Sabrient Commentary – October 2021 (as of 10/20/2021)

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Key talking points for the new Q4 2021 *Baker's Dozen*:

1. Sabrient Systems and subsidiary Gradient Analytics form a unique **collaboration of engineers and forensic accountants** who leverage quantitative models, a **process-driven methodology**, and expertise in financial statement analysis.
2. **After consistently strong performance** in 2009–2014, in 2015 the market became narrow and news-driven due to rancorous elections, Fed policy uncertainty, trade wars, and social unrest leading to **historic performance divergences** (due to perceived relative safety) in *Growth over Value* factors and *Large over Small* caps, despite an otherwise strong fundamental outlook for value/cyclicals and small-mid caps.
3. We implemented **process enhancements** in December 2019 to make portfolios more "all-weather," primarily by adding a Growth Quality Rank (GQR) to our Growth at Reasonable Price (GARP) quant model that rewards a consistent and reliable earnings history even if forward valuations are somewhat elevated. Newer portfolios now provide exposure to both the value and growth factors, cyclical and secular growth, and across market caps resulting in **improved performance and lower volatility**.
4. The **Q3 2020 *Baker's Dozen*** Model Portfolio terminates on 10/20/2021 after 15 months of life. It has outperformed the S&P 500 +52.5% versus +41.5% (gross return as of 10/19/2021), led by two strong performers from the Technology and Communications Services sectors. It launched on 7/20/20 with equal position weights and overweight allocations (relative to the benchmark) to small/mid-caps, the value factor, and the Technology sector, in accordance with our enhanced model.
5. Looking ahead, we expect **continued economic expansion** (despite a global slowdown from unrelenting supply chain issues and financial issues in China) as well as continued strong corporate earnings, productivity, and margins, plus ongoing fiscal and monetary policy support and moderating inflation in 2022 (as supply chain disruptions and labor shortages eventually resolve and disinflationary long-term structural trends resume). Regardless, the Energy sector looks particularly strong.
6. Moreover, given lofty valuations, slow recovery of supply chains, and China's new growth questions, **elevated volatility is likely, so we suggest staying long, *but hedged***. Moreover, we expect broadening leadership and share price reliance on earnings growth rather than multiple expansion. Active selection, strategic beta, equal weighting, and the Quality factor should thrive, which also should be **favorable for the newly launched *Q4 2021 Baker's Dozen*, as well as Small Cap Growth and Dividend.**

Market observations:

It had been quite a long stretch since the market had seen even a -5% correction, but we finally got it, with the S&P 500 falling -6% (intraday) in September. Although many commentators (including myself) felt we needed even more of a correction in the major market indexes to really wring out some excesses and the "weak" holders, the underlying internals tell a different story of a much harsher "stealth" correction. Alpine Macro reported that 90% of the stocks in the S&P 500 have fallen at least -10% from their recent highs, with an average decline of -17% … and -38% in the Nasdaq Composite! A casual observer might not have noticed this since these individual stock corrections didn't occur all at once, but rather in more of a rolling fashion as various industries fell in and out of favor at different times.

In any case, the dip buyers came swooping in, as usual … because, well, TINA ("there is no alternative"). After all, earnings are robust, interest rates are low, IG and HY credit spreads are tight, and total global debt paying negative yields remains near $15 trillion. In fact, those who have owned risk-free 10-year Treasury notes over the past 12 months have *lost* -11% of their real purchasing power as bond prices fell while inflation rose, while those owning IG corporate bonds lost nearly -5%. (So much for a comfortable retirement from a portfolio of safe bonds!) Q3 earnings reporting season is now underway, and I expect the number and magnitude of upside surprises and forward guidance will determine the next directional trend.

The Energy sector has been on fire (no pun intended). And not to be outdone, Financials, Industrials, and Materials also have joined the party as a cohort of cyclical sectors. This is indicative of increased market breadth, which hopefully will continue since I believe it is necessary for the market to make new highs. From a broader perspective, the "deep cyclical" sectors, with their more volatile revenue streams but relatively fixed (albeit high) cost structure (and high earnings leverage), remain poised to show strong sales growth and, by extension, upside earnings surprises.

