market benchmarks (including various mid- and small-cap indexes, both cap-weighted and equal-weight). As of 1/19 termination, it showed a gross total return of **+7.5% versus -12.4%** for the S&P 500, which is a ***+19.9% active return***.

7. The Fed's relentlessly hawkish tone has investors nervously reacting to every piece of economic data. **Inflation and bond yields have been receding** while recession expectations have grown, setting up a potential Fed rate hike pause in H1 2023, followed by a dovish pivot—perhaps igniting a new (and lasting) bull market. Equity valuation multiples have fallen in the face of a hawkish Fed and concerns about war, geopolitical turmoil, recession, and corporate earnings. Forward P/E for S&P 500 and S&P 600 small caps are now 17.6x and 13.5x (as of 1/19). The **Energy sector** remains atop our SectorCast rankings.

8. Until there is greater clarity, I expect more turbulence in the stock market. The passive, broad-market, mega-cap-dominated indexes that have been so hard for active managers to beat in the past may see further weakness during H1 2023. But that's not to say that all stocks would fall. Many individual stocks—particularly within the stronger sectors—could still do quite well. Thus, **the time seems ripe for active selection strategies that can exploit the performance dispersion** among individual stocks.

9. This should continue to be *favorable for Sabrient's portfolios*—including the brand new ***Q1 2023 Baker's Dozen*, *Small Cap Growth 36,*** and ***Dividend 42*** ***(sporting a near 5% current yield)***—all of which leverage our enhanced model that combines Value, Quality, and Growth factors to provide exposure to both longer-term secular growth trends and shorter-term cyclical growth and value-based opportunities.

10. Stock-bond correlations surged in 2022 along with interest rates, likely due to the *increasing dominance in the major market indexes of growth stocks*, whose valuations are highly sensitive to rising interest rates. This led many observers to declare the classic 60/40 portfolio allocation model dead. But as interest rates recede and capital continues to rotate into value stocks and cyclicals, stock-bond correlations should fall—and the traditional 60/40 portfolio just might regain its luster.

Market commentary:

Last year as we headed into 2022, I said, "I expect greater volatility and perhaps a rather significant market correction." I also opined that quality would be the primary investor focus in 2022, leading to higher performance dispersion among stocks that would benefit active management and long/short strategies. Indeed, Sabrient's portfolios have almost all outperformed, and our subsidiary Gradient Analytics (a forensic accounting/earnings quality research firm) had a successful year, with quite a number of short ideas that sold off precipitously for its clientele of institutional investors and long/short hedge funds.

In addition, I expected inflation readings to moderate by mid-to-late 2022, given higher base period comps and mending supply chains, which has come to pass. However, inflation surged higher than I anticipated, peaking at 9.1% in June before gradually receding. As Federal Reserve Chair Powell has pointed out, persistently low labor participation and falling productivity has led to wage inflation, which has partially offset the Fed's efforts to induce demand destruction and a bear market in risk assets (to reduce the "wealth effect").

But what I didn't foresee last January was Russia's invasion of Ukraine and the attendant impacts on energy prices and supply chains, which prolonged and propelled inflationary pressures—and by extension the Fed's hawkish approach to monetary policy. Thus, interest rates rose much higher than I predicted, surging well above 4% before finding hitting a peak. Nevertheless, my broad Fed storyline remains intact: softening of the hawkish jawboning, followed by slower rate hikes, a pause (or neutral pivot) to give the rapid hikes a chance to marinate (typically it takes 9-12 months for a rate hike to have its full effect), and then as inflation readings retreat and/or recession sets in, rate cuts commence leading to a relief rally and perhaps the start of a new (and lasting) bull market.

For now, the Fed's relentlessly hawkish tone has investors nervously reacting to every piece of economic data—bullish when it indicates the economy and inflation are slowing (suggesting an imminent Fed pause followed by a dovish pivot) or bearish when it indicates continued economic strength (suggesting additional rate hikes and contraction of the Fed's balance sheet). Moreover, the geopolitical landscape—including increasing aggression from Russia (in Ukraine), China (regarding Taiwan), and North Korea (nuclear escalation)—has been destabilizing for supply chains and the global economy.

