GLOBAL VALUE ADVISORS
A Division of Moody Aldrich Partners

Investment Insight

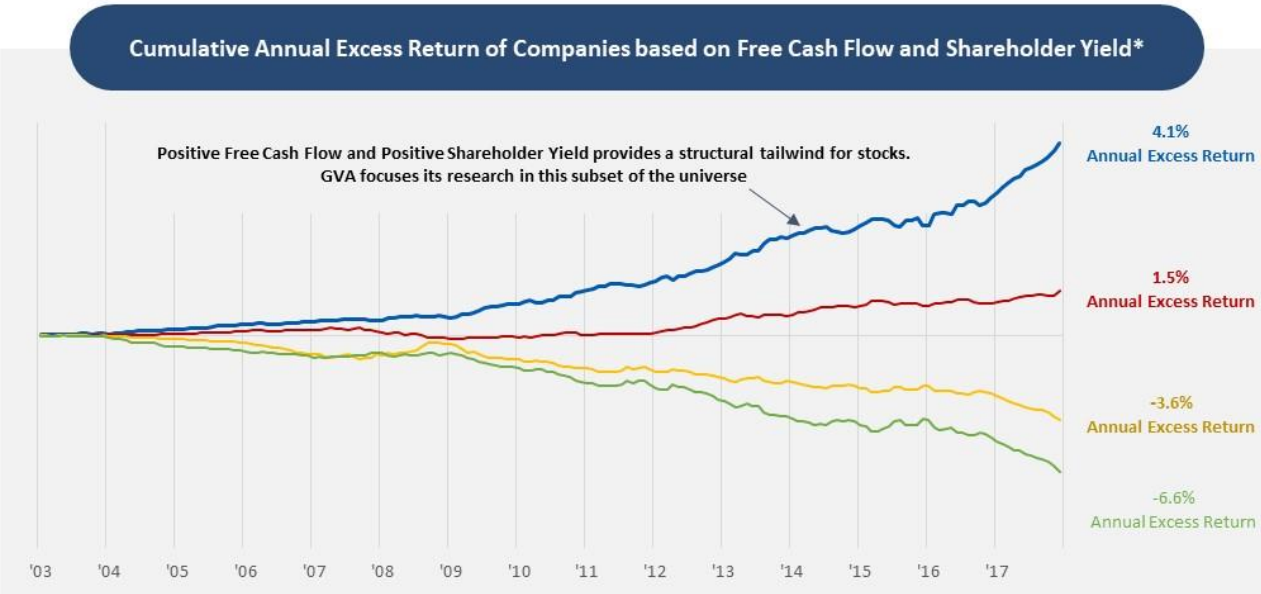
How Consistently do Companies with Positive FCF and Positive Shareholder Yield Outperform?

GVA's investment approach focuses exclusively on companies that generate positive Free Cash Flow (FCF) and have positive Shareholder Yields. For simplicity, we will refer to companies with these attributes as being in GVA's "Advantaged Subset". GVA's research shows that companies in the Advantaged Subset outperform the market.

The chart below shows the cumulative excess returns of companies that generate positive FCF and positive Shareholder Yields on a trailing 12 month basis (blue line). The study is for the MSCI All County World ex-US Small Cap Index from 2003-2017 and the portfolio is rebalanced monthly. If investors purchased only names in the Advantaged Subset, the annual excess return would be 4.1% with a high information ratio at 1.3x.

Although all companies should be striving to generate positive FCF and return capital to shareholders, only 47% of international small cap companies, on average, are actually in this category. The following graph shows the annual excess returns of companies with various combinations of positive and negative FCF and Shareholder Yields. The green subset is made up only of companies with negative FCF and negative Shareholder Yields on a trailing 12 month basis. If investors only purchased names in the green subset, they would have a high probability of destroying value (-6.6% annual excess return). Note that information ratios also deteriorate.

