

# TrimTabs Free Cash Flow Investment Research

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## *Defining Quality with Free Cash Flow*

A Note From Our Research Desk | December 2020

Free Cash Flow Investing



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## Free Cash Flow as a Quality Factor

“Quality,” as an investment category, has long been difficult to define. As evidenced by the wide range of Quality products being marketed, there are many different indicators used to designate a given company as “high-quality.”

The most common Quality measures evaluate profitability, earnings consistency and growth, or balance sheet leverage. However, these measures rely heavily on balance sheets and corporate earnings reports where management has great latitude and discretion. In fact, accounting standards allow management to discreetly shift, distort or manipulate financial results. For investors, this raises the fundamental question: “what is the most reliable metric to evaluate profitability and underlying organic growth?”

At TrimTabs, we have demonstrated that a company’s Free Cash Flow offers the best predictive utility as well as superior transparency into a company’s earnings. As any accounting student knows, “cash doesn’t lie” and therefore, “cash is king.” By using metrics derived from cash flow statements rather than earnings statements, we remove discretionary distortions that companies use to color their results.

With more than 30 years of Free Cash Flow research, TrimTabs products are designed around various Free Cash Flow-based measures. Our proprietary data decisively concludes that:

- **Free Cash Flow Strength (a combination of Free Cash Flow Profitability and Growth) has been a better alpha generator when compared to other indicators used to define quality companies.**
- **Cashflow-based quality indicators have outperformed other similar fundamental indicators that are used to define Quality: i.e profitability, leverage, coverage, and long-term growth.**

## Free Cash Flow Strength: A better “quality” alpha generator?

Free Cash Flow Strength has been the focus of our investment strategies. Our empirical research shows that Free Cash Flow Strength generates a better risk-adjusted return compared to other popular “Quality” indicators, such as Return on Equity, Operating Return on Assets, Gross Margin, Earnings Persistence, Debt to Equity and Change in Assets Turnover.

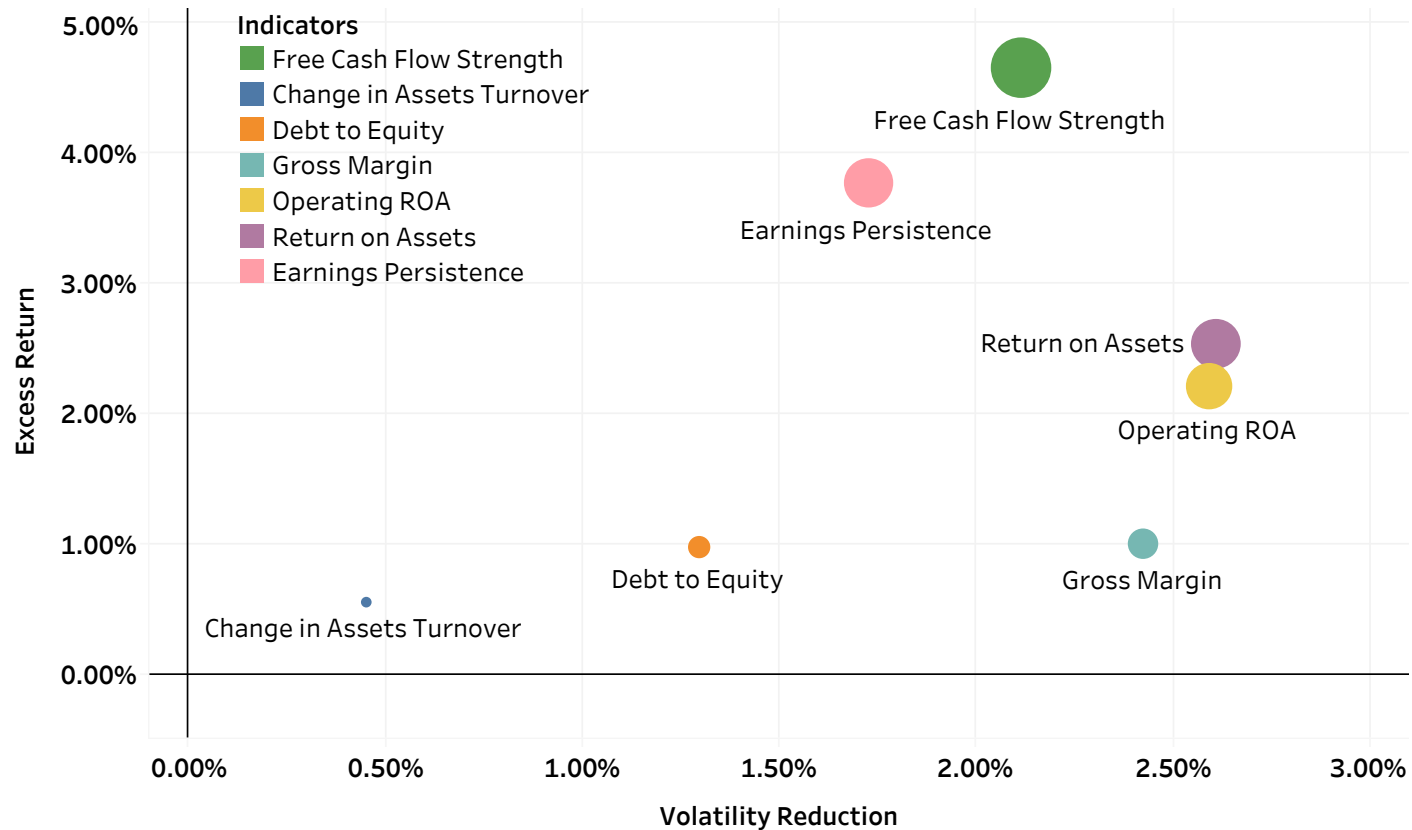
To evaluate the efficacy of Free Cash Flow Strength as a Quality factor, our empirical research starts by evaluating the US (S&P 1500 Index Constituents) and Global (FTSE Global All Cap Index Constituents) stock universes. For each Quality indicator that we measured, we constructed a hypothetical portfolio with the top 50% of constituents and a hypothetical portfolio with the bottom 50% constituents, ranked based on its respective indicator. Each portfolio is constructed using a monthly rebalance and an equal weighted approach. We then look at the excess return, volatility reduction, and excess Sharpe ratio between the top and bottom portfolios.

