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Free Cash Flow: Expensive to Ignore?

Hamilton Point selects individual stocks in our Global Core and Equity Income strategies based upon our firm's fundamental research. Our work strives to identify investments that produce "free cash flow" at levels that justify the risks taken. In our minds, this is how we differentiate between speculating and investing. Though future performance can never be guaranteed, we believe this methodology can allow investors to do well, even over periods when market performance, in hindsight, was lackluster.

This newsletter endeavors to illustrate our philosophy by drawing valuation comparisons between some stock prices today to those at the peak of the internet bubble and warns that, if history and math are any guide, today's highfliers may underperform holdings in higher cash-producing companies in the coming decade.

Be Home by Midnight

We believe one cause of excessive valuations in the internet bubble was Wall Street's argument that a stock priced reasonably relative to its peers was "cheap." Wall Street continues to embrace this methodology, even today, because it allows them to place high valuations on Initial Public Offerings by making the flawed (to us) case that a company with minimal earnings can be "fairly valued," or even cheap, if it trades at a discount *relative* to a peer – even if that peer has an absurd valuation. The investment bankers making those arguments probably tried to convince their mothers they should be able to stay out until 2:00 a.m. because all their teenage friends came home at 3:00! Sorry, but if moms don't buy such logic, why would we?

One strategy Hamilton Point employs to cut through

Wall Street noise is our calculation of a "cash-on-cash" statistic⁽¹⁾ for each company we evaluate. Before investing, we ask ourselves, "If we owned every share of the company in question at its current price and instructed management to send us all of the excess cash flow produced each year, what would that cash represent as a return on our investment?" As an example, if we bought all shares of XYZ Company for \$3.0 billion and the company produced free cash flow of \$195 million in its first year, we calculate a 6.5% cash-on-cash return (\$195 million divided into \$3.0 billion = 6.5%). Incidentally, and more on this later, our current Global Core strategy has a dollar-weighted average cash-on-cash statistic of about 6.9% as of August 31, with individual holdings ranging from a low of almost 4% at Nike to a high of nearly 14% for Cisco⁽²⁾.

Let's Look Back

While it is reasonable that an investor would pay more for a company expected to grow earnings faster (hence the spread between Nike and Cisco), we believe there is a limit to how much an investor should pay for that growth if they want a good return over the long-term. For perspective, we studied a set of 42 large company stocks⁽³⁾ (referred to hereafter as the "Sample") and

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1) Cash-on-cash is a Hamilton Point generated statistic which serves as a projection of the cash generated by a company over the next twelve months relative to the amount of cash a new investor would be required to pay when acquiring shares of the company.

2) Please contact us for a full list of all Global Core strategy recommendations made in the last twelve months.

3) Selected as follows: Out of the top 100 firms by market cap in the world in the year 2000, we took a sample of 42 that we feel are representative for this comparison. The 58 that were excluded were either financial stocks where the cash-on-cash return statistic is less meaningful when calculated as discussed (9), had corporate transactions such as mergers/acquisitions that obscure the financial history (9), or did not have accurate historical data for other reasons, primarily due to being foreign-listed (40).

how they performed since the peak of the internet bubble compared to each company's free cash flow generation at that time. In our opinion, the data is clear: Sample companies that were priced expensively in March 2000 – defined as a cash-on-cash statistic lower than 4% – produced below-market returns of 1.2% (annualized), on average, in the last thirteen years while Sample companies with more modest valuations (i.e. greater than 4% cash-on-cash) produced an average return of 7.0%. This 5.8% annualized return differential between the cash-producers and their overpriced counterparts means that someone investing \$1 million in March 2000 in an equal-weighted group of these Sample company stocks would, as of August 31, 2013, have \$1,294,695 more by selecting the “cash producers” as compared to the “highfliers.” The key results we found are summarized below:

<u>Sample Group</u>	<u>Companies</u>	<u>Value of \$1 Million Invested 3/24/2000 – 8/31/2013</u>
More than 4% Free Cash Flow	8	\$2,464,551
Less than 4% Free Cash Flow	34	1,169,856
Total Sample	42	1,416,464
S&P 500 Total Return Index	500	1,374,647

We have posted our full study on our website, which includes more details. Also, for skeptics curious to look at results from something other than a market top, our full study examines results measured off the market bottom in October 2002, where likewise, the cash producers in the Sample outperformed as a group.

To us it makes common sense that cash-on-cash returns ultimately matter. Specifically, for a high-quality, growing company that produces adequate free cash flow, it seems reasonable to expect the market to ultimately reflect those economics in the form of shareholder returns. To be sure, stock prices will vary considerably along the way (think tortoises and

hares), and there are likely to be isolated exceptions to the norm; however, we believe that remaining selective and mindful of valuation, particularly when broad market values have risen sharply, appears to matter over the long term.

Here We Go Again

Before concluding, we reviewed a number of today's highflying companies with ominously low cash generation relative to their valuation. The list ranged from **Amazon** (1.1% cash-on cash) to **Zillow** (0.5%) and included some outstanding companies that we may consider owning someday but are avoiding now primarily because of stretched valuation. Meanwhile, look for Wall Street to hype **Twitter's** much anticipated public offering by comparing it to names like **Facebook** (0.8%) or **LinkedIn** (0.2%). In our view, investors in these, and many other stocks may face an unpleasant surprise in the coming years whereby the companies themselves perform well in terms of growth and profitability but disappointing returns are made holding the shares.

In conclusion, when looking at the broader market we see a good deal of evidence of overvaluation in certain stocks that, to us, are speculative in nature. We continue to advise against short-term, market-timing strategies as a solution though. Instead, we are comforted by the cash-on-cash valuation metrics on the equity strategies we employ, and believe that some straight-forward techniques can be used to improve the odds of desired long-term returns by, among other things, simply “following the cash.”

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