This has led to elevated stock market volatility (+1 standard deviation above average, according to DataTrek, which historically has only happened during bear markets or periods of crisis). All of this has clouded the corporate earnings outlook and depressed consumer, business, and investor sentiment (although so far consumer spending and corporate earnings and profitability have held up fairly well).

Thus, there was no Santa rally, and we don't yet have the climate for a sustained bull run. Capital has flowed defensively into bonds, pushing down interest rates, and equity valuation multiples have fallen in the face of a hawkish Fed and concerns about war, geopolitical turmoil, recession, and corporate earnings. Forward P/Es for S&P 500 and S&P 600 small caps are now 17.6x and 13.5x (as of 1/19/23). Bullish conviction will require a pivot to neutral or dovish Fed policy, an improved investor outlook on corporate earnings, and lower market volatility. As the 10-year Treasury yield retreated from its October high of 4.33% to a low near 3.40% in December, the 10-2 yield curve inverted to the greatest degree in 40 years (around -70 bps), which historically is highly predictive of a significant recession.

However, I do not believe our political leaders will allow the economy (and especially the working class) to be crushed, despite the Fed's hawkish tone. Longer term, I believe the Fed not only will be *willing* to live with inflation somewhat above its 2% goal, but it may become an *intentional* tactic within a coordinated global monetary policy that seeks to weaken the dollar and gradually "inflate away" the massive dollar-denominated debt loads across the world.

Sabrient SectorCast ETF Rankings (as of 1/1/2023)		
Dow Jones U.S. Sector	Tracking ETF	Outlook Score
ENERGY	IYE	91
TECHNOLOGY	IYW	74
CONSUMER STAPLES	IYK	61
HEALTHCARE	IYH	61
CONSUMER DISCRETIONARY	IYC	50
INDUSTRIALS	IYJ	44
BASIC MATERIALS	IYM	42
FINANCIALS	IYF	31
TELECOMMUNICATIONS	IYZ	13
UTILITIES	IDU	6

Until we get greater clarity, I expect more turbulence in the stock market. The passive, broad-market, mega-cap-dominated indexes that have been so hard for active managers to beat in the past may see further weakness during H1 2023, with elevated volatility. At best, the indexes might simply gyrate within a trading range—and perhaps even retest the October lows. Worst case, however, could take the S&P 500 back down to the 3300 level of Q4 2020…or even lower.

But that's not to say that <u>all</u> stocks would fall. Many individual stocks—particularly within the stronger sectors—could still do well. For example, from a sector standpoint, Energy beat the S&P 500 in both 2021 and 2022, with the Energy Select Sector SPDR (XLE) up +53% in 2021 while the SPY was *up* +29%, and +64% in 2022 while the SPY was *down* -18%. And looking ahead, Sabrient's SectorCast ETF rankings still show Energy at the top as shown in the **table**, given its low (single digit) forward P/E, strong expected EPS growth rate, and favorable sentiment among both analysts and insiders.

Thus, we believe the time is ripe for active strategies that can exploit the performance dispersion among individual stocks. This should be *favorable for Sabrient's portfolios*—including the new ***Q1 2023 Baker's Dozen*, *Small Cap Growth 36*,** *and* ***Dividend 42 (sporting a near 5% current yield)***—which leverage our enhanced model that combines Value, Quality, and Growth factors to provide exposure to both longer-term secular growth trends and shorter-term cyclical growth and value-based opportunities.

Notably, high cash balances and low sentiment readings among consumers, investors, and fund managers are contrarian bullish indicators. Also, the third year (post-midterm elections) of the last 18 presidencies since 1950 have been flat or solidly positive, with the S&P 500 averaging +16.8%.

A compelling bearish thesis is that the long-running bull market was driven by low inflation, low interest rates, QE, world peace, and globalization. However, as those favorable variables have reversed, valuation multiples must ultimately revert to the lower levels of yore. However, I do not believe these variables have permanently reversed. I think inflation and interest rates will moderate, and onshoring and other forms of "deglobalization" will turn out to be simply some "deconcentration" of manufacturing away from China (and Taiwan, for semiconductors)—and the secular disinflationary and productivity-enhancing macro trends will resume.

