

## Cash Is King...When Measured Accurately

*Back-testing Shows Our Free-Cash-Flow-Yield Outperforms*

### Investment Perspective

The report presents unique investment ideas produced by our integrated research database and platform.

### Contributors

**David Trainer**

[david.trainer@newconstructs.com](mailto:david.trainer@newconstructs.com)  
 615-599-4462

**Kiran Akkineni**

[kiran.akkineni@newconstructs.com](mailto:kiran.akkineni@newconstructs.com)  
 615-599-4462

**Alan Chen**

[alan.chenhd@gmail.com](mailto:alan.chenhd@gmail.com)  
 615-599-4462

**Soleil**

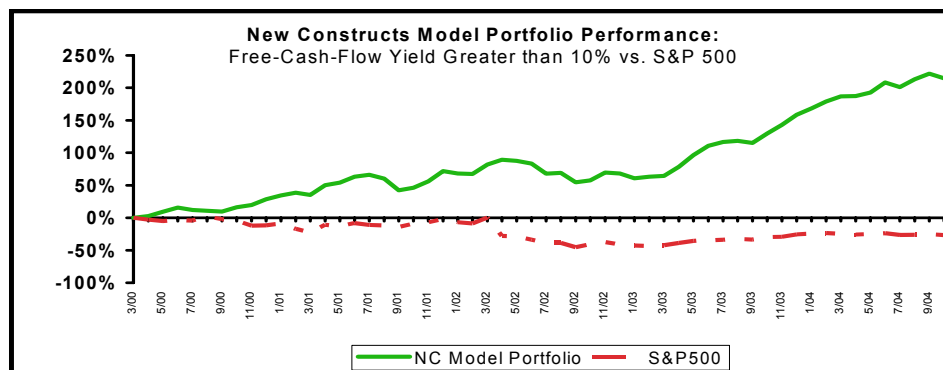
Sales and Trading  
 1-800-557-0226  
[www.soleilgroup.com](http://www.soleilgroup.com)

**Note**

This document is available to clients in the **Research** area of our site [www.newconstructs.com](http://www.newconstructs.com).

- **Rigorous back-testing shows that companies with a Free-Cash-Flow Yield > 10% have consistently outperformed the S&P 500 and peers by a wide margin.**
- **This report shows better data may improve stock picking.**
- **Over 5 years, our Model Portfolio (+215%) substantially outperformed the S&P 500 (-27%). After removing survivor bias, our Model Portfolio (+96%) still bested the market.**
- **We believe our Model Portfolio's superior results are driven by our more accurate measure of Free Cash Flow (FCF), which leverages data from Notes to the Financials.**
- **Our back-testing process is very simple. We buy stocks with a Free-Cash-Flow Yield averaging at least 10% for a minimum of 2 years. We hold these stocks for one year.**
- **Figures 1 and 2 compare the rebalanced performance of our Model Portfolio versus the S&P 500 over 5 years.**
- **Figure 4 shows the FCF and the FCF Yield for the S&P 500 over the past 5 years. Figure 6 shows the Russell 1000 companies with a 5-year average FCF Yield > than 10%.**

**Figure 1: Cash Is Still King as long as it is measured accurately**



Source: New Constructs, LLC and 10-K Filings

## ***Back-Testing Our Free-Cash-Flow Model Portfolio***

Rigorous back-testing shows that stocks with a Free-Cash-Flow<sup>1</sup> Yield averaging at least 10% for a minimum of 2 years will generate significantly higher stock market returns than both the S&P 500 and a survivor-bias-adjusted index. Figure 2 shows that our Model Portfolio outperforms both the S&P 500 and the survivor-bias-adjusted index in every year we measured.

**Figure 2: Annual Performance of Model Portfolio Versus Indices**

	2000-2001	2001-2002	2002-2003	2003-2004	Mar '04 - Oct '04	Cumulative Return
Model Portfolio	35%	35%	-10%	74%	9%	215%
Survivor Bias Adjusted Index	10%	20%	-21%	49%	0%	119%
S&P 500 Index	-23%	4%	-23%	28%	1%	-27%
<i>vs Survivor Bias Adjusted Index</i>	<b>25%</b>	<b>15%</b>	<b>11%</b>	<b>25%</b>	<b>9%</b>	<b>96%</b>
<i>vs S&amp;P 500</i>	<b>58%</b>	<b>31%</b>	<b>14%</b>	<b>46%</b>	<b>8%</b>	<b>242%</b>

Sources: New Constructs, LLC

Because our database is primarily comprised of companies that are in existence today, the performance of our model portfolio may be materially affected by survivor bias. In order to quantify the amount of survivor bias affecting the Model Portfolio, we created the survivor-bias-adjusted index and compared its performance to the Model Portfolio. The survivor-bias-adjusted index represents the pool of companies from which our model portfolio was chosen. To measure the performance of our Model Portfolio ex-survivor bias, we deducted the performance of the survivor-bias-adjusted index from the Model Portfolio performance.

