Sabrient Commentary – March 2021 (as of 3/1/2020)

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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 Q1 2020 *Baker's Dozen*, which terminates next month, 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, the growth factor, and the secular-growth Technology sector greatly outperforming small caps, the value factor, and cyclical-growth sectors* (like Financial, Industrial, Materials, and 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, driving the cap-weighted indexes to greatly outperform equal-weighted indexes.
2. However, 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, additional fiscal and monetary stimulus, infrastructure spending, rising inflation, and the start of a sustained recovery/expansionary economic phase. We expect the Value/Growth and Small/Large performance divergences to continue to converge while market leadership broadens. Moreover, we expect fundamental active selection, strategic beta ETFs, and equal weighting will outperform the passive cap-weighted indexes, and there may be 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. Regardless, **Sabrient implemented process enhancements** in December 2019 to make our portfolios more "all-weather" by: (a) reducing downside volatility versus the benchmark, and (b) focusing more on earnings consistency & reliability to improve the likelihood of meeting earnings estimates by adding our new Growth Quality Rank (GQR) to the GARP model. As a result, many top-performing secular growth stocks have become competitive in our model with the more attractively valued (lower P/E) cyclical stocks, and our more recent portfolios have reflected a better balance between secular and cyclical growth, between growth and value factors, and across market caps.
4. **Our live portfolios have shown improved performance relative to the benchmark, with many of them substantially outperforming** during these unusual and evolving market conditions. As a result, our **theoretical rolling January *Baker's Dozen* Model Portfolio** has resumed its solid historical outperformance versus the benchmark S&P 500 over the past 12 years (2009-2020), with a gross average annual return of +20.6% versus +14.9% for the S&P 500.
5. In our view, **investors should be positioned for <u>both</u> the major secular growth trends <u>and</u> the value/cyclicals/small caps that typically thrive during an expansionary phase**. And with our enhanced selection process, we believe our portfolios – including the **Q1 2021 *Baker's Dozen* that launched on 1/20/21, *Small Cap Growth* that will launch on 3/15/21, and *Sabrient Dividend* portfolio that launches on 3/19/21** – are better positioned for either: (a) continued broadening and rotation into value, cyclicals, and smaller caps, or (b) a return to narrow leadership from secular growth.
6. **The Q1 2020 *Baker's Dozen* portfolio**, which will terminate on 4/20/21, launched on 1/17/20 with equal position weights and overweight allocations (relative to the S&P 500 benchmark) to small/mid-caps, the value factor, and the Technology sectors, as indicated by our enhanced GARP quant model. **The portfolio has significantly outperformed the S&P 500 benchmark**, thanks to big winners from the Tech sector and big recoveries in the travel & leisure names on reopening speculation.

Market observations:

Of course, we know that 2020 was a highly anomalous year in many ways, including a huge selloff that took down many top performers in highly correlated market flush, followed by a speculative recovery rally (aka "reopening trade") led at first by the Big Tech darlings and new WFH / ecommerce / digitization / touchless transaction / precision medicine / genomics disruptors, and then rotating into many value/cyclical names that had been left for dead (often for good reason). Much of it was highly speculative with little regard for value, accounting practices, or earnings quality given that much of the "real economy" had essentially ground to a halt. But more recently, economic reports have been looking quite strong, and Q4 2020 earnings reports have far surpassed expectations (with +3.2% YOY increase in revenues and +3.9% in earnings). According to FactSet, expected YOY earnings growth during 2021 are +21.5% in Q1, +49.7% in Q2, +16.9% in Q3, and +13.0% in Q4).

