Sabrient Systems

Baker's Dozen Commentary – March 2023

March 2, 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. **19 of our 22 live and recently terminated portfolios are outperforming** or staying within 1% of their benchmarks (based on gross total return as of 3/1)—and *several are outperforming quite substantially*. These portfolios include ***Baker's Dozen*, Forward Looking Value, Small Cap Growth, and Dividend.**
5. Our **Dividend portfolios** seek both capital appreciation and solid yield by employing 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 of 4% or more. The **Dividend 42** portfolio launched 12/9 with overweights in Energy, Financials, and REITs, and currently offers a robust **4.7% dividend yield**. (Note: **Dividend 43** portfolio launches on 3/8.)
6. The **Q1 2022 *Baker's Dozen*** will terminate next month on 4/20, and it is outperforming by a wide margin all relevant market benchmarks (including mid- and small-cap indexes, both cap-weighted and equal-weight). As of 3/1, it showed gross total return of **+11.9% versus -10.2%** for the S&P 500, which is a ***+22.1% active return***. Of the other recently terminated portfolios, Q4 2021 *Baker's Dozen* terminated 1/20 with **+19.9%** active return, while Dividend 34 terminated 12/21 with **+11.7%** active return (vs. S&P 500), and Small Cap Growth 31 terminated 12/8 with **+27.1%** active return (vs. Russell 2000).
7. Inflation paused its rapid fall in February, leading bond yields to jump on fears that the anticipated Fed pause on rate hikes and dovish pivot are still a ways off. Nevertheless, I think **inflation will soon resume its descent** as disinflationary trends resume.
8. **Valuation multiples on broad stock market indexes remain elevated** on lingering investor optimistic speculation, despite the 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 17.7x and 13.6x.
9. Instead of the passive, mega-cap-dominated market indexes that have been so hard to beat, **investors may be better served by active strategies** that exploit performance dispersion among stocks. This should continue to be *favorable for Sabrient's portfolios,* which combine Value, Quality, and Growth factors and provide exposure to both secular and cyclical growth.
10. We continue to suggest investors **stay long but hedged, with a heightened emphasis on quality** and a balance between value/cyclicals/dividend payers and high-quality secular growers. Energy remains our top-ranked sector.

Market commentary:

The year started with the market showing resilience in the face of the Fed's rate hikes, balance sheet contraction, hawkish rhetoric, and willingness to inflict further economic pain, including a recession and rising unemployment (if that's what it takes)—not to mention the geopolitical landscape of escalating aggression by Russia in Ukraine, by China (regarding both Ukraine and Taiwan), and North Korea (persistent rocket launches and saber-rattling).

I have long opined that the Fed was simply trying to "talk up" interest rates without having to actually raise them so much—so that they wouldn't have to quickly reverse those rate hikes when the economy faltered. However, investors were not buying it, thus forcing the Fed to carry through on its threats—even doubling down on them—leading investors to sell bonds in expectation of even higher rates. This has led the entire yield curve to rise while increasing its inversion (to around 90 bps on the 2-10 spread, which is the worst in 40 years).

You see, although the capital markets are loathe to ignore the Fed—and the adage "Don't fight the Fed!" is still alive and well—the US economy and consumers have been willing to do so. Jobs growth and retail sales have stubbornly held up despite the Fed's efforts to suppress demand, although manufacturing indices are in contraction territory as consumers have shifted purchases from goods to services. As a result, progress on bringing down inflation has stalled (according to the January CPI, PPI, and PCE reports).

Thus, the optimism that drove the January surge in both stock and bond prices (and pushing down yields) subsided in February due to the resilience of the global economy and labor markets ("good news is bad news"), replaced instead by the realization that rates may stay "higher for longer" in an effort to depress excess consumer demand, inflationary pressures, and jobs growth.

As inflation's fall has paused (at least for the moment), investors have grown more fearful that a highly anticipated Fed pause and dovish pivot are still a ways off and that the Fed instead will have to follow through on its hawkish rhetoric. This led to February's 100% retracement of the January bond rally. The resulting rise in yields led to weakness in equities and a 50% retracement for the S&P 500 of its January rally. But another important factor (as pointed out by DataTrek) is the rise in *real yields* (as nominal yields rise while expected inflation stabilizes), which suggests growing investor caution. So, while it is evident that this market is itching to rally if only the Fed would get out of the way, the Fed is insistent on appearing laser-focused on a 2% inflation target.

Moreover, the unemployment rate has remained stubbornly low as employers deal with falling productivity, low labor force participation, and difficulty in finding experienced workers when they are needed. And then there is the historical observation that a CPI above 5% has never come back down without the *fed funds rate exceeding CPI*.

However, from my perspective, 1) I believe labor force participation will increase as pandemic-era supplemental income programs end, 2) commodity re-inflation in January subsided in February as have leading indicators, and 3) CPI has already fallen substantially from 9.1% in June to 6.4% in January without fed funds yet cracking the 5% handle—and CPI is a *lagging* indicator.