No doubt, economic challenges abound. Energy prices are surging. COVID persists in much of the world, especially emerging markets, which is at least partly responsible for the persistent supply chain issues and labor shortages in the manufacturing and transportation segments that are proving slow to resolve. Retail and restaurant industries continue to have difficulty filling jobs (and they are seeing a high rate of "quits"). And now we are seeing fiscal and monetary tightening in China – likely leading to lower GDP growth (if not a "hard landing") – due to long-festering financial leverage and "shadow banking" finally coming to roost (witness the Evergrande property development debacle, and now it appears developer Modern Land is next).

Regardless, we continue to like the Energy sector, even after its recent run (in fact, you will find two oil exploration & production firms in the new **Q4 2021 *Baker's Dozen*** that just launched). Sabrient's SectorCast ETF rankings continue to show Energy at or near the top. Wall Street estimates in the sector still appear to be too low based on projected prices, and dividend yields are attractive.

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 founder David Brown and his team 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.

Update on the terminating Q3 2020 *Baker's Dozen* portfolio:

The **Q3 2020 *Baker's Dozen*** launched on 7/20/2020 and terminates on 10/20/2021, at which time the new Q4 2021 *Baker's Dozen* launches. Like all our portfolios, the Q3 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 are typically overweight cyclical stocks, it launched with a heavily *underweight* allocation (7.7% vs. 24% in the benchmark) to attractively valued "deep cyclical" sectors (Financial, Industrial, Materials, and Energy), with only one position (from the Materials sector). 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 (not sound fundamentals). Instead, the initial portfolio approximately matched (23% vs. 27%) the benchmark weighting in the Information Technology sector and was overweight both Healthcare (31% vs. 13%) and Communications Services (15 vs. 11%). And as for value vs. growth exposure, the portfolio launched with an *overweight* 54% allocation (7 of the 13 positions) to the value factor (vs. the benchmark's roughly 40%), which is typical of a GARP portfolio, and it was about evenly split across market caps (with 5 large, 4 mid, and 4 small caps).

Q3 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
APPS	Digital Turbine, Inc.	553.4%	33.9	50.4	88.3%	239.3%
NXST	Nexstar Media Group, Inc.	91.5%	6.7	8.2	70.7%	161.9%
CACI	CACI International Inc	39.1%	14.4	16.2	25.7%	45.7%
EBAY	eBay Inc.	29.7%	16.1	18.3	23.5%	13.8%
CHTR	Charter Communications, Inc.	26.9%	40.8	28.0	63.0%	79.3%
WGO	Winnebago Industries, Inc.	17.4%	16.6	8.6	44.6%	229.7%
ABBV	AbbVie Inc.	14.7%	9.3	8.2	18.0%	27.0%
SWX	Southwest Gas Holdings, Inc.	0.9%	17.6	15.4	24.1%	32.0%
CNC	Centene Corporation	-0.2%	12.0	11.9	41.8%	-7.1%
GDDY	GoDaddy Inc.	-2.3%	17.1	21.7	44.5%	-7.3%
AZN	AstraZeneca PLC	-2.8%	22.4	32.2	12.0%	16.7%
SSRM	SSR Mining Inc.	-35.1%	11.6	9.9	90.6%	120.5%
QDEL	Quidel Corporation	-50.3%	28.6	14.9	184.6%	359.8%
	Average	**52.5%**	**19.0**	**18.8**	**56.3%**	**100.9%**
SPY	SPDR S&P 500 ETF Trust	41.5%				

Despite challenges arising from the pandemic, most of the holdings have lived up to expectations, with 10 of the 13 beating EPS estimates. Over the full life of the portfolio so far (7/20/2020-10/19/2021), **the gross average return of the Model Portfolio's equal-weighted holdings is +52.5% versus +41.5% for the S&P 500 cap-weighted index**. The table on the left shows each holding in the Model Portfolio. Of course, in a concentrated 13-stock portfolio, one or two breakout winners can help offset several laggards, and indeed, you can see that the portfolio was boosted by two stellar performers – **Digital Turbine (APPS)**, a provider of application media software for mobile communications operators and advertisers, and **Nexstar Media (NXST)**, a television station operator and digital media firm. Other winners include **CACI International (CACI)**, which provides intelligence and defense information technology solutions, e-commerce dominator **eBay (EBAY)**, and cable operator **Charter Communications (CHTR)**.