Moreover, both investment grade (IG) and high yield (HY) corporate bond spreads recently hit post-pandemic lows, so investors are displaying confidence in the Fed's conviction. Research Affiliates has opined that the equity risk premium versus bonds is close to its historical average, which may justify current equity valuations, but if the recent spike in long-term rates continues, the Fed may

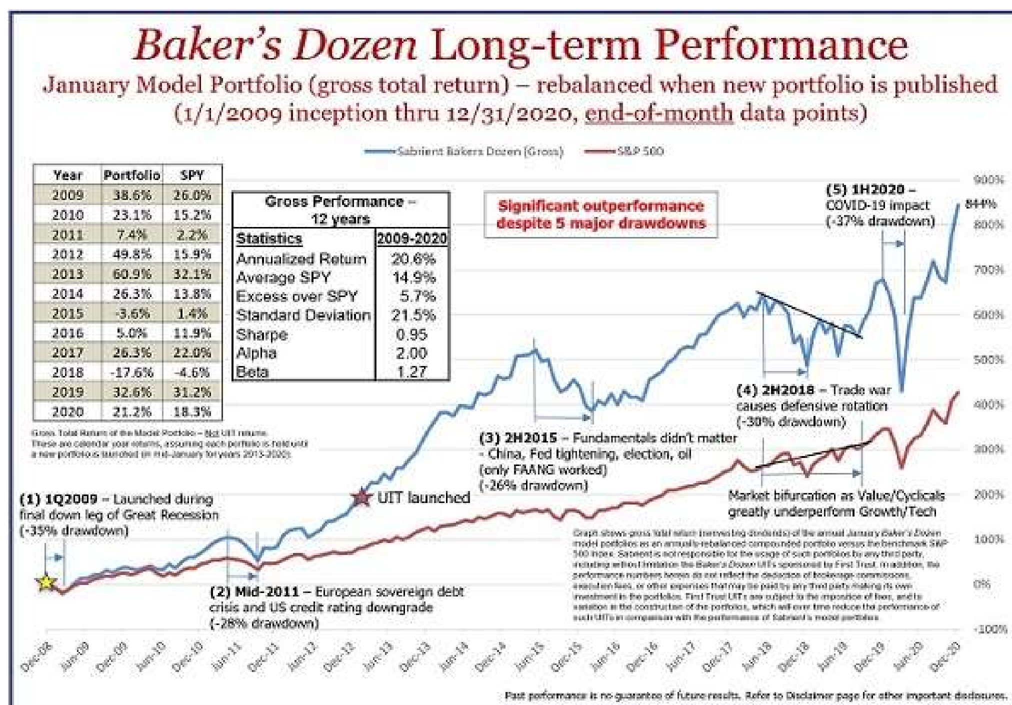
choose to implement yield curve control (YCC). This would be favorable for US equities and corporate bonds (both IG and HY) as well as bitcoin, gold, and commodities as *real* yields (net of inflation) and the dollar fall. Given the global push to alternative energy, I think we are entering a "commodity supercycle." All in all, after 30 years of disinflation and 39 years of falling rates, the ducks are lining up for a sustained reversal in these cyclical trends – much more so than during the last (sluggish) recovery cycle – with a much longer-lasting recovery/expansionary economic cycle and a more gradual inflationary climate than many are forecasting, in my view.

Indeed, the tailwinds sure seem both powerful and durable, including a rapid emergence from the economic effects of both the pandemic and the China trade war; a surge in corporate capex; "reflation" after 30 years of globalization and tech-induced disinflation; unlimited global liquidity and massive pro-cyclical fiscal and monetary stimulus here at home; low (and controlled) interest rates; low tax rates; rising (but still modest) inflation; and the innovation, disruption, and productivity gains of rapidly advancing technologies like 5G, IoT, robotics, autonomous vehicles, AI/ML, virtual reality, cloud computing, 3-D printing, blockchain, computer vision (CV), and automated manufacturing. Thus, it seems to me that investors should be *positioned for both cyclical growth opportunities over the next few years as well as the long-term secular growth trends*.

<u>*Baker's Dozen* model performance update</u>:

Of course, Sabrient's flagship product since 2009 has been our *Baker's Dozen* portfolio, which is now published on a *quarterly* basis. Sabrient founder and chief market strategist David Brown continues to lead the broad Sabrient portfolio selection team (which includes our wholly owned subsidiary Gradient Analytics, a forensic accounting research firm that primarily serves the long/short hedge fund community).

