TrimTabs Asset Management
Free Cash Flow Investing

Can or Kant?

A Stock Exchange or a Stock Market?

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Why do we have security analysts? From a certain logical perspective they are unnecessary. Going back to the earliest days of merchants and trade there were clearly times when those merchants had to transfer their interests, either to their heirs or to others interested in acquiring their business. Formally, the excess of an enterprise's assets over its liabilities was deemed the worth of the enterprise: assets minus liabilities equal the (book) value or equity in the business. (Sometime in the mid-11th century, merchants extended this equation-based concept to their every-day activities and adopted double-entry accounting where each entry to an account has a corresponding and opposite entry in a separate account.)

The SEC requires each publicly traded company to present its accounts so that this basic valuation is evident. The logic of this accounting is that the value of a company can only change four times a year - when the required accounting is made public. Yet, on a recent date when we checked on every one of the 3000 largest capitalization stocks, not one was trading at 1.00 times book value. Less than 5% of them were trading within plus or minus 5% of book value. Over the last 20 years we calculate that changes in book value explain less than 5% of the changes in stock prices.

So, in answer to the second question above in the title, we clearly have a "stock market," not a "stock exchange." In a market, values are haggled over. In an exchange, values are set and ownership is merely transferred.

Philosopher Immanuel Kant laid the groundwork for the way we can progress through an issue like this. Essentially, we can "deduce" a second thing if the first thing is true, "a priori," or true without the need for experience or evidence. Thus, no experience or evidence is needed if you assert that the area of a circle is equal to πr^2. This equation was a certainty whether it was experienced or not.

How about the value of a company? Clearly the evidence is that it is not a case that we can deduce the value from the accounts. If we are not dealing with certainty, the fallback is probability. This is where markets and security analysts come into play. As a direct result of the accounts, there have been literally scores of approaches that have been explored to assess the value of a company. Clearly those early merchants would be flabbergasted by the current practices. Equally, perhaps, investors have not stopped to think about what is going on here. And what is at play is that for some investors, "accounting" really is not "an accounting."

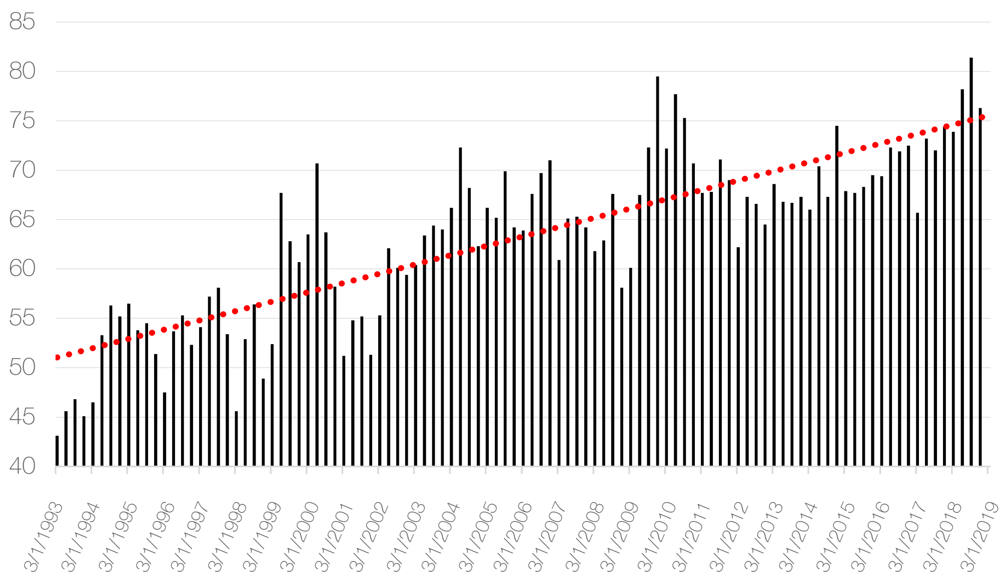
The SEC's directive in this regard is that companies must be audited in conformance to "Generally Accepted Accounting Principles" – GAAP. The key word is "principles" – rules. The experience of investors is that these are not rules like, "the fastest possible speed of this vehicle is 212 mph." More to the point, these rules are like, "the speed limit is 65 mph." The driver of the car has quite a bit of discretion regarding that rule.