So, the question is, will the Fed be willing to escalate its monetary tightening (as it insists it will) to force the economy into at least a mild recession (aka "soft landing")? Or will progress in supply chain recovery, labor force participation (as the pandemic-era handouts push workers back into the job market), and productivity—coupled with limits on money supply growth and the natural inclination of a fully-functioning US economy and secular trends to be *disinflationary*—provide the restraint on wage and price inflation that the Fed seeks without having to double-down on its intervention/manipulation?

My expectation is the latter. I believe inflation will soon resume its gradual fall as disinflationary trends resume. Nothing goes in a straight line for long, and inflation is no different, i.e., the path is volatile. But it is still in a downtrend as supply chains recover (albeit hindered by escalating war in Ukraine); labor participation rises; the US dollar remains strong; energy, commodity, and shipping prices remain near today's "reasonable" levels; and the Fed continues to restrain demand (and perhaps induce a mild recession).

As for U.S. equity valuations, they sit near the highest levels of the two decades prior to the COVID pandemic, despite much higher interest rates. Forward P/Es for S&P 500 and S&P 600 small caps ended February at 17.7x and 13.6x. Bullish conviction will require a pivot to neutral or dovish Fed policy, an improved outlook on corporate earnings, and lower market volatility.

Indeed, a compelling bearish thesis is that the long-running bull market was driven by low inflation, low interest rates, QE, world peace, and globalization, and 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 "de-concentration" of manufacturing away from China—and the secular disinflationary and productivity-enhancing macro trends will resume. As the Cato Institute observed after examining 2022 U.S. trade data from the Census Bureau, *"…the much-ballyhooed Death of Globalization has been greatly exaggerated. In fact, inflation-adjusted U.S. trade in goods—imports and exports—set records last year."*

Moreover, 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. Moreover, a hawkish Fed creates a strong dollar, which effectively exports inflation to our trading partners, which hurts emerging market economies the most, contributing to the political turmoil and mass migration we are seeing today. 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.

Nevertheless, my broad storyline remains intact, albeit slightly delayed: softening of the Fed's 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.

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. I suggested in January that the major indexes might remain in a trading range, such as 3600–4100 on the S&P 500.

But that's not to say that all stocks will struggle. Many individual companies—particularly within the stronger sectors—could still do well. Sabrient's SectorCast ETF rankings have consistently ranked the Energy sector at the top (as shown in the **table**), given its low (single digit) forward P/E, strong expected EPS growth, and favorable sentiment among both analysts and insiders.

Sabrient SectorCast ETF Rankings
(as of 3/1/2023)

Dow Jones U.S. Sector	Tracking ETF	Outlook Score
ENERGY	IYE	95
TECHNOLOGY	IYW	71
INDUSTRIALS	IYJ	60
CONSUMER STAPLES	IYK	57
CONSUMER DISCRETIONARY	IYC	50
FINANCIALS	IYF	44
HEALTHCARE	IYH	37
TELECOMMUNICATIONS	IYZ	34
BASIC MATERIALS	IYM	27
UTILITIES	IDU	5

Given the historical 90% correlation between economic growth and corporate profits, the passive, broad-market, mega-cap-dominated indexes that have been so hard for active managers to beat in the past may see further volatility. Thus, investors may be better served by pursuing active strategies that can exploit the performance dispersion among individual stocks, which should be favorable for Sabrient's portfolios—including the ***Q4 2022 Baker's Dozen, Small Cap Growth 36,*** *and* ***Dividend 42*** ***(sporting a near 5% current yield)***—which combine Value, Quality, and Growth factors and provide exposure to both longer-term secular growth trends and shorter-term cyclical growth and value-based opportunities.

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, **19 of our 22 live portfolios** (including the two that terminated last month) 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.

In addition, **33 of the 42 portfolios** launched since process enhancements were implemented in December 2019 are outperforming or staying even with (within 1%) their benchmarks. [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).]

Baker's Dozen & FLV - Gross return thru: 3/1/2023

Portfolio	Launch	Close	Gross Return (FTP website)	SPY Return	Active Return
Q4 2021 BD	10/20/21	1/20/23	9.1%	-10.8%	19.9%
Q1 2022 BD	1/20/22		11.9%	-10.2%	22.1%
Q2 2022 BD	4/20/22		11.2%	-10.1%	21.3%
FLV 10	7/15/22		21.7%	3.4%	18.3%
Q3 2022 BD	7/20/22		15.3%	0.9%	14.5%
Q4 2022 BD	10/20/22		5.4%	8.5%	-3.1%
Q1 2023 BD	1/20/23		2.0%	-0.3%	2.3%

Sabrient Dividend - Gross return thru: 3/1/2023

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		7.5%	4.0%	3.5%
Div 36	6/22/21		10.4%	-4.6%	14.9%
Div 37	9/20/21		17.4%	-7.3%	24.7%
Div 38	12/20/21		10.6%	-11.8%	22.4%
Div 39	3/18/22		-2.7%	-10.0%	7.3%
Div 40	6/15/22		5.2%	5.5%	-0.3%
Div 41	9/12/22		-3.1%	-3.1%	0.0%
Div 42	12/9/22		-1.2%	0.8%	-2.0%

Small Cap Growth - Gross return thru: 3/1/2023

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		3.4%	-12.5%	15.8%
SCG 33	3/4/22		5.3%	-3.8%	9.1%
SCG 34	6/1/22		11.6%	3.5%	8.1%
SCG 35	8/29/22		8.8%	1.6%	7.1%
SCG 36	11/14/22		0.6%	2.4%	-1.8%
SCG 37	2/10/23	NEW!			

