

# TrimTabs Asset Management Investment Research

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## *Using Free Cash Flow to Uncover Real Quality*

A Note From Our Research Desk | January 2021

Free Cash Flow Quality Investing



**TRIMTABS**  
Asset Management

## Using Free Cash Flow to Uncover Real Quality

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

The most common quality products use profitability, earnings consistency and growth, and balance sheet leverage. However, these measures rely 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 a more reliable metric to evaluate profitability and the underlying organic growth?”.

At TrimTabs, we have demonstrated that a company’s Free Cash Flow offers better 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.

TrimTabs products are designed around various Free Cash Flow-based measures. Our proprietary data decisively concludes that:

- **Free Cash Flow Profitability is a better quality alpha generator**
- **Cash Flow-Based Quality indicators outperform other common fundamental indicators**

## Free Cash Flow Profitability: A Better Quality Alpha Generator

Free Cash Flow Profitability has been the focus of our investment strategies. Our empirical research shows that Free Cash Flow Profitability 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.

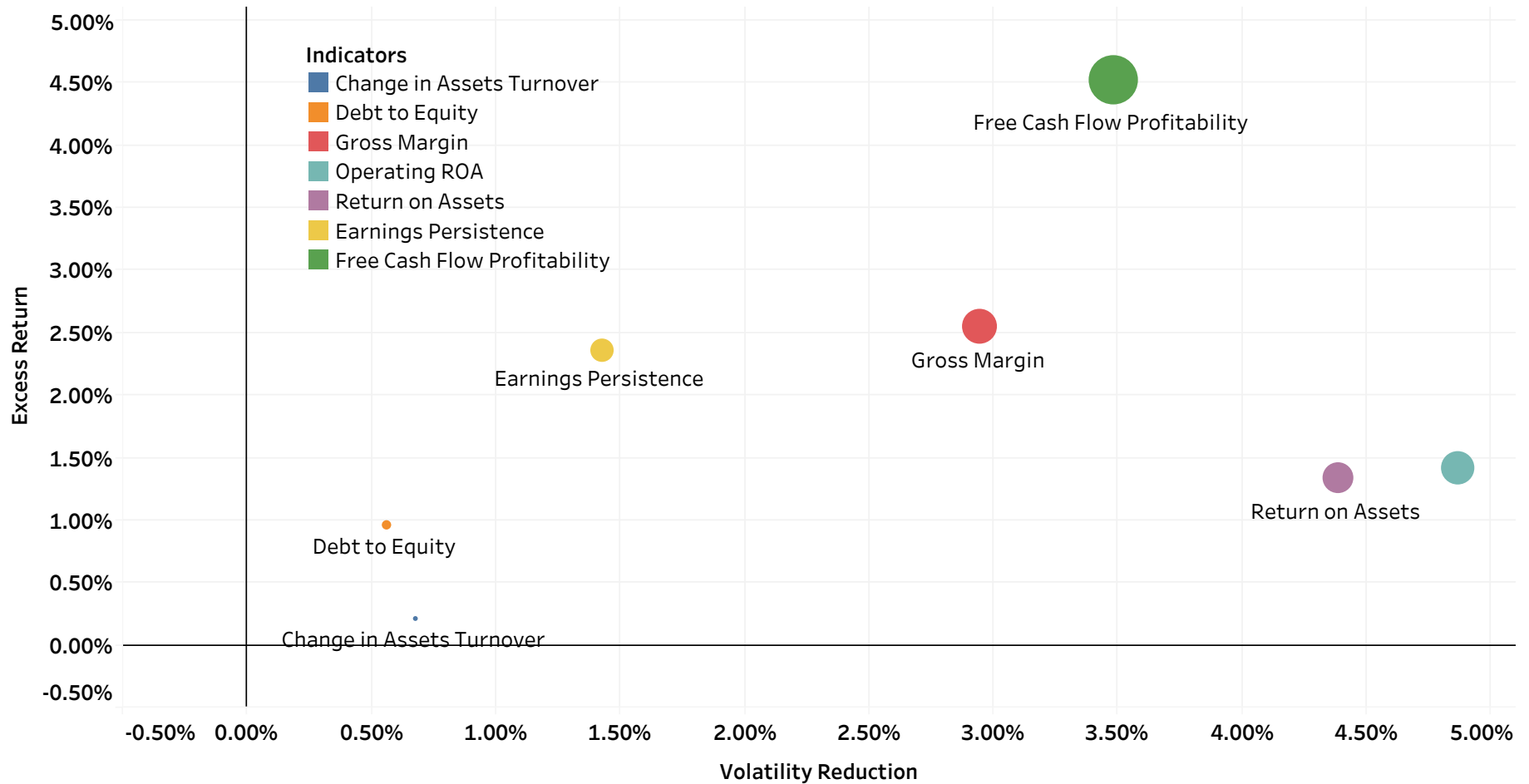
To evaluate the efficacy of Free Cash Flow Profitability as a Quality factor, our empirical research starts by evaluating the US (S&P 1500 Index Constituents) and Global (FTSE Global All Cap Index Constituents) stock universes. For each Quality indicator that we measured, we constructed a hypothetical 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 Profitability has generated a better risk-adjusted return amongst peer categories, driven by a superior excess return and moderate volatility reduction in both the US and Global equity markets.

