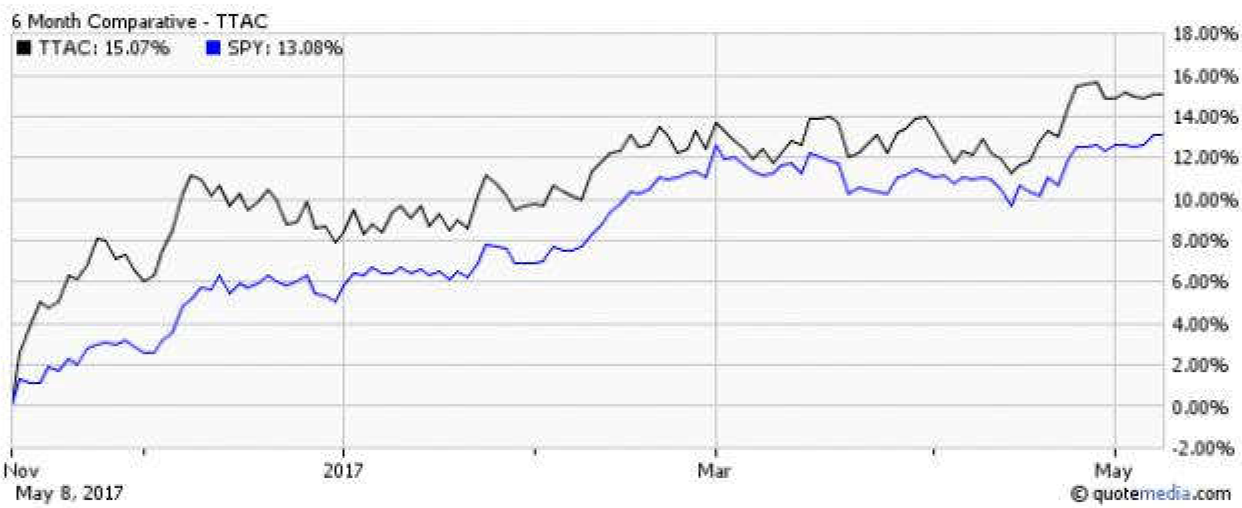
Free Cash Flow: An Overlooked Metric for Finding Winning Stocks?

By **Eric Dutram** Published on May 09, 2017

Since the presidential election in 2016, U.S. stocks are posting a pretty solid performance including a roughly 13% gain for (SPY). But while this double-digit percentage performance is quite impressive, there are plenty of funds that have easily beaten out this gain.

One that you might not be too familiar with, but has posted a 15% gain since the election, is the **TrimTabs Float Shrink ETF (TTAC)**. This fund focuses on companies that are reducing their share count but are also generating free cash flow.



To get more information on this approach, I recently spoke with Ted Theodore, the Vice Chairman and CIO of TrimTabs, for some insights. In particular, we take a closer look at free cash flow and why focusing on this metric could be a good strategy for investors seeking quality stocks going.

What follows is the Q&A we had on the topic, which should hopefully give investors some insights into this process.