Market Inefficiency: A Structurally Advantaged Subset



Quadrant	% of Universe	Annual Excess Return	Hit Rate*	Information Ratio
Companies with positive FCF and positive shareholder yield*	47%	4.1%	68%	1.24
Companies with positive FCF and negative shareholder yield*	20%	1.5%	56%	0.61
Companies with negative FCF and positive shareholder yield*	10%	-3.6%	36%	-1.14
Companies with negative FCF and negative shareholder yield*	22%	-6.6%	33%	-1.32

**Source: FactSet – Versus MSCI ACWI ex-US Small Cap Index, Equally Weighted, Jan 2003 – Dec 2017. Free Cash Flow (FCF) = cash from operations minus capital expenditures. Shareholder Yield = Dividends + Net Buy Backs + Change in Debt. Hit rate measures the % of stocks that outperform the index. Index returns are gross of all fees and expenses. An Index cannot be invested in directly.*

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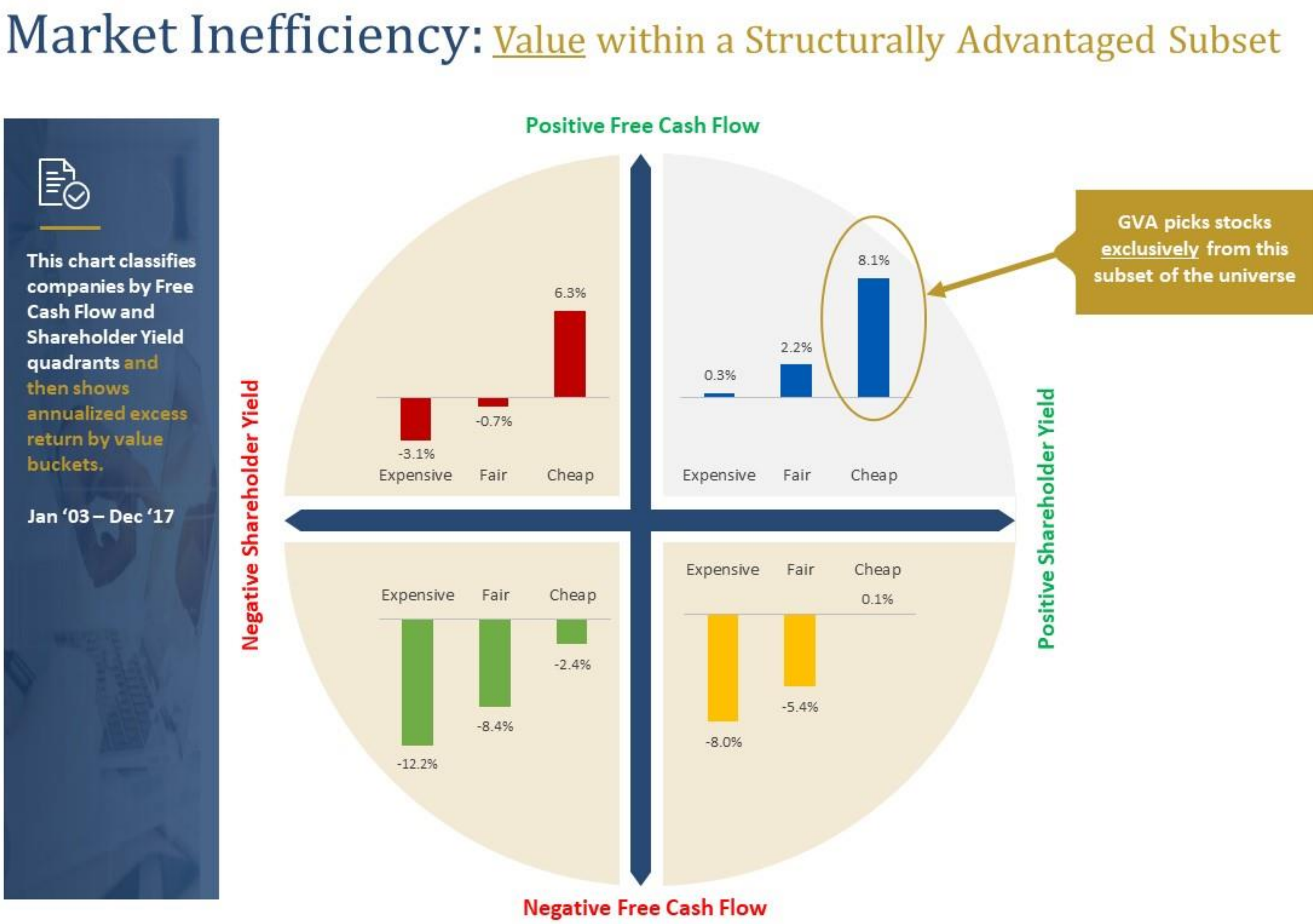
Incorporating a valuation metric into the study increases the excess returns. The chart below breaks down each of the four subsets into three equally sized valuation buckets. The most important take-away is that the cumulative annual excess return jumps to 8.1% if investors focus, as GVA does, only on the cheapest segment of the Advantaged Subset (blue quadrant). In other words, focusing on the value names within the Advantaged Subset essentially doubles your annual excess returns vs investing in the Advantaged Subset alone.