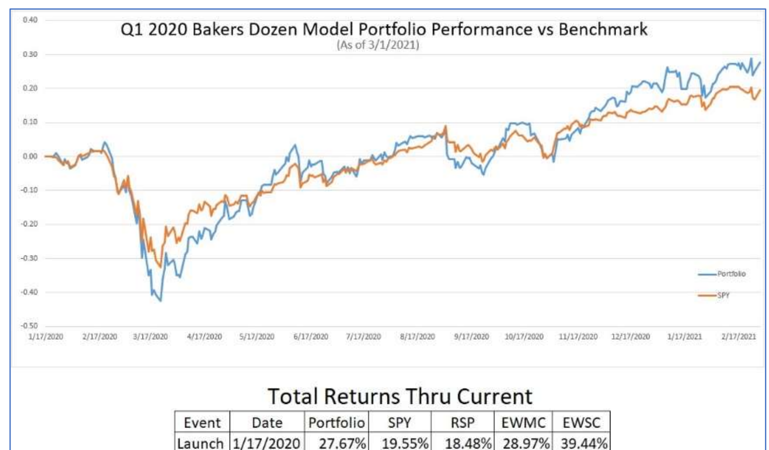
Below is a chart of the long-term performance of a theoretical **<u>Model Portfolio</u> that has been rebalanced every January** upon publication of the newest stock list (equal weighted) since we started publishing the *Baker's Dozen* in 2009. The chart shows the tremendous outperformance over the SPDR S&P 500 Trust (SPY) over the past 12 years *despite five major drawdowns* as shown – including the scary 37% peak-to-trough pandemic selloff. The average annual return is +20.6% versus +14.9% for the SPY.



As illustrated by the June 2018-August 2019 market bifurcation (Value/Cyclicals greatly underperforming Growth/Tech), there is little doubt that the China trade war severely impacted corporate visibility, supply chains, investor psyche, and indeed most value- and cyclicals-oriented portfolios like Sabrient's. But the market rotation into quality, value, cyclical sectors, and small-mid caps – which first began during the last 4 months of 2019 and then regained traction after the pandemic selloff starting in mid-May 2020 – has been quite favorable for us.

Regardless, the "new normal" market conditions and investor preferences suggested to us that we should enhance our legacy GARP model to make it more "all-weather." Of course, we have enhanced it periodically in the past, including the addition of our proprietary *Earnings Quality Rank (EQR)* in 2013 as an alpha factor. So, in December 2019, we developed and added a new *Growth Quality Rank (GQR)* that favors companies with consistent and reliable earnings growth, thus *allowing secular growth stocks to score competitively in the rankings* with more attractively valued (i.e., lower P/E) cyclical and value stocks that our model historically has preferred. As a result, our newer GARP portfolios have reflected a better balance between secular and cyclical growth, between growth and value factors, and across market caps, while also displaying better relative performance versus the benchmark.

The chart on the right focuses solely on the most recent portfolio in the previous 12-year chart, i.e., the **Q1 2020 *Baker's Dozen*** model portfolio that launched on 1/17/2020. You can see that it has shown much less volatility relative to the benchmark. Also, its balance between secular and cyclical growth and across market caps has been an advantage, as performance was first driven mainly by the Technology and Communications Services names, but then during the market rotation into the value, cyclical, and smaller caps we saw leadership from the Travel & Leisure and Energy names.



Total Returns Thru Current

Event	Date	Portfolio	SPY	RSP	EWMC	EWSC
Launch	1/17/2020	27.67%	19.55%	18.48%	28.97%	39.44%

With our enhanced selection process, we believe our portfolios are well-positioned for either: (a) continued broadening and rotation into value, cyclicals, and smaller caps, or (b) a return to narrow leadership from secular growth. Indeed, our live portfolios have shown improved performance relative to the benchmark, with most substantially outperforming. To illustrate, the table on the left shows the performance of the live *Baker's Dozen, Forward Looking Value,* and *Small Cap Growth* model portfolios, both from their launch dates and since the year-end market rotation into value commenced on 10/30/20, relative to the benchmark S&P 500 ETF (SPY) and S&P SmallCap 600 Growth ETF (SLYG), through 3/1/21. All but the Q2 2020 *Baker's Dozen* and *Small Cap Growth* 25 have nicely <u>outperformed</u> on a gross return basis.