### Chart 1.1 Quality Indicators Performance Spread

S&P 1500 Universe, 11/30/1998 to 12/31/2020

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



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

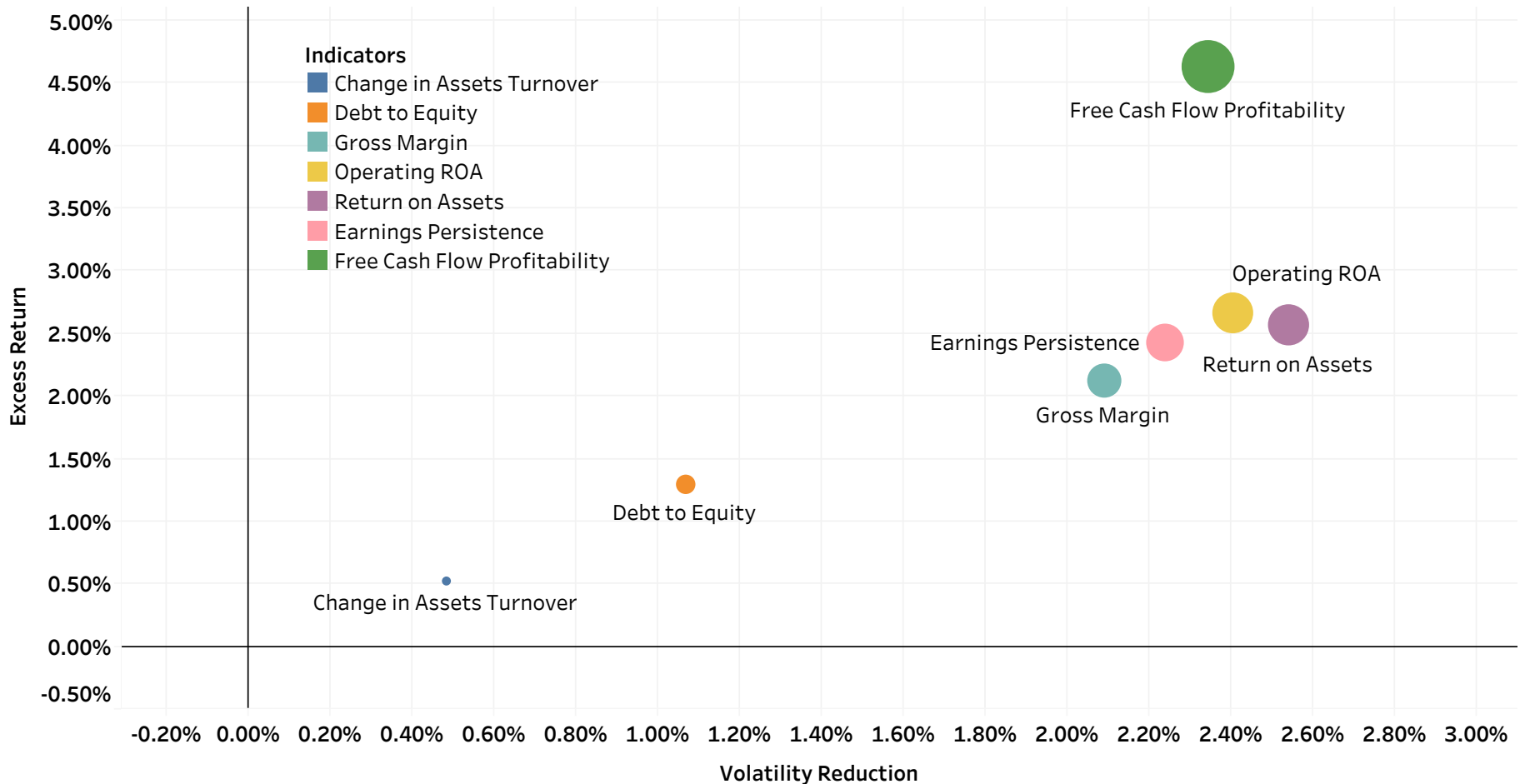
Free Cash Flow Profitability is a composite profitability indicator developed by TrimTabs Asset Management. For financial institutions and real estate, net income and funds from operations are used instead of free cash flow. Volatility Reduction is the difference between the top/bottom portfolio annualized standard deviation of returns. The start date reflects 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 1.2 Quality Indicators Performance Spread - Global Universe

