GLOBAL VALUE ADVISORS
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Investment Insight

Why Strong FCF Companies Outperform and GVA Compared to Peers

By Philippe Rolland, Chief Investment Officer

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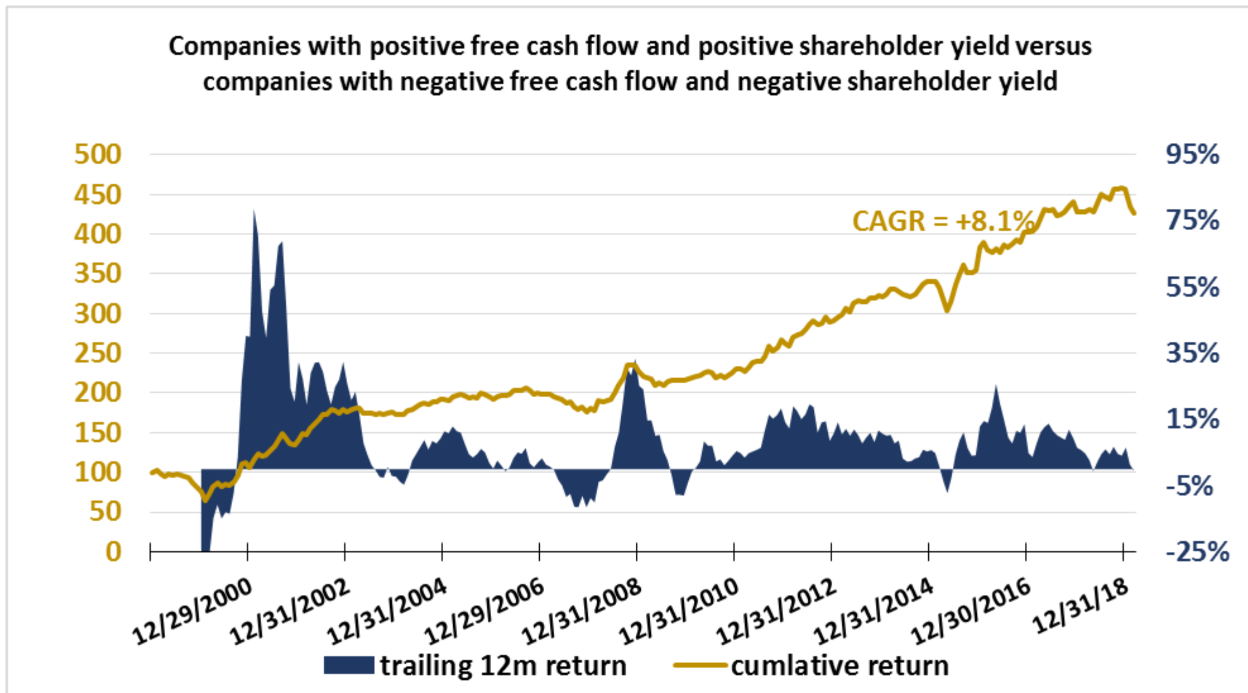
GVA's proprietary quantitative process identifies a structurally advantaged subset of the universe. Our research shows that companies that generate positive Free Cash Flow (FCF) and return cash to shareholders outperform the market.

Our investment methodology characterizes 'risk' as the inability for a company to internally finance its operations: it has a negative free cash flow and relies on external sources of financing (debt or equity) to survive. Our research shows that over the past 20 years, these companies structurally underperform (by 8% annually) our pool of "better" companies, the ones that generate positive free cash flow and positive shareholder yield.



Source: FactSet, Largest 5,000 market cap companies in the world. Equally weighted returns.

Only 5 times have companies with negative FCF and Shareholder Yield outperformed on a trailing twelve months basis. The outperformance of the risky names was typically short lived (less than a year), and usually coincided with bubble episodes (1999 and 2007) or central bank interventions. The first quarter of 2019 saw a similar pattern which was a headwind to our portfolio.

These brutal stock market fluctuations and changes in style leadership have no influence on our investment methodology: we are committed to value and our portfolio will always trade at a significant valuation discount to the market. Similarly, we are not now nor will we ever be exposed to this risky segment of the market.

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Our systematic approach ensures adherence to our key investment principles: the companies we invest in generate sufficient cash flow to maintain their assets, internally finance their growth and return unused capital to shareholders, either directly through the payment of dividends or indirectly through share buybacks or debt repayments. We avoid debt laden companies, and most importantly, we only purchase companies with cheap valuations using a blend of standard valuation metrics. We revisit on a monthly basis the compliance of each stock within the portfolio: any non-compliant name will be sold immediately. This prevents any drift away from our investment philosophy.