In addition, as investors continue to place greater emphasis on quality and value, I expect the historically anomalous high correlation between stocks and bonds to revert back to more normal behavior As I discussed in my December commentary, correlations grew most likely due to speculative investing and the increasing *dominance in the major market indexes 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 also should fall—and the traditional 60/40 stock/bond allocation model just might regain its luster.

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.

In fact, as shown in the table, **20 of our 21 live portfolios** (including the 3 that recently terminated) are outperforming or staying even with (within 1% of) their benchmarks (based on gross total return as of year-end)—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).] In addition, **34 of the 41 portfolios** launched since process enhancements were implemented in December 2019 are outperforming or staying even with (within 1%) their benchmarks.

Baker's Dozen & FLV - Gross return thru: 1/19/2023

Portfolio	Launch	Close	Gross Return (FTP website)	SPY Return	Active Return
Q4 2021 BD	10/20/21	1/19/23	7.5%	-12.4%	19.9%
Q1 2022 BD	1/20/22		4.5%	-11.6%	16.1%
Q2 2022 BD	4/20/22		4.5%	-11.5%	16.0%
FLV 10	7/15/22		18.3%	1.8%	16.5%
Q3 2022 BD	7/20/22		8.9%	-0.7%	9.6%
Q4 2022 BD	10/20/22		1.3%	6.8%	-5.6%

Sabrient Dividend - Gross return thru: 1/19/2023

Portfolio	Launch	Close	Gross Return	SPY Return	Active
Div 34	12/21/20	12/21/22	19.8%	8.1%	11.7%
Div 35	3/19/21		4.8%	2.4%	2.4%
Div 36	6/22/21		8.6%	-6.0%	14.6%
Div 37	9/20/21		16.6%	-8.7%	25.3%
Div 38	12/20/21		10.9%	-13.2%	24.1%
Div 39	3/18/22		-2.5%	-11.4%	8.9%
Div 40	6/15/22		5.1%	3.8%	1.3%
Div 41	9/12/22		-0.4%	-4.6%	4.2%
Div 42	12/9/22		-0.2%	-0.7%	0.5%

Small Cap Growth - Gross return thru: 1/19/2023

Portfolio	Launch	Close	Gross Return	IWM Return	Active
SCG 31	9/8/21	12/8/22	9.2%	-18.0%	27.1%
SCG 32	12/6/21		-3.1%	-15.4%	12.3%
SCG 33	3/4/22		-2.6%	-7.0%	4.5%
SCG 34	6/1/22		6.0%	0.0%	5.9%
SCG 35	8/29/22		3.1%	-1.8%	4.9%
SCG 36	11/14/22		-1.6%	-1.0%	-0.6%

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 yield of 4% or more.

Update on the just-terminated Q4 2021 *Baker's Dozen* Portfolio:

The **Q4 2021 *Baker's Dozen*** terminated on 1/19/2023. 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). It 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.

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 (10/20/21-1/19/23), the gross total return of the model portfolio is **+7.5% versus -12.4%** for the S&P 500 index and **-18.5%** for the Russell 2000.

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	56.6%	9.8	8.1	321.6%	277.5%
ACGL	Arch Capital Group Ltd.	Financials	48.7%	12.4	11.5	38.8%	38.1%
FANG	Diamondback Energy, Inc.	Energy	31.7%	8.2	6.3	121.4%	164.5%
TJX	The TJX Companies, Inc.	Consumer Discretionary	24.4%	20.1	23.2	41.7%	29.1%
KLAC	KLA Corporation	Information Technology	21.5%	17.1	18.9	33.7%	46.0%
NTR	Nutrien Ltd.	Materials	16.0%	13.0	8.6	140.1%	239.0%
TMHC	Taylor Morrison Home Corporation	Consumer Discretionary	14.0%	4.6	4.6	64.0%	120.5%
WLK	Westlake Corporation	Materials	8.6%	7.7	11.1	76.4%	80.5%
BLD	TopBuild Corp.	Consumer Discretionary	-20.3%	18.8	11.8	30.6%	60.4%
AMAT	Applied Materials, Inc.	Information Technology	-20.8%	16.8	16.3	29.8%	12.4%
HRI	Herc Holdings Inc.	Industrials	-24.3%	20.7	10.8	63.2%	60.9%
WRK	WestRock Company	Materials	-25.6%	9.6	9.7	75.1%	41.7%
MRNA	Moderna, Inc.	Health Care	-42.8%	7.5	32.9	452.6%	69.5%
		Average =	+7.5%	12.8	13.4	114.5%	95.4%
SPY	SPDR S&P 500 ETF Trust		-12.4%				
RSP	S&P 500 Equal-Weight		-6.2%				
MDY	SPDR S&P MidCap 400 ETF Trust		-8.0%				
IWM	iShares Russell 2000 ETF		-18.5%				
EWMC	S&P 400 MidCap Equal-Weight		-6.1%				
EWSC	S&P 600 SmallCap Equal-Weight		-11.2%				

