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**HIGH CASH FLOW-RELATIVE STRENGTH PORTFOLIOS**

Fidelity’s Peter Lynch has been quoted as saying that share price follows earnings. We agree with this statement, but we also believe that share price follows cash flow better. This presentation demonstrates that the use of cash flow as a selection criteria combined with the concept of relative strength leads to superior performance.

# **Inflation Versus Disinflation**

Theme investing is an approach that attempts to identify and profit from the onset of a longer-term economic or financial trend. For example, the inflationary environment of the 1970s caught Wall Street by surprise. Asset-rich stocks such as gold and energy shares outperformed, and value investing was the most profitable approach. This period ended in 1980, bringing in a period that favored growth analysis. This technique led many investors to place funds in technology stocks, thereby generating very high returns. Theme investing seeks to identify and capitalize upon a trend which will remain in force for some time. The inflationary psychology lasted for more than a decade; the disinflation theme is now in its twentieth year. Thus, the portfolio manager can let his profits run and not be concerned about high valuations or overweighting of stocks in his portfolio, if the manager understands the implications of theme investing.

# **Identifying Disinflation Hedges by Cash Flow Generation**

The rationale behind this cashflow approach is that inflation hedges, companies with physical assets such as oil or real estate, were the leaders in the 1970's. With the onset of disinflation, it was reasonable to assume that stocks that are the reverse of companies with physical assets would be the leaders. Paper assets are the opposite of hard assets. So, high cash flow generators were designated to be this opposite group. Since each dollar of cash is more valuable (or is depreciating less rapidly) when the prices of physicals decrease, the cash generators will likely rise during disinflation.

Cashflow analysis has advantages over traditional earnings-per-share analysis. First, net income represents only about a third of gross cashflow. Second, earnings are subject to accounting distortions. For example, in 2017, the new FASB 606 rule will increase earnings volatility for some companies while free cash flow will be less impacted. And, research by Merrill Lynch’s quantitative unit demonstrates that the ability of analysts to predict earnings is limited. Their analysis reveals that the projection of continuing low growth (less than 5 percent) for slow-growing companies tends to be most accurate. These estimates were accurate over a five-year period about 75 percent of the time. The projection of continuing high growth (more than 20 percent) for the fastest-growing companies tends to be second most accurate. These estimates were accurate over 5 years about 40 percent of the time. In the first case, the stocks tend to underperform. In the second, the stocks tend to outperform, but the stocks of those companies that fail to meet projections (60 percent) suffer severely. In fact, 24 percent of the estimates were dramatically inaccurate.

The point is that investors pay for real economic performance as measured by cashflow and not necessarily for accounting performance as measured by earnings per share. A unique and proprietary cashflow measurement is utilized to screen companies. The list is then sorted to determine the top 100 companies on this basis. The accumulated cash will likely be put to one of these four uses by the companies:

\*Be paid out as dividends

\*Be utilized to buy back shares

\*Be employed to acquire other companies or to expand operations

\*The cash will accumulate, which may lead to the company itself becoming a takeover target.