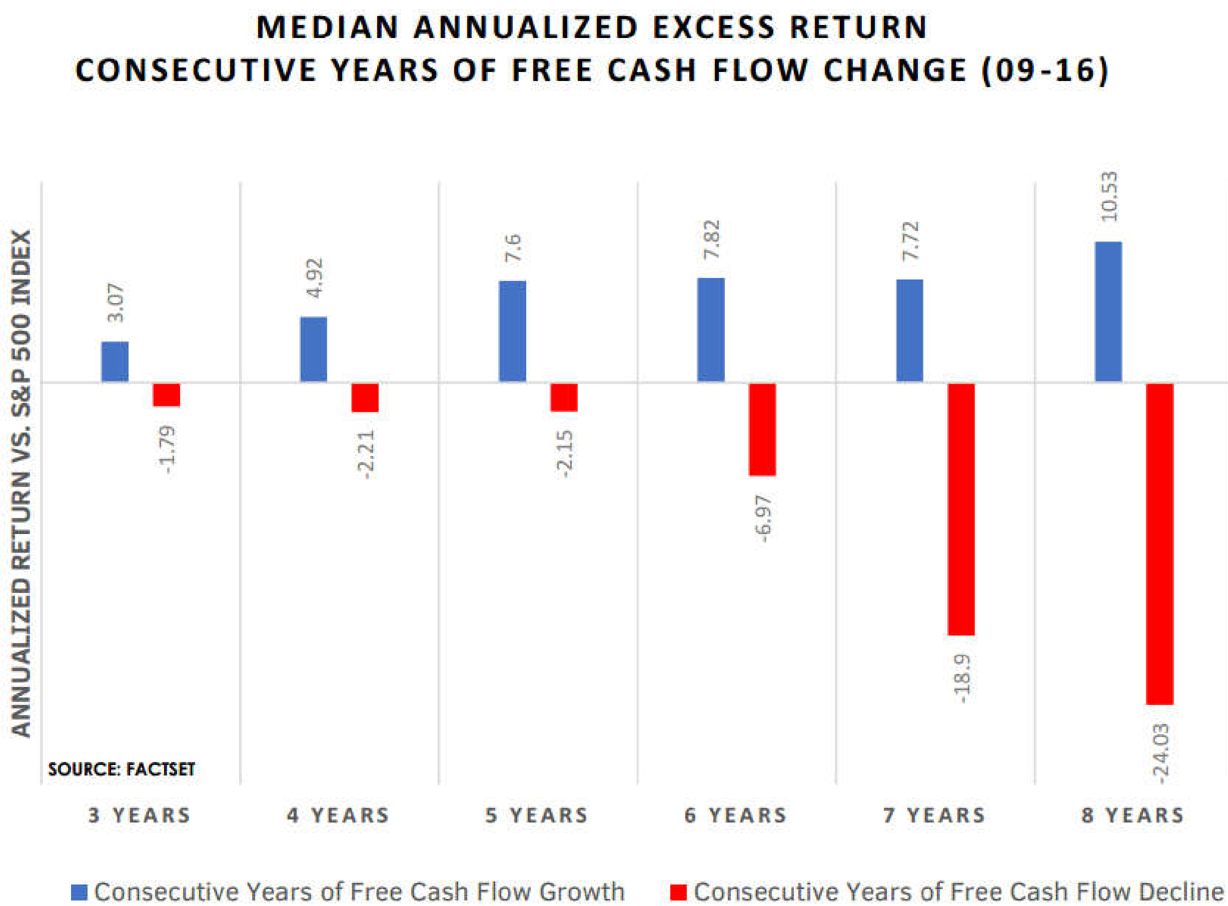
Eric Dutram: What is 'free cash flow' and why should investors put importance on this metric?

Ted Theodore: Free cash flow is derived in several steps. Changes in working capital are subtracted from operating earnings in order to focus on actual changes in cash balances of the company. Then the amounts shown as depreciation and amortization expense are added back because no cash was utilized for those items during the period.

The cash outlay for the items needing depreciation and/or amortization were actually incurred prior to the current period. These calculations result in "cash flow." The amount the company spent on capital expenditures in the period is also subtracted. This final number is called "free cash flow" as it means the company's cash balances reflect not only changes in cash from operations, but also takes into account the necessity of the company to provide for its future growth through capital investments.

In all regards, shareholder value is enhanced. Clearly, investors will have the sense of a much stronger, higher quality company where free cash flow is strong. Companies that generate strong free cash flows also can be potential takeover or merger candidates. In fact, one of our holdings – Swift (SWFT) - just announced a merger with another trucking company and the stock rose considerably after the announcement.

Investors should care about this because companies that can string together years of free cash flow growth are able to outpace the S&P 500. Unfortunately, those companies that have periods of sustained free cash flow declines see their stocks underperform the market. (*We can see just how dramatic the differences are in the chart below*)



Eric: What kinds of activities can companies engage in when they have strong free cash flows? Ted: The excess over free cash flow itself is available for any number of uses. Some of this amount can stay in the company and contribute to improving its fundamental balance between assets and liabilities. Some of the excess free cash flow can be used to acquire other companies and some of it can be returned to investors in the form of increased dividends.