The empirical results shown in charts 1.1 and 1.2 illustrate that over the past 20 years, Free Cash Flow Strength has generated a better risk-adjusted return amongst peer categories, driven by a superlative excess return and moderate volatility reduction in both the US and Global equity markets.

### Chart 1.2 Quality Indicators Performance Spread - Global Universe

FTSE Global All Cap Index Universe, 11/30/1998 to 10/31/2020

Top minus Bottom Portfolio Excess Return, Volatility Reduction, Sharpe Ratio Spread, Equally Weighted



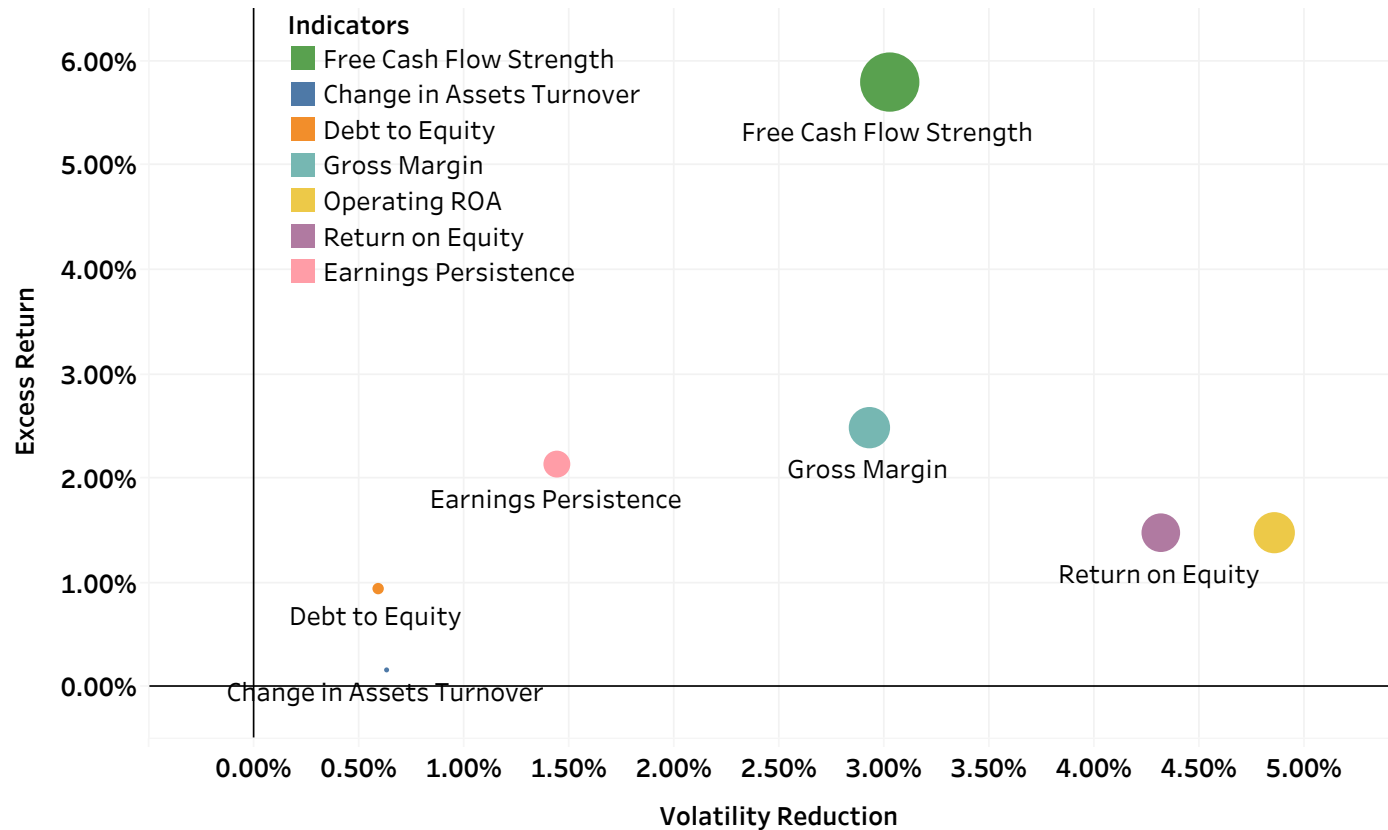
Source: TrimTabs Asset Management, FactSet, S&P Global

Free Cash Flow Strength is a composite indicator developed by TrimTabs Asset Management to measure a company's free cash flow profitability and growth, for financial institutions and real estate, net income and funds from operations are used instead of free cash flow. Volatility Reduction is the difference between the top/bottom portfolio annualized standard deviation of returns. The start date selected was based on when reporting of quarterly free cash flow became standard for most U.S. companies. All indicators are calculated with trailing twelve-month data. Earnings persistence is the trailing three-year earning volatility. Asset Turnover is the year over year growth in asset turnover. Debt to Equity is ranked from low to high and all other indicators from high to low. The top/Bottom portfolios are constructed by equally weighted top/bottom 50% stocks ranked by factor exposure on a monthly rebalance approach. They do not represent actual fund or portfolio performance. **Past performance does not guarantee future returns.**

### Chart 1.1 Quality Indicators Performance Spread

S&P 1500 Universe, 11/30/1998 to 10/31/2020

Top minus Bottom Portfolio Excess Return, Volatility Reduction, Sharpe Ratio Spread, Equally Weighted



Source: TrimTabs Asset Management, FactSet, S&P Global

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## Cashflow-Based Quality Indicators: Outperformed other common fundamental indicators