FTSE Global All Cap Index Universe, 11/30/1998 to 12/31/2020



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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## Cash Flow-Based Quality Indicators: Outperform Other Common Fundamental Indicators

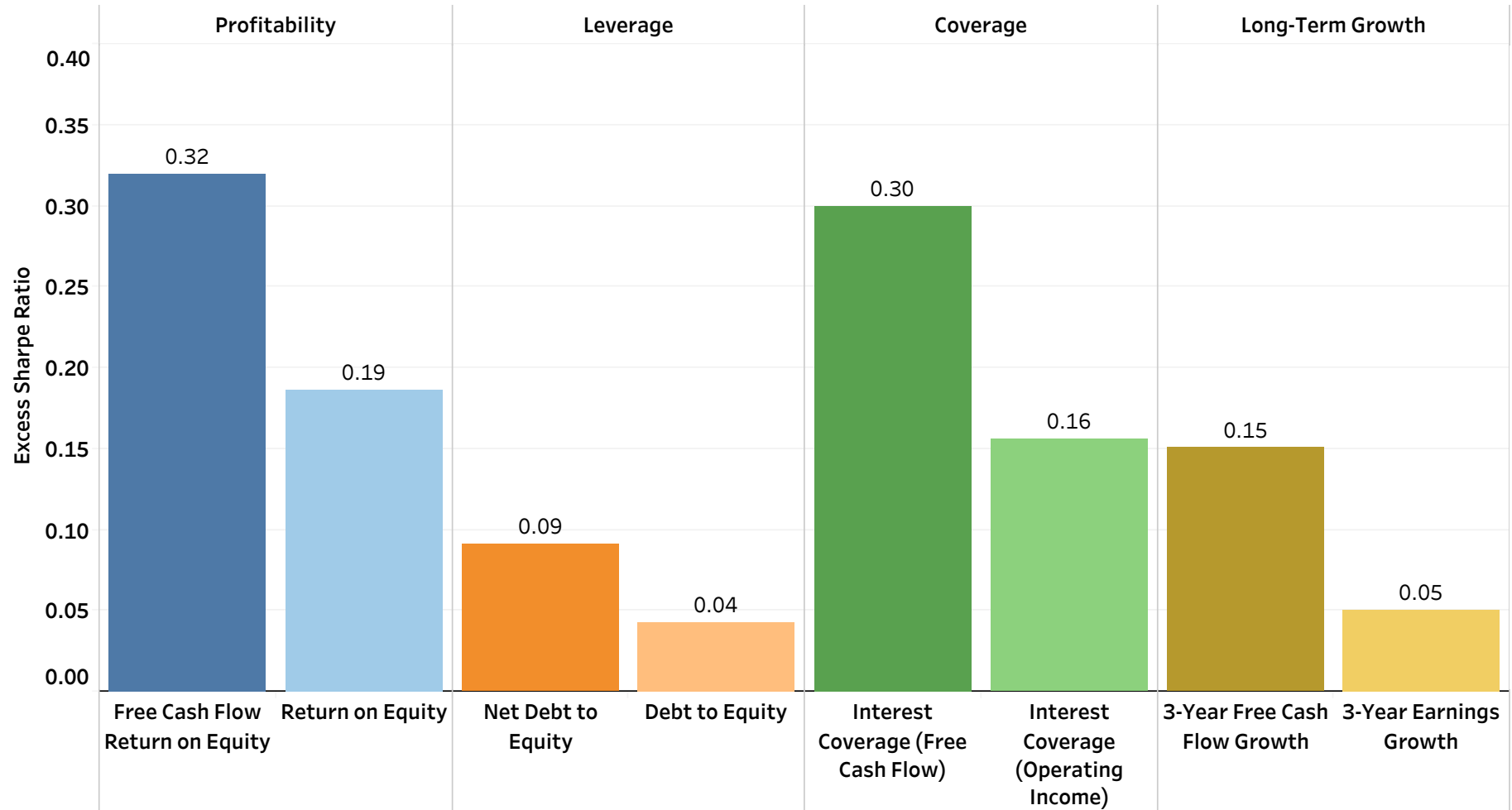
To supplement our primary focus on Free Cash Flow Profitability, we leverage various cash flow-based indicators to support our investment decisions. We believe that cash flow-based indicators provide a clearer picture of how a company is performing and historically generated a better risk-adjusted return.