In regards to consistency of excess returns, it is apparent that all three valuation buckets in the Advantaged Subset produce positive excess returns over time.



Note: Free Cash Flow (FCF) = cash from operations minus capital expenditures. Shareholder Yield = Dividends + Net Buy Backs + Change in Debt. Source: Factset versus MSCI ACWI ex-US Small Cap Index, Jan 2003 – Dec 2017. Index returns are gross of all fees and expenses.

The consistency of the Advantaged Subset can also be seen by viewing the rolling annualized excess returns on a 1, 3, and 5 year basis. The three charts below show that the Advantaged Subset is almost always at the top of the group (blue line). The few times that other quadrants outperform are short-lived. It is also important to note that as the time horizon gets longer, the consistently outperformance improves. On a rolling 5 year basis, no other quadrant outperforms the blue line at any point during the study.

	Subset
(blue)	Companies with positive FCF and positive shareholder yield*
(red)	Companies with positive FCF and negative shareholder yield*
(yellow)	Companies with negative FCF and positive shareholder yield*
(green)	Companies with negative FCF and negative shareholder yield*

Market Inefficiency: A Structurally Advantaged Subset

International Small Cap

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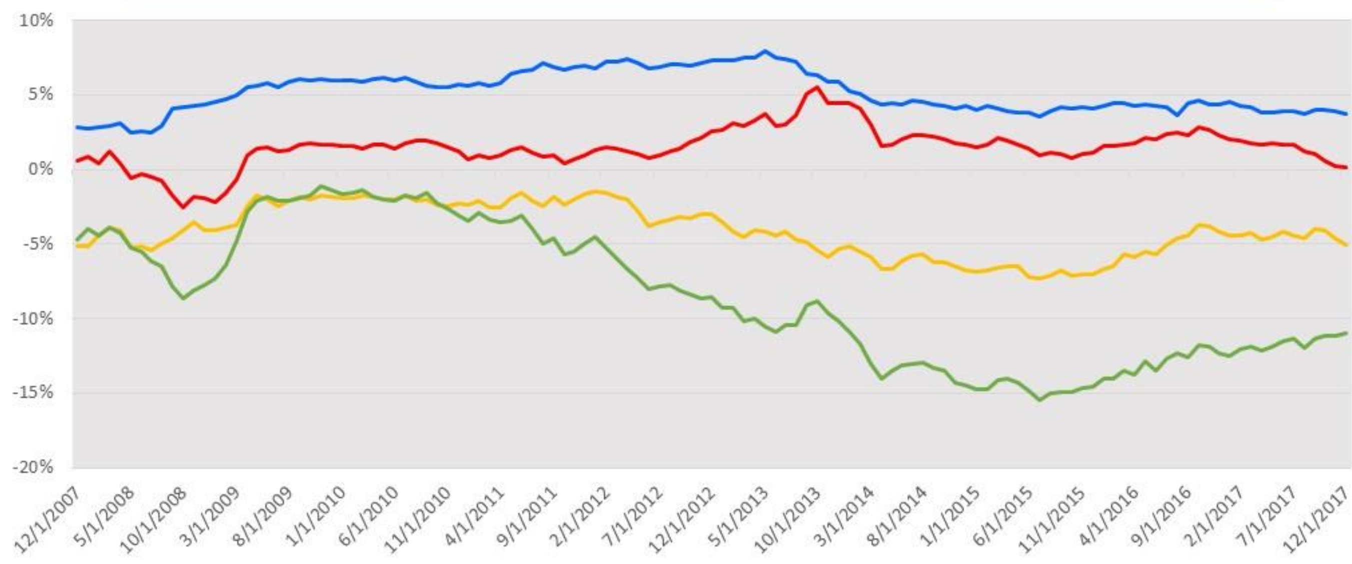
3 Year Rolling Annualized Excess Returns based on Free Cash Flow and Shareholder Yield*

5 Year Rolling Annualized Excess Returns based on Free Cash Flow and Shareholder Yield*



**Source: FactSet – Versus MSCI ACWI ex-US Small Cap Index, Jan 2003 – Dec 2017.*

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