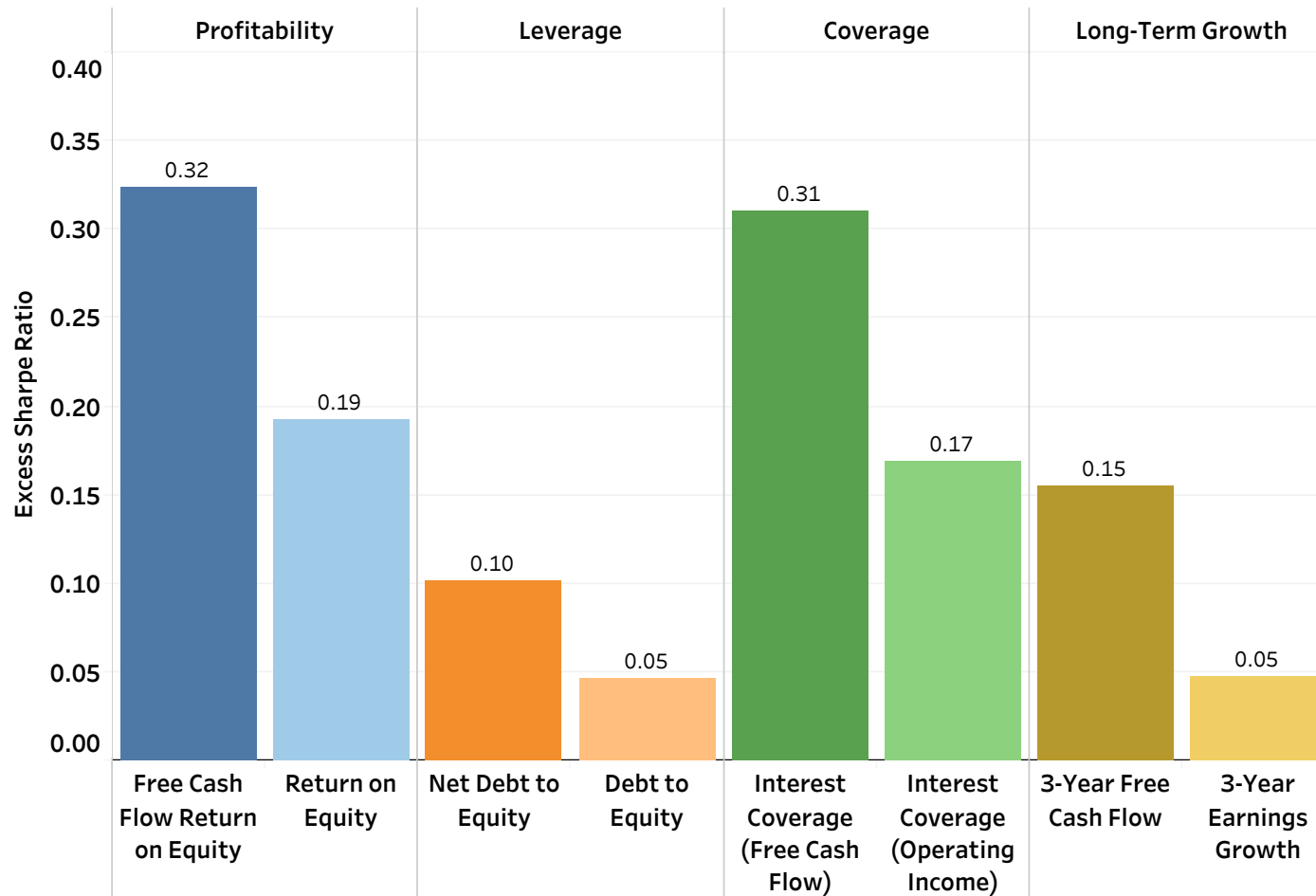
To supplement our primary focus on Free Cash Flow Strength, we leverage various cashflow-based indicators to support our investment decisions. We believe that cashflow-based indicators provide a clearer picture of how a company is performing and historically generated a better risk-adjusted return.

Continuing our empirical analysis on different sets of Quality indicators, we conduct a side-by-side comparison between cashflow-based indicators and other common fundamental indicators used to define high-quality companies. These include profitability, leverage, coverage, and long-term growth. Our analysis found that, historically, cashflow-based indicators outperformed in almost every category for both the US and Global equity market, as shown in charts 2.1 and 2.2.

