Sabrient Commentary – September 2021 (as of 9/22/2021)

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This month's commentary can be summarized with the following talking points:

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 next month on 10/20/2021 after 15 months of life. It has outperformed the S&P 500 +41.8% versus +37.5% (gross return as of 9/22/2021), 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** (both at home and abroad) as well as continued strong corporate earnings reports, productivity, and margins, plus ongoing fiscal and monetary policy support and moderating inflation in 2022 (as supply chain disruptions and labor shortages resolve, and disinflationary structural trends resume).
6. Moreover, given lofty valuations, we expect **broadening leadership and a resumption in performance reversion** in the Value/Growth and Small/Large divergences, as well as share price reliance on earnings growth rather than multiple expansion. Thus, active selection, strategic beta, equal weighting, and the Quality factor should thrive, which also **should be favorable for Sabrient's GARP portfolios – including *Baker's Dozen*, Small Cap Growth, Dividend, and Forward Looking Value.**

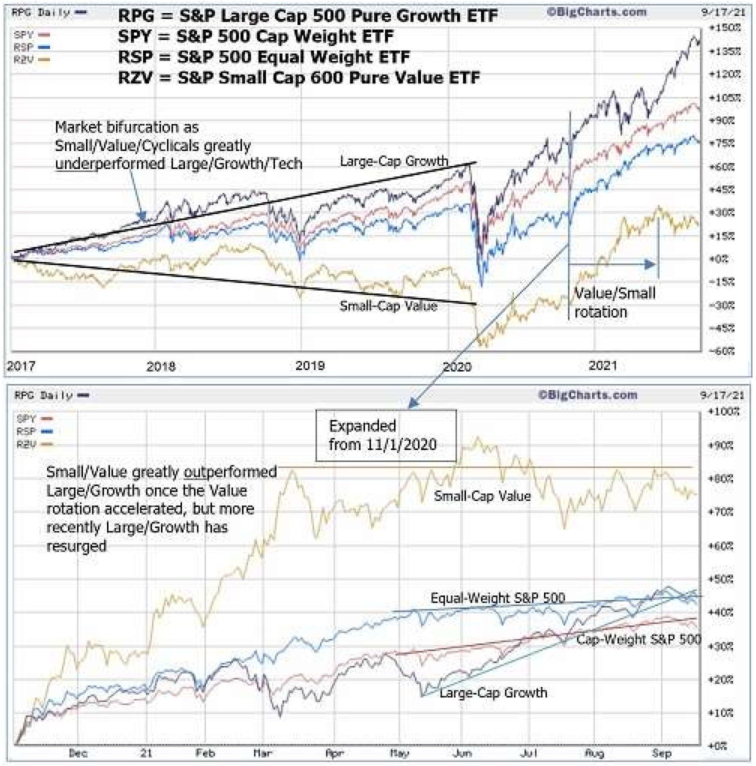
Market observations:

August was yet another positive month for the major indexes, despite plenty of new bricks in the proverbial Wall of Worry. That made 7 months in a row – the most in over 30 years – and 14 of the past 17 months (since the pandemic low). From a technical (chart) perspective, the S&P 500 has tested its 50-day simple moving average seven times this year, each time going on to hit a new high. And it's not just the cap-weighted index (SPY) as the equal-weight version (RSP) has been moving in lockstep, illustrating good market breadth and confirming market conviction. However, there have been some chinks in the market's armor, as small caps, value stocks, and the transports have been lagging all summer (much like 2018). So, as the long-overdue correction finally seems to be unfolding here in mid-September, investors are wondering if this dip is once again buyable. I think the answer is yes.

Q2 corporate earnings reports showed that 87% of S&P 500 companies beat revenue expectations, which was the highest percentage since 2008. Strong EPS growth and raised guidance has allowed the forward P/E multiple to contract even as share prices have surged. Q3 forecasts call for continued earnings growth, with more beats likely. For the S&P 500 to hit 5,000 at a reasonable forward P/E of 20, it requires full-year earnings of $250/share. But given that revenue growth in 2021 is only about 3% higher than pre-pandemic 2019 while earnings growth is closer to 23% – thanks to rising productivity, operating leverage, and ROE – investors will be looking for stronger top-line growth, which I think is likely.