Eric: Do you have any examples of companies with 'strong' or 'weak' free cash flow right now?

Ted: Two companies we own that have strong free cash flow are Deckers (DECK) and BestBuy (BBY). Interestingly they are both in the consumer sector that has been under pressure from online shopping. Each company however has been able to steadily increase their presence in that channel as well as provide stronger merchandising than their competitors.

At the other end of the spectrum, Humana (HUM) and Kroger (KR) are struggling with competitors as well, but the challenges are even more daunting. In the case of Humana, regulatory uncertainties are contributing to having to cover more contingencies than the company is likely to desire. Kroger competes in an environment of both declining food and staples prices as well as brand new kinds of competition even from the likes of Amazon and Walmart.

Eric: Are certain sectors/industries more (or less) prone to companies with strong free cash flows? Is a good free cash flow in one industry a poor one in another?

Ted: As it turns out, banks have historically chosen a particularly wide variety of ways to provide the basic accounting building blocks for calculating cash flow. While bank managers have been granted perfectly acceptable discretion to report in these different manners by their auditors, most other industries share common approaches to these values.

On the other hand, and except for banks, we have not found much industry bias in the calculation of free cash flow to either accept or eliminate them from consideration. For that reason, free cash flow is a particularly useful metric to separate good and bad performers within and between industries.

The actual portfolios are designed to equally weight each security at the time of purchase. Additionally, on average we invest in 100 companies. The resulting sector allocations just reflect these three guiding factors, rather than a top-down sector preference. As we use an equal weighting process with a large number of stocks, it is clear we want the benefits of diversification. But recognizing the chance that this approach could result in a truly unbalanced portfolio from a sector perspective, we actively monitor that bet. Yet, as implied here, it is a secondary consideration.

Eric: How might investors utilize this strategy in today's uncertain market environment?

Ted: While very few companies are completely isolated from the impact of the general environment for the economy, companies that have exhibited strong free cash flow have built something of a cushion should times become uncertain. These are companies likely to be relatively the last to feel an overall downturn.

Eric: How does a product like TTAC fit into an investor’s portfolio?

Ted: Over the years our process implies the portfolios will likely have about the same risk as the market. And given the large number of stocks in the portfolio and the fact that they are not weighted by market capitalization, we tend to create returns which have similar risk to the overall market. So, we consider our strategy to fit into the “core” category rather than one of the satellite kind. But even with market risk, our emphasis on strong long term fundamentals, implemented with quantitative disciplines, gives the chance to outperform the broad market.

Diversification does not guarantee a profit or protect from loss in a declining market.

Opinions expressed are subject to change at any time, are not guaranteed and should not be considered investment advice.

Standardized performance as of 3/31/2017

Gross Expense Ratio: 0.59%

The inception date of TTAC was September 27, 2016.

Quarter End Performance (as of 3/31/2017)

Fund Performance	Quarter	1 Year	Since Inception (9/27/2016 – 3/31/2017)
Market Price	5.62%	N/A	14.54%
NAV	5.96%	N/A	14.39%

The performance data quoted represents past performance. Past performance does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when sold or redeemed, may be worth more or less than their original cost and current performance may be lower or higher than the performance quoted. Performance current to the most recent month-end can be obtained by calling (toll free 800-617-0004).

Fund holdings and allocations are subject to change at any time and should not be considered a recommendation to buy or sell any security. Click here for fund holdings.

References to other funds should not be interpreted as an offer of these securities.

Free cash flow is a measure of a company's financial performance, calculated as operating cash flow minus capital expenditures. The Standard & Poor's Stock Index (S&P 500) is an unmanaged index generally representative of the U.S. stock market, without regard to company size. It is not possible to invest directly in an index.

*Before investing you should carefully consider the Fund's investment objectives, risks, charges and expenses. This and other information is in the prospectus, a copy of which may be obtained by visiting the Fund's website at **www.trimtabsfunds.com/etf**. Please read the prospectus carefully before you invest. Quasar Distributors, LLC, is the distributor for TTAC.*

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