The 100 highest cashflow generators were entered into a portfolio reporting system at the beginning of each year. At the end of the year, the portfolio was sold and re-invested on the first of the New Year in the highest cashflow generators on that date. The performance versus 3 benchmarks was calculated and is summarized below. This test assumed that an equal dollar amount was placed in each stock from the beginning of the year to yearend.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **YEAR** | **HI CASH FLOW** | **S&P 500** | **DJIA** | **NASDAQ INDUST.** |
| **1985** | 52.3% | 26.3% | 27.7% | 26.6% |
| **1986** | 12.7 | 14.6 | 22.6 | 5.8 |
| **1987** | 3.8 | 2.0 | 2.3 | -3.0 |
| **1988** | 32.2 | 12.4 | 11.9 | 11.8 |
| **1989** | 46.7 | 27.3 | 27.0 | 18.2 |
| **1990** | 10.4 | -6.7 | -4.3 | -9.4 |
| **1991** | 87.0 | 26.3 | 20.3 | 64.8 |
| **1992** | 19.8 | 4.5 | 4.2 | 8.4 |
| **1993** | 20.3 | 7.06 | 13.64 | 11.16 |
| **1994** | 1.41 | -1.54 | 2.25 | -6.46 |
| **1995** | 29.98 | 34.11 | 33.45 | 27.97 |
| **1996** | 26.35 | 20.26 | 26.01 | 15.03 |
| **1997** | 29.48 | 31.01 | 22.64 | 10.04 |
| **1998** | 25.74 | 26.67 | 16.10 | 39.63 |
| **1999** | 25.32 | 19.53 | 25.22 | 71.67 |
| **2000** | 8.69 | -10.14 | -6.18 | -33.76 |
| **2001** | 19.41 | -13.04 | -7.10 | -21.05 |
| **2002** | -13.96 | -23.37 | -16.76 | -31.53 |
| **2003** | 58.10 | 26.4 | 25.3 | 55.7 |
| **2004** | 19.00 | 3.2 | 9.0 | 8.6 |
| **2005** | 10.65 | 3.0 | -0.6 | 1.4 |
| **2006** | 5.3 | 11.8 | 14.9 | 11.1 |
| **2007** | 10.04 | 3.5 | 6.4 | 9.6 |
| **2008** | -32.8 | -33.8 | -38.5 | -45.3 |
| **2009** | 37.7 | 18.8 | 23.5 | 43.9 |
| **2010** | 25.7 | 12.8 | 11.0 | 25.0 |
| **2011** | -2.7 | 0 | -5.5 | -0.7 |
| **2012** | 8.3 | 13.4 | 7.3 | 15.9 |
| **2013** | 41.6 | 29.6 | 26.5 | 43.1 |
| **2014** | 13.1 | 11.4 | 6.9 | 13.3 |
| **2015** | 0.7 | -0.7 | -2.2 | 5.8 |
| **2016** | 24.5 | 9.5 | 13.4 | 7.5 |
| **2017** | 21.7 | 2.9 | 0.7 | 6.3 |
| **2018** | -5.5 | -6.2 | -5.6 | -3.9 |
| **2019** | 32.8 | 30.0 | 23.7 | 36.3 |

Comparison of Buy and Hold Strategies:

$1,000,000 invested in each average in January 1985 would have grown to these amounts at the December 31, 2019 close:

Hi Cash Flow= $327,196,000

S&P 500= 16,797,000

Dow Jones Ind. = 18,956,000

NASDAQ Ind. = 27,238,000

The unfiltered cashflow portfolio outperformed the S&P in 29 out of the 35 years under review.

# **Practical Considerations**

There are several practical rules that I have developed for the actual management of such a fund due to the nature of the companies selected:

1. There are usually many building stocks on the list because they pay no dividends and have no plant spending. Because these stocks are so interest-sensitive, the stocks will not be purchased if the interest-rate environment is unfavorable.

2. There are many technology stocks. Due to the short product life cycles, these stocks move very quickly. One must use some timing methodology to get in and out early. Buy only when share price momentum comes out of a base and accelerates.

3. There were many ‘cash cows’ like Playboy Enterprises, King World, or Dairy Queen that had good cash flows, but no revenue growth. Investors generally are not going to pay up for these stocks unless the company shows sales growth. Practically speaking, these stocks are not buy candidates.

**Improving the Results With a Relative Strength Screen**

Richard Bernstein, Merrill Lynch’s Chief Strategist rated over forty stock selection techniques from 1987 through 2006. This test was conducted by selecting the top 50 stocks in each category on a monthly basis. For example, the top 50 relative strength stocks were chosen, held for one month, and then sold. The ratings of the methods are listed in the table below:

|  |  |
| --- | --- |
| **Technique** | **19-Year Compound Annual Return** |
| EV/EBITDA | +17.3% |
| Low PEG Ratio | +16.9% |
| High Relative Strength | +16.8% |
| Low Price/Free Cashflow | +16.0% |
| S&P 500 | +9.0% |

Only two stock selection methodologies exceeded the return generated by high relative strength. Also note that low price/free cashflow ranked highly. Although this is not the cash flow method that we use, it is reassuring to see its high ranking.