Baker's Dozen & FLV - Gross performance thru: 3/1/2021

Portfolio	Launch Date	Portfolio Gross Return Since Launch	SPY Return Since Launch	Portfolio Gross Return Since 10/30/20	SPY Return Since 10/30/20
Q1 2020 BD	1/17/20	27.7%	19.6%	28.2%	19.8%
Q2 2020 BD	4/20/20	19.5%	40.1%	8.0%	19.8%
2020 FLV	7/2/20	29.2%	25.8%	28.2%	19.8%
Q3 2020 BD	7/20/20	49.8%	21.1%	49.0%	19.8%
Q4 2020 BD	10/20/20	33.3%	13.9%	38.2%	19.8%
Q1 2021 BD	1/20/21	2.7%	1.5%	N/A	

Small Cap Growth - Gross performance thru: 3/1/2021

Portfolio	Launch Date	Portfolio Gross Return Since Launch	SLYG Return Since Launch	Portfolio Gross Return Since 10/30/20	SLYG Return Since 10/30/20
SCG 25	12/12/19	25.3%	38.8%	38.6%	46.1%
SCG 26	3/11/20	93.7%	74.5%	56.2%	46.1%
SCG 27	6/9/20	58.9%	47.7%	56.1%	46.1%
SCG 28	9/4/20	52.0%	44.5%	48.0%	46.1%

Going forward, our portfolio will continue to have *exposure to <u>both</u> the major secular growth trends and the value, cyclicals, and smaller caps* that typically thrive during an expansionary economic phase. As an example, the latest **Q1 2021 *Baker's Dozen*** holds 3 large caps, 5 mid-caps, and 5 small caps; 4 growth versus 9 value stocks; and 6 secular-growth Tech and Healthcare names to balance the 7 cyclical-growth stocks from Consumer, Industrial, and Materials sectors. There is even a gold miner in the group, given its strong earnings forecast based on the bull case for gold.

Update on the Q1 2020 *Baker's Dozen* portfolio:

The Q1 2020 *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. Although the broad market indexes continued to hit new highs last summer during the post-selloff recovery, many of the attractively valued cyclical sectors and smaller caps continued to languish due to the "K-shaped" nature of the recovery, with some market segments doing quite well and others falling into depression.

The portfolio mostly favored the value factor and small/mid-caps due to their more attractive valuations. And even though narrow market leadership and an investor penchant for the more highly valued market segments created challenges at times, 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 creates*. Of course, in a concentrated 13-stock portfolio, one or two breakout winners can help offset a number of laggards, and this portfolio has been well-served by stellar performance from **SolarEdge Technologies (SEDG)** despite extreme impacts from the pandemic selloff on the value/cyclical stocks from Consumer Discretionary, Industrials, and Energy.

The portfolio launched with a slight *underweight* allocation (23% vs. 29% in the benchmark) to attractively valued "deep cyclical" sectors – Industrial (15.4% vs. 9.1%), Energy (7.7% vs. 4.3%), Materials (0.0% vs. 2.7%), and Financial (0.0% vs. 13.0%). Also, it had a significant allocation (23%) to Travel & Leisure companies that saw severe impact from the pandemic shutdown, although these names have come roaring back recently on reopening speculation. Also, unlike many prior portfolios, it was slight *overweight* (31% vs. 23%) the Information Technology sector, which was quite helpful as these names were among the best performers.

Moreover, it had a 46% underweight allocation (6 positions) to large caps (vs. the S&P 500 benchmark being solely a large cap index). 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 a large 77% allocation (10 positions) to the value factor (vs. the benchmark's roughly 40%).

In aggregate, despite the myriad challenges from the pandemic Black Swan, several of the holdings have lived up to earnings expectations, with 5 of the 13 having beat or come close to EPS estimates, and it has shown significant outperformance since the 3/23/20 selloff low through 3/1/21 with a return of **+119% versus +77% for the S&P 500**. Moreover, the year-end value rotation and "reopening trade" have been good for the portfolio as it grew **+28% versus +20% for the SPY** (10/30/20-3/1/21).