The two biggest laggards were healthcare diagnostics firm **Quidel Corp (QDEL)** and goldminer **SSR Mining (SSRM)**. Other laggards include mega-cap drugmaker **AstraZeneca PLC (AZN)**, web services firm **GoDaddy (GDDY)**, and under-insured/uninsured healthcare plan provider **Centene (CNC)**. The three worst performers suffered seemingly unwarranted weakness given that they all beat earnings estimates; however, each are projected to have lower earnings over the next 12 months.

Introducing the new Q4 2021 *Baker's Dozen* portfolio:

The new **Q4 2021 *Baker's Dozen*** launched today, 10/20/2021. 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 5 large caps, 6 mid caps, and 2 small caps; and essentially even Value/Growth mix with 7 value and 6 growth stocks. It also has a slightly higher bias toward cyclical sectors Consumer, Financial, Industrial, Materials, and Energy.

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	16.6	38.8%	12.4	0.32	0.0%	5	10
AMAT	Applied Materials	Information Technology	Semiconductor Equipment	121.5	29.6%	16.8	0.57	0.7%	5	10
BLD	TopBuild	Consumer Discretionary	Homebuilding	7.2	31.6%	18.7	0.59	0.0%	5	10
DVN	Devon Energy	Energy	Oil and Gas Exploration and Production	27.3	321.3%	9.8	0.03	1.1%	5	7
FANG	Diamondback Energy	Energy	Oil and Gas Exploration and Production	20.1	120.1%	8.2	0.07	1.6%	3	6
HRI	Herc Holdings	Industrials	Trading Companies and Distributors	5.4	63.2%	20.7	0.33	1.1%	3	10
KLAC	KLA Corp	Information Technology	Semiconductor Equipment	50.5	33.7%	17.1	0.51	1.3%	4	10
MRNA	Moderna	Health Care	Biotechnology	134.7	452.6%	7.5	0.02	0.0%	5	7
NTR	Nutrien	Materials	Fertilizers and Agricultural Chemicals	41.0	140.0%	13.0	0.09	2.6%	4	7
TJX	The TJX Companies	Consumer Discretionary	Apparel Retail	76.8	41.5%	20.2	0.49	1.6%	4	8
TMHC	Taylor Morrison Home	Consumer Discretionary	Homebuilding	3.4	64.0%	4.6	0.07	0.0%	3	9
WLK	Westlake Chemical	Materials	Commodity Chemicals	12.9	75.7%	7.7	0.10	1.2%	5	8
WRK	WestRock	Materials	Paper Packaging	12.9	74.9%	9.6	0.13	2.0%	5	6
			Average:	40.8	114.4%	12.8	0.11	1.0%	4.3	8.3

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 what each company is doing that makes it attractive.

Final thoughts:

Market maven Alexander Green has opined, *"The greatest threat to this long-running bull market is not a tightening Fed, higher valuations or moderating corporate profits. It's the growing clamor for regulatory and redistributive policies that will reduce innovation, lessen productivity and undermine the economy."* I still believe we are witnessing a "Roaring '20s redux" from 100 years ago, with only modest inflation and an extended expansionary economic cycle – so long as our political leaders don't screw it up.

I expect continued global economic expansion (even if it slows a bit), strong corporate earnings growth, robust capex and share buybacks, ongoing fiscal and monetary policy support, low interest rates, and receding inflationary pressures in 2022 as supply chain issues continue to resolve, labor returns to work, velocity of money stock remains low, and the dollar stays strong as a global safe haven, plus the long-term disinflationary structural trends of aging demographics, slowing global population growth, re-globalization of supply chains, and ongoing disruptive innovation. Regardless, keep in mind that inflation doesn't kill economic growth on its own; rather it is rising interest rates (aka borrowing costs), which are not likely any time soon.

But equity valuations remain lofty, and elevated volatility is likely. So, I suggest staying invested in equities, *but hedged.* I continue to recommend a balance between value/cyclicals and secular growth stocks, but with a greater focus on quality as we move past the exuberant speculative recovery phase. Hedges might be found in inverse ETFs, out-of-the-money index put options, gold, and cryptocurrencies (especially now that the SEC has signaled its intention to bless bitcoin futures ETFs). I am personally holding all these hedges.

With our enhanced selection process, we believe Sabrient's portfolios – including the new **Q4 2021 *Baker's Dozen* that just launched on 10/20/2021, Small Cap Growth that launched on 9/8/2021, and Sabrient Dividend that launched on 9/20/2021** – 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. My latest post discusses oil prices and China's troubles in detail.