The thesis that stock analysis and portfolio analysis can be improved with relative strength is supported by research. Professors Philip Brown and Ray Ball (Journal of Accounting Research, August 1968) found that when a company’s reported earnings were better than forecasted, the share price rose in the 12 months *prior* to the announcement and tended to fall in the 6 months *after* the announcement. Manown Kisor and Van Messner studied trends in earnings in the Financial Analysts Journal in January of 1969. They did not find predictability in earnings trends. Instead, they found that stocks that advance in price substantially ahead of the market for 6 months tend to have above average appreciation potential in the following 6 months. Thus, share price appreciation tends to precede favorable earnings, and stocks that perform well over 6 months tend to do so in the ensuing 6 months.

In order to improve returns, a unique and proprietary screen was employed beginning in 1996. The high cashflow group was screened at the beginning of each quarter from Q1 1996 to the present. The proprietary methodology eliminates any stock that gave negative relative strength signals for the previous 6 months. (Previous tests reveal that there is little difference between use of a 6-or 12-month time horizon. This process usually eliminates about 55% of the stocks being screened. On average, it eliminated 51% of the stocks during the study period.)

The purpose of this screen is to eliminate stocks that either have temporarily run their course, or to drop stocks that are simply beginning to fail. In the first situation, the positive fundamentals have been recognized and exploited. The stock is beginning a period of consolidation that will not contribute alpha to the portfolio. In the second case, the fundamentals have deteriorated, and informed investors are selling the stock. Note that stocks frequently give signals in relative terms before they do so in absolute terms.

# **Portfolio Results**

The following table depicts the results. It was assumed that each stock was equally weighted in the portfolio. **The screened group outperformed the S&P 500 in 71 of 99 quarters.** The first three columns depict the returns. *Kindly note that these are ongoing test results and not an active portfolio.* Securities are selected from this group for client portfolios.

Because the list contains stocks from the S&P, and the NASDAQ, a second composite benchmark was created. This was constructed in the following way. If 60% of the stocks selected were NYSE issues, the S&P return was multiplied by 0.60. If 40% of the stocks were from the NASDAQ, then 40% of the NASDAQ's return for the quarter was calculated. These amounts were then added to create a composite return. This number and the difference from the portfolio are listed in columns 5 and 6. The portfolio outperformed this composite in 62 of 99 quarters.

Looking at the returns on an annualized basis from January 1, 1996 through December 31, 2019:

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **1996-2019 QUARTERLY RETURNS OF CASH FLOW/RELATIVE STRENGTH PORTFOLIO** | | | | | | | |  |
|  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  | **Hit Ratio-** |
|  | **Portfolio %** | **S&P %** | **Difference** | **Composite %** | **Difference** | **No.Stocks** | **Hit Ratio-S&P** | **Comp.** |
| Q1 1996 | 6.76 | 4.8 | **1.96** | 4.91 | **1.85** | 49 | 53% | 53% |
| Q2 1996 | 10.56 | 3.89 | **6.67** | 5.52 | **5.04** | 48 | 63% | 58% |
| Q3 1996 | 11.06 | 2.49 | **8.57** | 1.16 | **9.90** | 47 | 43% | 72% |
| Q4 1996 | 8.88 | 7.77 | **1.11** | 3.97 | **4.91** | 42 | 48% | 57% |
| Q1 1997 | 1.27 | 2.21 | **-0.94** | -3.08 | **4.35** | 38 | 50% | 66% |
| Q2 1997 | 18.21 | 16.91 | **1.3** | 16.07 | **2.14** | 32 | 44% | 44% |
| Q3 1997 | 21.19 | 7.02 | **14.17** | 11.31 | **9.88** | 27 | 74% | 56% |
| Q4 1997 | 5.88 | 2.44 | **3.44** | -2.75 | **8.63** | 47 | 62% | 72% |
| Q1 1998 | 18.71 | 13.53 | **5.18** | 12.39 | **6.32** | 50 | 60% | 62% |
| Q2 1998 | 7.94 | 2.91 | **5.03** | 0.43 | **7.51** | 39 | 62% | 64% |
| Q3 1998 | -13.22 | -10.3 | **-2.92** | -15.24 | **2.02** | 38 | 42% | 45% |
| Q4 1998 | 22.05 | 20.86 | **1.19** | 22.49 | **-0.44** | 22 | 50% | 41% |
| Q1 1999 | 2.12 | 4.65 | **-2.53** | 5.65 | **-3.53** | 32 | 53% | 39% |
| Q2 1999 | 12.1 | 6.71 | **5.39** | 12.34 | **-0.24** | 35 | 60% | 49% |
| Q3 1999 | 2.06 | -6.56 | **8.62** | 3.87 | **-1.81** | 35 | 69% | 49% |
| Q4 1999 | 31.46 | 14.54 | **16.92** | 28.32 | **3.14** | 39 | 54% | 54% |
| Q1 2000 | 14.52 | 2.00 | **12.52** | 13.07 | **1.45** | 42 | 62% | 45% |
| Q2 2000 | -0.33 | -2.93 | **2.6** | -9.04 | **8.71** | 44 | 55% | 66% |
| Q3 2000 | 2.6 | -1.24 | **3.84** | -1.9 | **4.50** | 49 | 51% | 57% |
| Q4 2000 | 13.33 | -8.09 | **21.42** | -14.8 | **28.13** | 43 | 79% | 84% |
| Q1 2001 | -5.35 | -12.11 | **6.76** | -13.4 | **8.05** | 39 | 74% | 74% |
| Q2 2001 | 12.98 | 5.52 | **7.46** | 11.48 | **1.50** | 53 | 60% | 53% |
| Q3 2001 | -17.91 | -14.99 | **-2.92** | -20.3 | **2.39** | 64 | 52% | 56% |
| Q4 2001 | 23.46 | 10.29 | **13.17** | 17.47 | **5.99** | 50 | 50% | 54% |
| Q1 2002 | 4.22 | -0.06 | **4.28** | 0.59 | **3.63** | 62 | 66% | 65% |
| Q2 2002 | -7.33 | -13.73 | **6.4** | -12.71 | **5.38** | 63 | 60% | 56% |
| Q3 2002 | -13.92 | -17.63 | **3.71** | -19 | **5.08** | 54 | 44% | 54% |
| Q4 2002 | 3.49 | 7.92 | **-4.43** | 8.7 | **-5.21** | 47 | 38% | 32% |
| Q1 2003 | -2.74 | -3.6 | **0.86** | -2.1 | **-0.64** | 54 | 52% | 52% |