Our discipline produces a differentiated strategy compared to our peers, as illustrated by the research paper published earlier this year by Martin Lettau, Sydney Ludvigson and Paulo Manoel titled "Characteristics of Mutual Fund Portfolios: Where are the Value Funds?". It studies the positioning of active mutual funds, Exchange-Traded Funds and hedge funds through the lens of risk factors mainly size, value and momentum. Their observations are summarized here:

"We show that that ***these funds*** ***do not systematically tilt their portfolios towards profitable factors, such as low price to book ratios, high momentum, small size, high profitability and low investment growth****. Strikingly, there are virtually no low price to book funds in our sample while there are many high price to book "growth" funds.*

Portfolios of "growth" funds are concentrated in high price to book stocks ***but "value" funds hold stocks across the entire price to book spectrum. In fact, most "value" funds hold a higher proportion of their portfolios in high price to book ("growth") stocks than in low price to book ("value") stocks.*** *While there are some micro/small/mid-cap funds, the vast majority of mutual funds hold very large stocks. But the distributions of mutual fund momentum, profitability and investment growth are concentrated around market average with little variation across funds. The characteristics distributions of ETFs and hedge funds do not differ significantly from those of mutual funds. We conclude that the characteristics of mutual fund portfolios raise a number of questions about why funds do not exploit well-known return premia."*

This study illustrates that our portfolio positioning is significantly different from our peer group, as our investment approach precisely tries to take advantage of most of these premia. For instance, the following graphs demonstrate the magnitude of our value tilt versus peers combined with a best-in-class quasi debt free profitability level.

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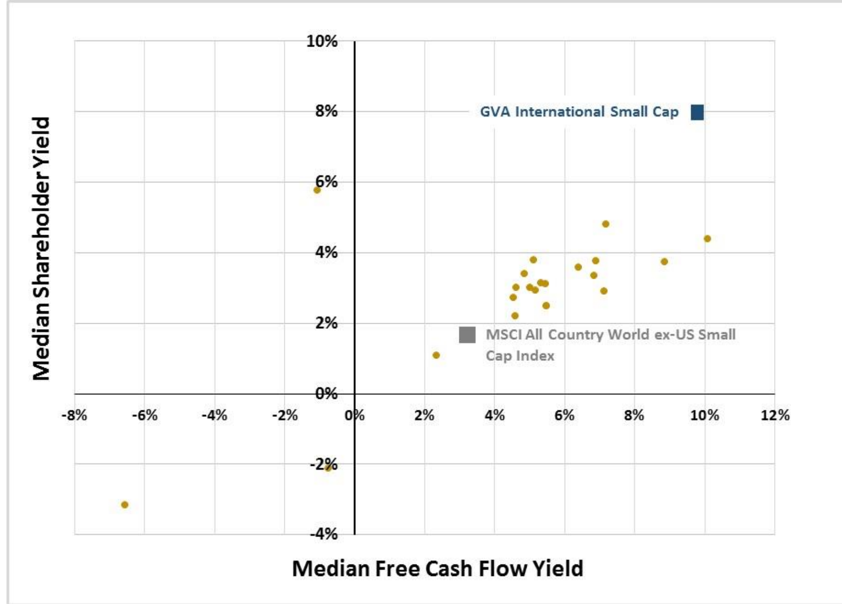
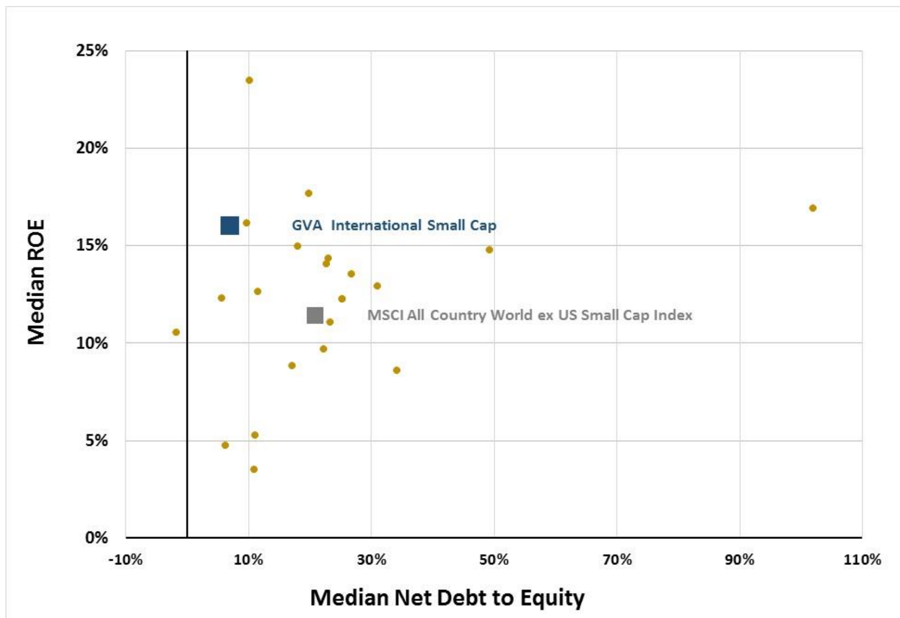


Source: Morningstar constituents in the Foreign Small Mid category as of March 31, 2019. Holdings, ex-financials, for each fund were analyzed in FactSet.



Source: Morningstar constituents in the Foreign Small Mid category as of March 31, 2019. Holdings, ex-financials, for each fund were analyzed in FactSet.

We remain steadfast in our confidence that GVA's disciplined approach that captures several proven alpha premia will deliver superior returns over time.

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