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 next-to-terminate Q1 2022 *Baker's Dozen* Portfolio:

The **Q1 2022 *Baker's Dozen*** terminates on 4/20/2023. 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 1/20/2022 with an overweight in attractively valued "deep cyclical" sectors (Energy, Financials, Industrials, Materials), i.e., 6 positions out of 13, plus 1 from Consumer Discretionary. It was slightly underweight secular growth Technology and Healthcare (4 positions). As for Value vs. Growth exposure, the portfolio launched with 38% allocation (5 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 4 large, 4 mid, and 5 small caps.

Q1 2022 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
ACLS	Axcelis Technologies, Inc.	Information Technology	117.0%	16.8	22.1	64.7%	88.9%
ACGL	Arch Capital Group Ltd.	Financials	55.5%	11.0	12.0	45.1%	35.0%
TEX	Terex Corporation	Industrials	43.0%	12.1	12.2	30.9%	27.5%
DVN	Devon Energy Corporation	Energy	21.6%	9.3	7.5	146.5%	136.1%
ARCB	ArcBest Corporation	Industrials	11.9%	10.2	9.7	36.0%	63.0%
TOL	Toll Brothers, Inc.	Consumer Discretionary	2.6%	5.9	7.0	53.2%	61.5%
AEL	American Equity Investment Life Holdi	Financials	1.6%	9.2	8.4	51.0%	29.6%
KLAC	KLA Corporation	Information Technology	0.3%	18.0	20.7	35.5%	37.1%
DAR	Darling Ingredients Inc.	Consumer Staples	-1.1%	13.0	11.4	50.9%	21.1%
HRI	Herc Holdings Inc.	Industrials	-5.1%	15.2	10.0	62.5%	50.2%
PFE	Pfizer Inc.	Health Care	-22.5%	9.1	11.4	56.2%	48.9%
WDC	Western Digital Corporation	Information Technology	-36.4%	7.4	NE	32.2%	-59.7%
CHTR	Charter Communications, Inc.	Communication Services	-36.6%	19.4	10.5	37.3%	23.9%
	Average		**+11.9%**	**12.0**	**11.9**	**54.0%**	**43.3%**
SPY	SPDR S&P 500 ETF Trust		-10.2%				
RSP	Invesco S&P 500 Equal Weight		-4.1%				
MDY	SPDR S&P MidCap 400 ETF Trust		0.4%				
IWM	iShares Russell 2000 ETF		-4.8%				
EWMC	S&P 400 MidCap Equal-Weight		1.7%				
EWSC	S&P 600 SmallCap Equal-Weight		-2.7%				

As shown in the table, 9 of the 13 holdings have exceeded or come close to EPS estimates. Regardless, the overall 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 (1/20/2022–3/1/2023), the gross total return of the model portfolio is **+11.9% versus -10.2%** for the S&P 500 index (**+22.1%** active return!) and -4.8% for the Russell 2000, led by a diverse set of strong performers from InfoTech, Financials, Industrials, and Energy.

Top performers include specialty semiconductor maker **Axcelis Technologies (ACLS)**, insurer/reinsurer **Arch Capital Group (ACGL)**, industrial equipment maker **Terex Corp (TEX)**, and oil & gas producer **Devon Energy (DVN)**. Laggards include data storage hardware maker **Western Digital (WDC)**, cable provider **Charter Communications (CHTR)**, mega-pharma **Pfizer (PFE)**, and construction equipment firm **Herc Holdings (HRI)**.

Overview of the latest Q1 2023 *Baker's Dozen* Portfolio:

The **Q1 2023 *Baker's Dozen*** launched on 1/20. 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).

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

The portfolio has a diverse (but small-biased) mix across market caps, with 2 large caps, 4 mid-caps, and 7 small cap; a 7/6 split between value and growth stocks; and a 7/6 split between cyclical and secular growers. As for sectors, there are 4 Financials, 3 Energy, 2 InfoTech, 2 Healthcare, 1 from Industrials, and 1 from Consumer Staples.

Only one is a truly familiar name, **Delta Airlines (DAL)**, while the others are all relatively "under the radar" stocks, like oil & gas firm **EQT Corp (EQT)**, regional bank **Preferred Bank (PFBC)**, medical diagnostics firm **Lantheus Holdings (LNTH)**, and drugmaker **Collegium Pharma (COLL)**, which focuses on alternatives to opioids for severe pain.

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), **Forward Looking Value 10** (launched on 7/15), **Small Cap Growth 37** (launched on 2/10), **Sabrient Dividend 42** (launched on 12/9), and the upcoming **Dividend 43** (launching on 3/8)—are positioned to outperform their passive benchmarks.

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