Continuing our empirical analysis on different sets of Quality indicators, we conduct a side-by-side comparison between cash flow-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, cash flow-based indicators outperform 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 by Quality Indicators Group - US Universe

S&P 1500 Universe Ex Financials, 11/30/1998 to 12/31/2020

Top minus Bottom Portfolio Sharpe Ratio Spread, Equally Weighted



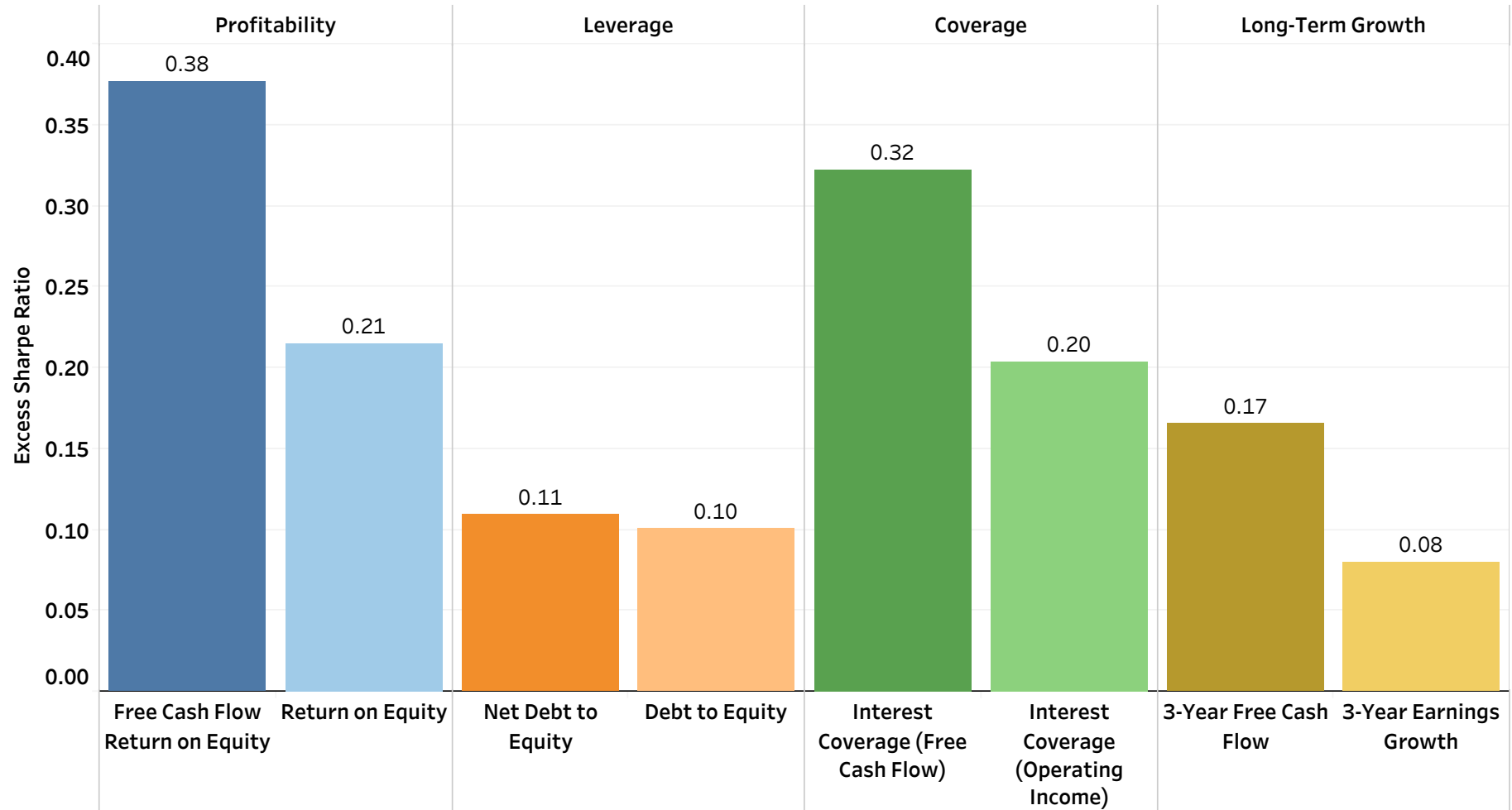
Source: TrimTabs Asset Management, FactSet, S&P Global

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 excluded 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 by Quality Indicators Group - Global Universe

FTSE Global All Cap Index Universe Ex Financials, 11/30/1998 to 12/31/2020

Top minus Bottom Portfolio Sharpe Ratio Spread, Equally Weighted



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

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## TrimTabs Free Cash Flow Quality Approach

The TrimTabs investment process fully integrates the proprietary free cash flow research outlined above into our two flagship ETF's, TrimTabs U.S. FCF Quality (TTAC) and TrimTabs International FCF Quality (TTAI). Our goal is to build robust investment solutions that can generate alpha and outperform products that compete in the quality category in a consistent and repeatable manner.

Our systematic process generates trade recommendations that align with how our systems capture the most recent free cash flow data from our investment universe. From there, we apply a disciplined active overlay process to flag and exclude companies displaying extreme increases in share count and balance sheet leverage. Additionally, we recognize that ESG (Environmental, Social, and Governance) considerations could potentially impact business profitability, the sustainability of earnings, and business risks, which are crucial in defining a high-quality company. An ESG screening process is also applied to maintain strong sustainability standing for our portfolios.

Our proprietary quantitative free cash flow research can be applied to gain exposure to a wide range of U.S and Global benchmarks, or paired with thematic investment ideas to build robust investment solutions for clients.

## Definitions, Risks and Disclosures

*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.*

*Fund holdings and/or sector allocations are subject to change at any time and are not recommendations to buy or sell any security.*

Click [here](#) for TTAC Holdings and TTAI Holdings

**Investing involves risk. Principal loss is possible. There is no guarantee that any fund will achieve its investment objective. 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 large-cap securities. Return on investments in foreign securities could be more volatile than investments in the domestic securities.**

The TrimTabs ETFs are distributed by Quasar Distributors, LLC.

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.**

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

## Definitions, Risks and Disclosures

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.

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 shareholder's equity.

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

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.

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.