| Q2 2003 | 24.2 | 14.9 | **9.3** | 18.5 | **5.70** | 51 | 63% | 57% |
| Q3 2003 | 11.9 | 2.2 | **9.7** | 5.9 | **6.00** | 61 | 62% | 51% |
| Q4 2003 | 16.9 | 11.6 | **5.3** | 13.4 | **3.50** | 80 | 60% | 53% |
| Q1 2004 | 8.9 | 1.29 | **7.61** | 2.62 | **6.28** | 71 | 59% | 55% |
| Q2 2004 | 0.64 | 1.3 | **-0.66** | 2.05 | **-1.41** | 68 | 50% | 47% |
| Q3 2004 | -5.16 | -2.3 | **-2.86** | -4.22 | **-0.94** | 55 | 49% | 51% |
| Q4 2004 | 13.25 | 8.73 | **4.52** | 11.54 | **1.71** | 39 | 56% | 46% |
| Q1 2005 | -3.58 | -2.59 | **-0.99** | -4.48 | **0.90** | 56 | 45% | 54% |
| Q2 2005 | 5.65 | 0.91 | **4.74** | 1.25 | **4.40** | 59 | 61% | 61% |
| Q3 2005 | 2.66 | 3.15 | **-0.49** | 3.8 | **-1.14** | 61 | 50% | 48% |
| Q4 2005 | 5.81 | 1.59 | **4.22** | 2.09 | **3.72** | 72 | 49% | 58% |
| Q1 2006 | 8.25 | 3.73 | **4.52** | 5.82 | **2.43** | 63 | 56% | 48% |
| Q2 2006 | -2.43 | -1.9 | **-0.53** | -4.53 | **2.10** | 60 | 48% | 62% |
| Q3 2006 | 4.01 | -1.9 | **5.91** | -2.74 | **6.75** | 43 | 77% | 79% |
| Q4 2006 | 8.85 | 6.17 | **2.68** | 7.42 | **1.43** | 38 | 60% | 58% |
| Q1 2007 | 2.08 | 0.18 | **1.9** | 1.29 | **0.79** | 68 | 57% | 56% |
| Q2 2007 | 9.5 | 5.81 | **3.69** | 7.86 | **1.64** | 36 | 61% | 56% |
| Q3 2007 | -1.41 | 1.56 | **-2.97** | 1.11 | **-2.52** | 39 | 41% | 51% |
| Q4 2007 | -0.85 | -3.82 | **2.97** | -5.17 | **4.32** | 36 | 53% | 61% |
| Q1 2008 | -12.26 | -9.92 | **-2.34** | -11.19 | **-1.07** | 31 | 48% | 45% |
| Q2 2008 | -2.91 | -3.23 | **0.32** | -1.652 | **-1.26** | 36 | 58% | 44% |
| Q3 2008 | -3.67 | -9 | **5.33** | -10.25 | **6.58** | 32 | 59% | 63% |
| Q4 2008 | -18.1 | -22.56 | **4.46** | -26.73 | **8.63** | 42 | 62% | 79% |
| Q1 2009 | -1.23 | -11.67 | **10.44** | -7.7 | **6.47** | 40 | 75% | 65% |
| Q2 2009 | 16.04 | 15.22 | **0.82** | 18.51 | **-2.47** | 39 | 44% | 41% |
| Q3 2009 | 17.43 | 14.98 | **2.45** | 17.48 | **-0.05** | 57 | 51% | 37% |
| Q4 2009 | 3.45 | 5.49 | **-2.04** | 6.28 | **-2.83** | 45 | 47% | 44% |
| Q1 2010 | 6.92 | 4.87 | **2.05** | 6.87 | **0.05** | 34 | 53% | 53% |
| Q2 2010 | -5.9 | -11.86 | **5.96** | -11.62 | **5.72** | 40 | 58% | 58% |
| Q3 2010 | 11.29 | 10.72 | **0.57** | 14.27 | **-2.98** | 19 | 56% | 47% |
| Q4 2010 | 18.22 | 10.2 | **8.02** | 12.61 | **5.61** | 19 | 43% | 64% |
| Q1 2011 | 14.12 | 5.42 | **8.7** | 7.55 | **6.57** | 34 | 67% | 73% |
| Q2 2011 | 0.71 | -0.39 | **1.1** | 1.45 | **-0.74** | 55 | 51% | 44% |
| Q3 2011 | -19.17 | -14.33 | **-4.84** | -16.95 | **-2.22** | 43 | 28% | 28% |
| Q4 2011 | 3.28 | 11.15 | **-7.87** | 6.7 | **-3.42** | 28 | 18% | 29% |