## Chart 2.1 Compare Performance of Cash-based Indicators with Other Fundamental Indicators

S&P 1500 Universe Ex Financials, 11/30/1998 to 10/31/2020

Top minus Bottom Portfolio Sharpe Ratio Spread, Equally Weighted



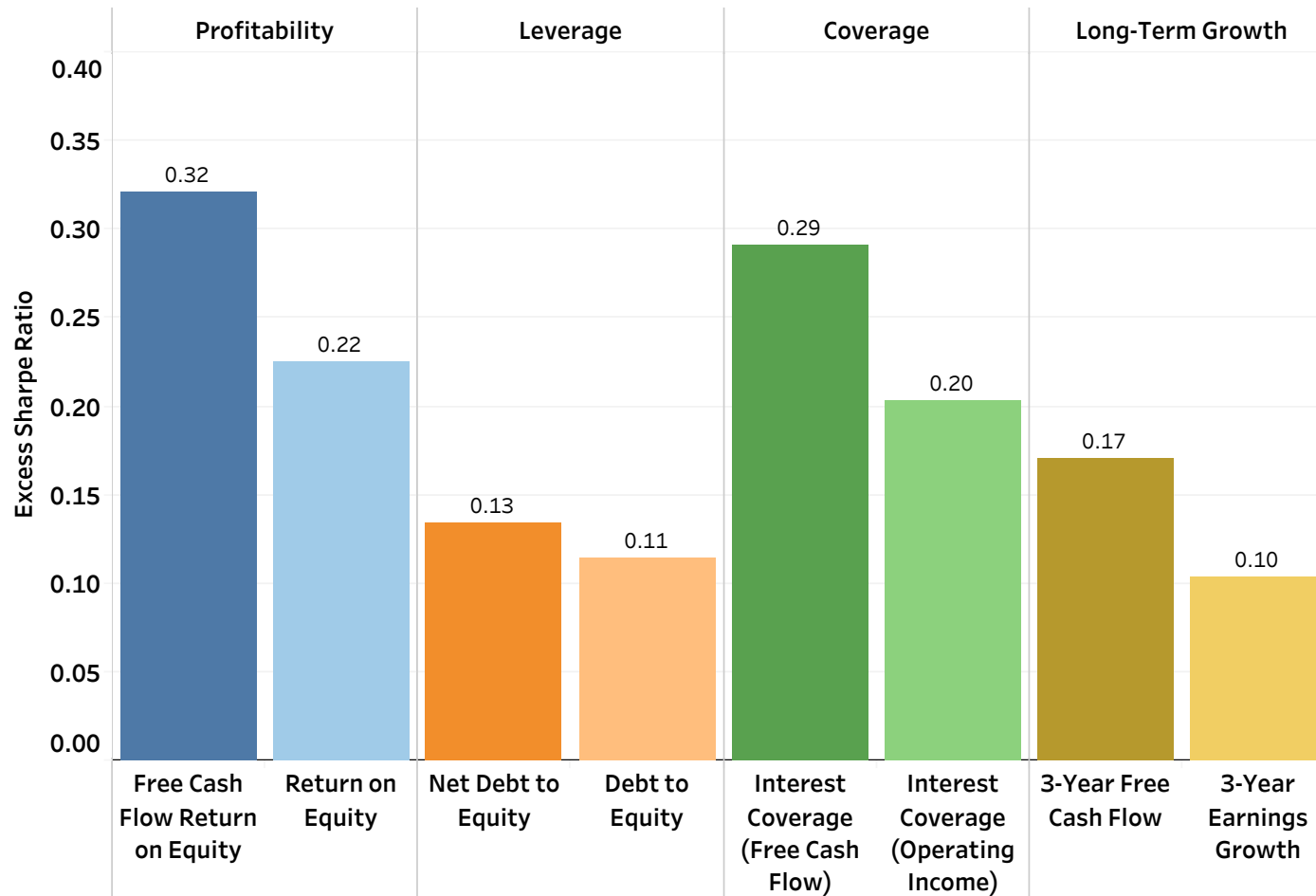
Source: TrimTabs Asset Management, FactSet, S&P Global

All indicators are calculated using trailing twelve month reported numbers. Leverage indicators are ranked from low to high and all other indicators ranked from high to low. The top/Bottom portfolios are constructed by equally weighted top/bottom 50% stocks ranked by factor exposure on a monthly rebalance approach. The start date selected was based on when reporting of quarterly free cash flow became standard for most U.S. companies. Financials firms are included because their cash flow calculations and implications are different from non-financials firm. They do not represent actual fund or portfolio performance. **Past performance does not guarantee future returns.**

## Chart 2.2 Compare Performance of Cash-based Indicators with Other Fundamental Indicators in Quality Indicators Groups - Global Universe

