Smith Group
ASSET MANAGEMENT

Market Perspectives Excerpt

Cash Flow is King

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Among all the various metrics investors use to judge the future return of a security, those involving some valuation based on a company's financial statements are among the most common. Even within the value investor community there is a dizzying array of ratios, discounting mechanisms and asset evaluations people utilize to determine the overall "cheapness" of an individual company. We examined, from a purely empirical standpoint, which financial statement valuations are associated with future returns.

We started with a calculation examining Russell 3000 company point-in-time elements from the income statement (Sales, EBITDA, Net Income), cash flow statement(operating cash flow), and balance sheet (book value of equity). For each element we computed the ratio of that element to enterprise value (market value + net debt) then formed quintile portfolios. Those portfolios were rebalanced monthly to derive spread returns to each of the value factors. The results are in the table below As a disclaimer, these are hypothetical returns with no transaction costs, information delay or consideration of liquidity.

As you might have guessed from the title, cash flow was the clear performance winner, followed by its close cousin on the income statement, EBITDA. Interestingly, net income slightly underperformed sales, which was not a result we expected. The lone balance sheet item, book value, had the worst return although still positive at 7.9% per year. The risk-adjusted return (the return spread divided by the spread volatility) shows similar results although sales and net income were roughly equal.

	Annualized Spread Returns*	Spread Volatility	Spread/ Volatility Ratio
Sales	10.7	15.61	0.68
EBITDA	14.1	12.16	1.16
Net Income	9.8	14.45	0.68
Operating Cash Flow	18.1	12.76	1.42
Book Value	7.9	14.38	0.55
* Monthly rebalanced 1996 –2011			

In addition to the broad cross sectional analysis of performance we also examine the effectiveness of each measure within economic sectors to determine if biases exist. These results are displayed in the table at bottom left.

	Annualized Spread Return of Quintile Ranked Portfolios				
	Operating Cash Flow	EBITDA	Net Income	Sales	Book Value
Consumer Discretionary	19.9	14.0	7.4	7.5	4.6
Consumer Staples	15.2	11.8	12.4	3.2	5.3
Energy	10.3	11.3	12.0	12.1	12.7
Financials	9.2	7.8	9.8	4.3	5.6
Health Care	11.1	0.2	-6.6	9.2	9.2
Industrials	19.4	16.7	12.4	9.6	10.4
Information Technology	22.5	17.2	7.6	11.0	4.8
Materials	7.7	10.1	9.9	8.3	2.6
Telecom	11.4	10.6	-8.9	0.8	-3.6
Utilities	7.3	6.6	5.0	4.0	5.3

The performance among economic sectors generally held a similar pattern to the cross sectional analysis with a few notable exceptions.

- Energy companies display no clear difference in returns between the five value factors although it was the only sector where book value was the best performer.
- Financials tended to perform better on net income value as opposed to cash flow or EBITDA, which is not surprising given the accrual nature of most financials core businesses.
- Health Care companies had the best relative performance on sales value which is probably driven by the large number of biotech companies that don't generate profits in their early stages.
- Materials, telecomm and utilities are sectors with unclear empirical evidence, mainly due to the small sample size of companies in the universe.

While our results show that many valuation metrics are broadly associated with positive future returns, the two factors focusing on cash flow outperformed both in terms of return and volatility. Cash flows have the distinction of being focused on the ability of a firm to generate profits unencumbered by many of the accounting constructs necessary to calculate net income as well as a company's tax and financing structure. Our data suggests that investors are more focused on a firms ability to generate operating profits rather than earnings on the bottom line.