| Q1 2012 | 14.36 | 12 | **2.36** | 13.69 | **0.67** | 31 | 58% | 45% |
| Q2 2012 | -7.98 | -3.29 | **-4.69** | -3.22 | **-4.76** | 45 | 42% | 42% |
| Q3 2012 | 3.41 | 5.76 | **-2.35** | 5.72 | **-2.31** | 30 | 34% | 34% |
| Q4 2012 | -0.56 | -1.01 | **0.45** | 0.5426 | **-1.10** | 27 | 56% | 56% |
| Q1 2013 | 10.94 | 7.3 | **3.64** | 6.3 | **4.64** | 34 | 59% | 62% |
| Q2 2013 | 10.75 | 2.36 | **8.39** | 3.08 | **7.67** | 41 | 80% | 27% |
| Q3 2013 | 11.57 | 4.69 | **6.88** | 8.48 | **3.09** | 40 | 73% | 58% |
| Q4 2013 | 16.29 | 9.92 | **6.37** | 9.46 | **6.83** | 34 | 68% | 71% |
| Q1 2014 | 3.38 | 1.3 | **2.08** | -2.07 | **5.45** | 63 | 51% | 60% |
| Q2 2014 | 3.74 | 4.48 | **-0.74** | 4.76 | **-1.02** | 30 | 50% | 50% |
| Q3 2014 | -3.79 | 0.62 | **-4.41** | 1.30 | **-5.09** | 30 | 27% | 20% |
| Q4 2014 | 7 | 4.4 | **2.6** | 5 | **2.00** | 33 | 61% | 61% |
| Q1 2015 | 3.5 | 0.4 | **3.1** | 1.4 | **2.10** | 30 | 63% | 60% |
| Q2 2015 | 3.2 | 0.2 | **3** | 1.1 | **2.10** | 30 | 63% | 60% |
| Q3 2015 | -4.65 | -6.94 | **2.29** | -5.76 | **1.11** | 27 | 60% | 60% |
| Q4 2015 | 3.37 | 6.45 | **-3.08** | 8.49 | **-5.12** | 30 | 37% | 55% |
| Q1 2016 | -3.68 | 1.41 | **-5.09** | -0.87 | **-2.81** | 30 | 23% | 43% |
| Q2 2016 | 4.53 | 1.9 | **2.63** | -0.51 | **5.04** | 30 | 60% | 73% |
| Q3 2016 | 3.33 | 3.31 | **0.02** | 7.1 | **-3.77** | 30 | 73% | 63% |
| Q4 2016 | 5.25 | 3.25 | **2** | 1.91 | **3.34** | 32 | 47% | 70% |
| Q1 2017 | 1.87 | 5.53 | **-3.66** | 9.69 | **-7.82** | 30 | 40% | 17% |
| Q2 2017 | 5.16 | 2.57 | **2.59** | 3.44 | **1.72** | 30 | 30% | 55% |
| Q3 2017 | 4.38 | 3.96 | **0.42** | 4.99 | **-0.61** | 30 | 53% | 33% |
| Q4 2017 | 2.6 | 6.12 | **-3.52** | 6.195 | **-3.60** | 30 | 50% | 50% |
| Q1 2018 | -1.91 | -1.22 | **-0.69** | 0.55 | **-2.46** | 30 | 40% | 40% |
| Q2 2018 | 9.6 | 2.93 | **6.67** | 5.3 | **4.30** | 30 | 70% | 60% |
| Q3 2018 | 8.9 | 7.2 | **1.7** | 7.9 | **1.00** | 30 | 63% | 60% |
| Q4 2018 | -19.3 | -14 | **-5.3** | -16 | **-3.30** | 30 | 37% | 43% |
| Q1 2019 | 15.6 | 14 | **1.6** | 16.2 | **-0.60** | 30 | 57% | 57% |
| Q2 2019 | 7.1 | 3.8 | **3.3** | 3.9 | **3.20** | 30 | 63% | 63% |
| Q3 2019 | 0.2 | 1.2 | **-1** | 1.1 | **-0.90** | 30 | 43% | 43% |
| Q4 2019 | 10.6 | 8.5 | **2.1** | 11 | **-0.40** | 30 | 47% | 40% |
| Q1 2020 | -22.6 | -19.8 | **-2.8** | -16 | **-6.60** | 30 | 50% | 27% |
|  |  |  |  |  |  |  |  |  |
|  | **Annualized Return=17.3%** | | |  |  |  |  |  |
|  | **S&P Return=6.2%** | |  |  |  |  |  |  |