FTSE Global All Cap Index Universe Ex Financials, 11/30/1998 to 10/31/2020

Top minus Bottom Portfolio Sharpe Ratio Spread, Equally Weighted



Source: TrimTabs Asset Management, FactSet, S&P Global

All indicators are calculated using trailing twelve month reported numbers. Leverage indicators are ranked from low to high and all other indicators ranked from high to low. The top/Bottom portfolios are constructed by equally weighted top/bottom 50% stocks ranked by factor exposure on a monthly rebalance approach. The start date selected was based on when reporting of quarterly free cash flow became standard for most U.S. companies. Financials firms are included because their cash flow calculations and implications are different from non-financials firm. They do not represent actual fund or portfolio performance. **Past performance does not guarantee future returns.**



## Incorporating Other Layers of Quality:

As active managers, we build layers of quality and “moats” into our core equity solutions. What is a “moat” and why does it matter for Quality investors?

Warren Buffett coined the term “moat” to describe companies with a sustainable competitive advantage. For us, the first moat starts with strong Free Cash Flow. As was emphasized earlier, “Cash is King” and gives a company the ability to mitigate unforeseen economic circumstances. In addition, these companies have the resources to invest, acquire, and or buyback stock.

After our proprietary quantitative process has done the heavy lifting, we look for qualitative moats that give us a higher level of confidence that a company is likely to deliver alpha with positive asymmetric returns. Different types of moats can add another level of diversification and strength to a quality portfolio. The most common moats for us include companies with a large market share, strong global brands, disruptive technology, strong digital footprint, and innovative technology.

## Definitions, Risks and Disclosures

The hypothetical examples are for illustrative purposes only and do not represent the returns of any particular investment. **Past performance does not guarantee future results. Index performance is not illustrative of Fund performance. One cannot invest directly in an index. Fund performance may be obtained by calling 800-617-0004.**

*The fund's investment objectives, risks, charges and expenses must be considered carefully before investing. The prospectus contains this and other important information about the investment company, and it may be obtained by calling 18006170004. Read it carefully before investing.*

*Investing involves risk, and principal loss is possible. There is no guarantee that the Funds will achieve their investment objectives. Returns on investments in foreign securities could be more volatile than investments in domestic securities.*

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

Shares of any ETF are bought and sold at market price (the current price at which shares are bought and sold, not NAV (the dollar value of a single share, based on the value of the underlying assets of the fund minus its liabilities, divided by the number of shares outstanding)). They may trade at a discount or premium to NAV, are not individually redeemed from the Fund, and brokerage commissions will reduce returns.

The TrimTabs ETFs are distributed by Quasar Distributors, LLC.

Free Cash Flow (FCF) represents the cash that a company is able to generate after accounting for capital expenditures.

Alpha is a measure of performance on a risk-adjusted basis.

Return on Equity is a measure of financial performance calculated by dividing net income by shareholders' equity.

## Definitions, Risks and Disclosures

Operating Return on Assets measures the level of profits relative to the company's assets.

Gross Margin is a company's net sales revenue minus its cost of goods sold.

Earnings persistence is defined as the continuity and durability of the current earnings.

Debt to Equity calculates the weight of total debt and financial liabilities against total shareholders' equity.

Asset Turnover measures the value of a company's sales or revenues relative to the value of its assets.

Free Cash Flow Strength is a composite indicator developed by TrimTabs Asset Management to measure a company's free cash flow profitability and growth, for financial institutions and real estate, net income and funds from operations are used instead of free cash flow.

Sharpe ratio is a way to examine the performance of an investment by adjusting for its risk.

The S&P Composite 1500 combines three leading indices, the S&P 500, the S&P MidCap 400, and the S&P SmallCap 600 to cover approximately 90% of the U.S. market capitalization. Index performance is not indicative of fund performance. Past performance does not guarantee future returns.

FTSE Global All Cap Index is a market-capitalisation weighted index representing the performance of the large, mid and small cap stocks globally. The index aggregate of around 8,000 stocks cover Developed and Emerging Markets and is suitable as the basis for investment products, such as funds, derivatives and exchange-traded funds.

Profitability refers to a class of financial metrics that are used to assess a business's ability to generate earnings relative to its revenue, operating costs, balance sheet assets, or shareholders' equity over time.

Leverage refers to a class of financial measurements that look at how much capital comes in the form of debt (loans) or assesses the ability of a company to meet its financial obligations.

Coverage measures a company's ability to service its existing debt.

Long-Term Growth refers to a category of metrics that may indicate security performance over the long-term.