Top performers include oil & gas production firms **Devon Energy (DVN)** and **Diamondback Energy (FANG)**, insurer/reinsurer **Arch Capital Group (ACGL),** retailer **The TJX Companies (TJX)**, and semiconductor equipment maker **KLA Corp (KLAC)**. Laggards have been biopharma/vaccine maker **Moderna (MRNA)**, construction suppliers **TopBuild (BLD)** and **Herc Holdings (HRI)**, packaging maker **WestRock (WRK)**, and semiconductor equipment maker **Applied Materials AMAT)**. 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 new Q1 2023 *Baker's Dozen* Portfolio:

The **Q1 2023 *Baker's Dozen*** just launched on 1/20/23. 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, but biased smaller, with 2 large caps, 4 mid-caps, and 7 small caps; a 6/7 split between growth/value; and a 7/6 split between cyclical and secular growers. As for sectors, there are 4 names from Financials, 3 Energy, 2 Healthcare, 2 InfoTech, 1 from Industrials, and 1 from Consumer Staples. **Delta Air (DAL)** is a familiar name, but most are more "under the radar," like natural gas producer **EQT Corp (EQT)**, or crisis management software firm **Everbridge (EVBG)**, or **Collegium Pharma (COLL)**, which is developing alternative medicines to opioids for severe pain.

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	23.3	36.9%	11.6	0.31	0.0%	5	10
COLL	Collegium Pharmaceutical	Health Care	Pharmaceuticals	0.9	122.8%	4.1	0.03	0.0%	5	4
DAL	Delta Air Lines	Industrials	Airlines	24.5	60.4%	7.5	0.12	0.0%	4	7
DAR	Darling Ingredients	Consumer Staples	Agricultural Products	10.4	42.8%	9.9	0.23	0.0%	4	8
EQT	EQT Corporation	Energy	Oil and Gas Exploration and Production	12.5	109.6%	5.2	0.05	1.8%	3	9
EVBG	Everbridge	Information Technology	Application Software	1.1	401.2%	23.7	0.06	0.0%	5	7
EXTR	Extreme Networks	Information Technology	Communications Equipment	2.4	43.0%	16.9	0.39	0.0%	5	9
LNTH	Lantheus Holdings	Health Care	Health Care Supplies	3.7	31.9%	13.3	0.42	0.0%	5	10
MKL	Markel Corporation	Financials	Property and Casualty Insurance	18.5	33.4%	17.6	0.53	0.0%	5	9
NEX	NexTier Oilfield Solutions	Energy	Oil and Gas Equipment and Services	2.1	97.9%	4.1	0.04	0.0%	4	8
PFBC	Preferred Bank	Financials	Regional Banks	1.0	8.8%	7.3	0.83	3.1%	5	10
TALO	Talos Energy	Energy	Oil and Gas Exploration and Production	1.7	29.5%	4.9	0.17	0.0%	3	8
ZION	Zions Bancorporation	Financials	Regional Banks	7.4	26.2%	7.6	0.29	3.4%	4	7
			Average:	8.4	80.3%	10.3	0.13	0.6%	4.4	8.2

Final Comments:

You can find more detail on our latest *Baker's Dozen* 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.

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 **Q1 2023 *Baker's Dozen*** (launched on 1/20/23), **Forward Looking Value 10** (launched on 7/15/22), **Small Cap Growth 36** (launched on 11/14/22), and **Sabrient Dividend 42** (launched on 12/9/22)—are positioned to outperform their passive benchmarks.