Accounting is really a language. It has rules, syntax and its own logic. But there is good evidence that managements - exercise material discretion in "conforming" to these rules. Yes, accountants are paid substantial amounts to produce their reports and years of scholarship and convocations slowly bring more meat to their subject. But what this is, essentially, is a guild. "Licenses" of various kinds limit entry and maintain good rewards to those allowed to interpret (translate?) the vaunted language.

Despite all of that, managements can pretty much determine when revenues and expenses are recognized and still receive the stamp of an audit. Managements have enormous sway over the valuation of assets and liabilities. A major survey conducted several years ago among 400 chief financial officers (published in the Financial Analysts Journal) found that they believed 20% of audited, GAAP reports are deliberately misleading and by a material amount: 10%. These are high stakes.

By the way, all of the above discussion deals just with GAAP reports. Beyond that, management has been given even more prerogative to depict what they label as “operating” conditions, albeit forced to be disclosed in footnotes. The presumed goal is for management to help investors understand what kind of revenues and expense are “one-time,” and which are “continuing.” Yet, it is pretty obvious that investors are even more swayed by these operating numbers than GAAP numbers. The chart below shows the 25 year path toward greater percentages of earnings “surprises” for operating earnings each quarter. Do we think that analysts have become less smart? Or do we believe managements have become smarter? How is it possible in a complex economic and market cycle that 75% of these reports somehow managed to exceed expectations by a few pennies per share?

Positive Earnings Surprises S&P 500, Percent of Reported Operating Earnings (source: Bloomberg)



Green eye shades. Sleeve garters. The old images of accountants can be dragged up. When I first took my required accounting courses (1963), the textbook did not have in it or allow the word “flow.” But investors back then were no more respecting of book value than they are today.

For our part, our defense in this challenging environment has always been to realize, as some have said, “earnings are an opinion, cash is a fact.” As reported in the FAJ article, the CFOs recommend crosschecking GAAP accounts to cash flow reports. We agree. We mange two ETFs, one for US stocks (TTAC) and one for developed ex-US stocks (TTAI) where cash flow plays a central role. Our website has a number of research papers showing why we think free cash flow is so - important. (https://trimtabsfunds.com/research/)

While not perfect, in our experience, cash flow reports (and, even better, free cash flow) act as a kind of sunlight on GAAP reports and managements. So, more than ever in this regard, we think free cash flow should be a primary tool for investors.

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Before investing you should carefully consider the Fund's investment objectives, risks, charges and expenses. This and other information is in the statutory and summary prospectuses, a copy of which may be obtained by visiting the Fund's website at www.trimtabsfunds.com/ttac, www.trimtabsfunds.com/ttai. Please read the prospectus carefully before you invest."

Investing involves risk. Principal loss is possible. There is no guarantee that TTAC will achieve its investment objective. Investing involves risk, including the possible loss of principal. Because the Fund is an ETF (rather than a mutual fund), shares are bought and sold at market price (not NAV), may trade at a discount or premium to NAV, and are not individually redeemable. Owners of the shares may acquire those shares from the Fund and tender those shares for redemption to the Fund in Creation Unit aggregations only, consisting of 25,000 shares. Brokerage commissions will reduce returns. Investments in the Fund include risks associated with small and midcap securities, which involve limited liquidity and greater volatility than largecap securities.

The TrimTabs All Cap US Free-Cash-Flow ETF is distributed by Quasar Distributors, LLC. Free Cash Flow (FCF) represents the cash that a company is able to generate after accounting for capital expenditures.

The Standard & Poor's 500, often abbreviated as the S&P 500, or just the S&P, is an American stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ. It is not possible to invest directly in an Index.