For the full life of the portfolio so far (1/17/20-3/1/21), ***the Q1 2020*** **Baker's Dozen** ***has managed to handily outperform the benchmark***. The table below shows each holding in the Model Portfolio. You can see that the gross average return of the 13 equal-weight holdings is **+27.7% versus the S&P 500 cap-weight performance of +19.6%.** The top performer by far has been **SolarEdge Technologies (SEDG)**, a provider of solar power solutions. Other winners include software design and services firm **Autodesk (ADSK)**, resort & timeshare operator **Marriott Vacations Worldwide (VAC)**, which has come on strong of late, software & cloud solutions provider **Adobe (ADBE)**, recreational vehicle maker **Winnebago (WGO)**, which has prospered from the pandemic-driven popularity of "vacations in isolation," communications equipment maker **Ciena (CIEN)**, and cable operator **Charter Communications (CHTR)**.

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.	194.0%	21.0	60.9	43.0%	-7.4%
ADSK	Autodesk, Inc.	47.0%	48.5	56.5	69.6%	44.6%
VAC	Marriott Vacations Worldwide Corpo	36.2%	14.3	41.6	30.1%	-133.4%
ADBE	Adobe Inc.	34.3%	35.2	41.8	24.5%	28.2%
WGO	Winnebago Industries, Inc.	32.6%	12.8	12.3	29.3%	4.6%
CIEN	Ciena Corporation	25.6%	16.5	19.0	23.9%	40.0%
CHTR	Charter Communications, Inc.	23.3%	44.3	30.7	107.8%	108.0%
KBH	KB Home	12.0%	9.8	7.7	27.2%	7.2%
ANTM	Anthem, Inc.	3.4%	13.8	12.8	22.8%	15.4%
ALK	Alaska Air Group, Inc.	-2.1%	9.7	NE	19.7%	-257.7%
BMY	Bristol-Myers Squibb Company	-4.7%	12.0	8.3	26.6%	37.9%
VLO	Valero Energy Corporation	-7.8%	9.8	113.9	71.5%	-157.3%
HII	Huntington Ingalls Industries, Inc.	-33.9%	15.1	14.7	25.6%	22.2%
	Average	**27.7%**	**20.2**	**35.0**	**40.1%**	**-19.0%**
SPY	SPDR S&P 500 ETF Trust	19.6%				
RSP	S&P 500 Equal-Weight	18.5%				
EWMC	S&P 400 MidCap Equal-Weight	29.0%				
EWSC	S&P 600 SmallCap Equal-Weight	39.4%				

Those underperforming the benchmark include military shipbuilder **Huntington Ingalls Industries (HII)**, oil & gas refiner **Valero Energy (VLO)**, drug maker **Bristol-Myers Squibb (BMY)**, regional airliner **Alaska Air Group (ALK)**, health plan provider **Anthem (ANTM)**, and homebuilder **KB Home (KBH)**. Note that VLO and ALK have recovered quite a bit over the past 4 months from steep COVID selloffs.

Final thoughts:

Again, we believe investors should be positioned for both the major secular growth trends and the value/cyclicals/small caps that typically thrive during an expansionary economic phase. However, investors should be selective with those secular growth favorites that sport high P/E multiples as they likely will need to "grow into" their current valuations through old-fashioned earnings growth rather than through further multiple expansion, which may limit their upside. Regardless, with our enhanced selection process, we believe our portfolios – including the Q1 2021 *Baker's Dozen* that launched on 1/20/21, *Small Cap Growth* portfolio that will launch on 3/15/21, and *Sabrient Dividend* portfolio that launches on 3/19/21 – are better positioned for either: (a) continued broadening and rotation into value, cyclicals, and small/mid-caps, or (b) a return to narrow leadership from secular growth.

I am particularly excited about these new portfolios because, whereas last year we were *hopeful* based on our testing that our enhanced portfolio selection process would provide better "all-weather" performance, this year we have seen solid evidence (over quite a range of market conditions!) that a better balance between secular and cyclical growth companies and across market caps has indeed provided significantly improved performance relative to the benchmark.

As a reminder, we post on our public website my commentaries and presentation slide deck on the Marketing Materials tab at https://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.

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