The bearish view among many of Wall Street's heavyweights seems to be tied primarily to rising bond yields and inflation. Although a priority for capital preservation might suggest heeding their defensiveness, I'm not at all convinced that yields are on the verge of spiking or that inflation will spiral – in fact, quite the opposite.

Unemployment is still elevated (even with so many unfilled jobs), and capacity utilization remains well below the important 80% threshold that often presages worrisome inflation. So, as supply chain disruptions resolve, bottlenecks are fixed, and labor shortages ease, inflationary pressures should recede. Indeed, when you consider moribund gold prices, a low 10-year yield, and a strong US dollar, it appears that investors are not especially concerned about recent inflation signals. Moreover, there remains many *disinflationary* structural factors at work like aging demographics, slowing global population growth, re-globalization of trade and supply chains, economic migration of labor, and the rapid pace of automation and new innovative/disruptive technologies (which improve productivity in ways that are hard to fully foresee).



As for the Value/Growth and Small/Large relative performance, the outperformance of Large Cap Growth over much of the past several years was reflected in poor market breadth. Narrow leadership in a rising market usually indicates significant outperformance of the large-cap, secular-growth Tech juggernauts and, by extension, the cap-weighted indexes. On the other hand, broad participation in a rising market typically suggests outperformance of the equal-weighted indexes, small and mid-caps, the value factor, and cyclical sectors (particularly the transportation segment).

The 4.7-year chart on the top left shows the massive divergence between both Growth/Value and Large/Small. After the initial "Trump Bump" at the end of 2016 that briefly boosted Value, Small, and Cyclicals, there was a stark market bifurcation starting in 2017 primarily due to trade wars, which only worsened from the pandemic and economic lockdowns. Large Cap Growth (RPG) enjoyed a strong uptrend driven by mega-cap secular-growth Tech, while Small Cap Value (RZV) was mired in a persistent downtrend. **This also was hard on Sabrient's GARP portfolios.**

However, as magnified on the lower chart, there was a strong rotation into small caps, the value factor, and cyclical sectors starting in November 2020 (concurrent with rising bond yields – i.e., the reflation trade), leading to a "blow-off top" in mid-March, a pullback, and then a continued surge into early-June, i.e., a significant convergence of the historic Growth/Value and Large/Small divergences. **This was favorable for Sabrient's GARP portfolios.**

Since June, however, Small Cap Value has essentially flatlined while Large Cap Growth has been resurging, which has come with more narrow leadership and the perceived safety of the large-cap, secular-growth juggernauts (given their market dominance, strong cash flows and cash balances, high margins and operating leverage, and low correlation with the economic cycle (i.e., "all-weather" performance), which boosted the major cap-weighted indexes. Many small-cap, high-growth stocks took a hit despite great earnings reports, including top-performing *Baker's Dozen* holding **Digital Turbine (APPS)** – although it just recently got a boost by being selected to join the S&P MidCap 400 Index.

Looking ahead, I expect the bullish combination of continued global economic expansion (even if it slows a bit), strong corporate earnings growth, increased capex and share buybacks, ongoing fiscal and monetary policy support, low interest rates, and receding inflationary pressures in 2022. Equity valuations have fallen a bit from lofty levels as strong earnings reports have come in. In such a climate, I expect that active selection, equal weight indexes, and strategic beta indexes will outperform, which also *should be favorable for Sabrient's GARP portfolios.*

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 at 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 Q3 2020 *Baker's Dozen* portfolio:

The **Q3 2020 *Baker's Dozen*** portfolio launched on 7/20/2020 and will terminate next month on 10/20/2021, at which time the new Q4 2021 *Baker's Dozen* will launch. 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).

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 (7/20/2020-9/22/2021), **the gross average return of the Model Portfolio's equal-weighted holdings is +41.8% versus +37.5% 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 cable operator **Charter Communications (CHTR)**, e-commerce dominator **eBay (EBAY)**, and **CACI International (CACI)**, which provides intelligence and defense information technology solutions.

Launch Date:	7/20/2020						
Current Date:	9/22/2021						
Q3 2020 Baker's Dozen 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.	430.2%	33.9	40.6	88.3%	239.3%
NXST	Nexstar Media Group, Inc.	92.2%	6.7	8.2	70.7%	161.9%
CHTR	Charter Communications, Inc.	32.9%	40.8	29.1	63.0%	79.3%
EBAY	eBay Inc.	27.0%	16.1	17.7	23.5%	13.8%
CACI	CACI International Inc	23.7%	14.4	14.7	25.7%	45.7%
ABBV	AbbVie Inc.	12.2%	9.3	8.1	18.0%	27.0%
WGO	Winnebago Industries, Inc.	8.6%	16.6	8.2	73.8%	244.3%
GDDY	GoDaddy Inc.	0.6%	17.1	22.5	44.5%	-7.3%
SWX	Southwest Gas Holdings, Inc.	-0.5%	17.6	15.3	24.1%	32.0%
CNC	Centene Corporation	-3.0%	12.0	11.2	41.8%	-7.1%
AZN	AstraZeneca PLC	-4.2%	22.4	31.9	12.0%	16.7%
SSRM	SSR Mining Inc.	-36.0%	11.6	8.7	90.6%	120.5%
QDEL	Quidel Corporation	-40.8%	28.6	35.9	184.6%	359.8%
	Average	**41.8%**	**19.0**	**19.4**	**58.5%**	**102.0%**
SPY	SPDR S&P 500 ETF Trust	37.5%				

The biggest laggards were healthcare diagnostics firm **Quidel Corp (QDEL)** and goldminer **SSR Mining (SSRM)**. Other laggards include mega-cap drugmaker **AstraZeneca PLC (AZN)**, under-insured/uninsured healthcare plan provider **Centene (CNC)**, and natural gas utility **Southwest Gas Holdings (SWX)**. 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.

Final thoughts:

Economic tailwinds continue to strengthen, including recovery from the economic impacts of both the pandemic and the China trade war; rising corporate capex and manufacturing activity; unlimited global liquidity and massive pro-cyclical fiscal and monetary stimulus here at home; low interest rates; low tax rates; modest inflation expectations; strong corporate earnings growth; and a strong consumer. In addition, we enjoy the innovation, disruption, and productivity gains of many amazing and rapidly advancing technologies, which include 5G, IoT, Big Data, AI/ML, Web 3.0, cloud computing, digitization, ecommerce, video conferencing, augmented/virtual reality (AR/VR), computer vision (CV), gaming, networks, sensors, 3-D printing, robotics, sustainability, horizontal drilling & fracking, clean fuels, green/renewable energy, nuclear fusion, electric/hydrogen transportation, autonomous vehicles, automated manufacturing, space exploration, cybersecurity, blockchain, cryptocurrency, DeFi, fintech, nanotech, biotech, telehealth, precision medicine, computational biology, genomics, genetic sequencing, biologics – and the rapid development of diagnostics, therapeutics, and vaccines that may render future pandemics obsolete. It's enough to make your head spin.

In any case, Sabrient continues to recommend a balance between value/cyclicals and secular growth stocks and across market caps, although defensive investors may prefer an overweight on large-cap, secular-growth Tech and high-quality dividend payers. And with our enhanced selection process, we believe Sabrient's portfolios – including the **Q3 2021 *Baker's Dozen* that launched on 7/20/2021, Small Cap Growth that launched on 9/8/2021, Sabrient Dividend that just launched on 9/20/2021, and the upcoming Q4 2021 *Baker's Dozen* that will launch next month on 10/20/2021** – are positioned for any growth scenario.

Please be sure to thumb through my accompanying slide deck as well, which is available on the *Baker's Dozen* website. 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.