## ***What Makes Our Investment Strategy Unique***

Using Free-Cash-Flow Yields to pick stocks is not a new strategy. Yet, our strategy is different because our measure of Free Cash Flow is different. Our measure of FCF is different because it leverages significantly better data and analytics for a large number of companies.

Our data is better because each of our company models captures important financial data from the Notes to the Financial Statements in addition to the Income Statement, Balance Sheet and Cash Flow Statement. Our analytics, including our measure of Free-Cash-Flow, are better because we leverage a more comprehensive data set to rectify accounting distortions that cause reported financials not to be as representative of economic cash flows as investors might expect.

Investors that rely on reported financials may overlook important financial data points that can meaningfully affect the profits of a company. Each item in Figure 3 can cause reported earnings to differ from the company's economic earnings.

Reconciling reported financials to economic earnings requires data gathering from all parts of an annual report or 10-K. We specialize in

<sup>1</sup> Free Cash Flow equals NOPAT minus the change in Invested Capital. NOPAT equals Net Operating Profit After Tax and Invested Capital equals all cash invested in a business over its lifetime.

**Our Model Portfolio consistently outperforms by a wide margin even after removing survivor bias.**

**Our data is better because each of our company models captures important financial data from the Notes to the Financial Statements.**

**Analyzing the Notes to the Financial Statements is necessary to calculate economic cash flow.**

efficiently and accurately gathering financial data from the Notes to the Financial Statements in addition to the Income Statement, Balance Sheet and Cash Flow Statement.

**Figure 3: Accounting Issues that Distort GAAP Profit Reports**

- Employee Stock Options
- Pension Over/Under Funding
- Excess Cash
- Restructuring charges
- Pooling Goodwill
- Minority Interests
- Cost of Equity Capital
- Off-Balance-Sheet Financing
- LIFO/Loan Loss Reserves
- Unrealized Gains/Losses
- Goodwill amortization
- Unconsolidated Subsidiaries

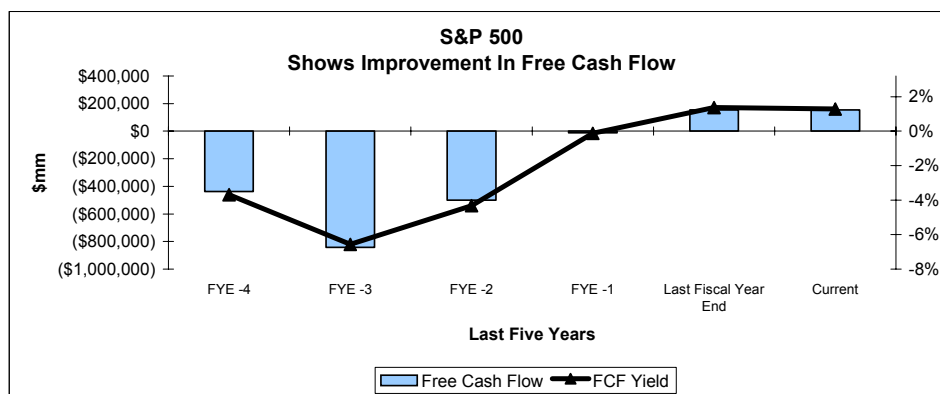
**New Constructs rectifies accounting distortions in GAAP financial statements.**

Sources: New Constructs, LLC

Only after analyzing the comprehensive data set culled from the entire annual report can one build high-integrity financial statements that enable measurement of economic free cash flow and earnings.

Figure 4 graphs our measure of Free Cash Flow and FCF Yield for the S&P 500 over the past five years. Note that the S&P 500 exhibits a meaningful improvement in FCF over the past couple of years. The FCF Yield is positive for the first time in almost 5 years.

**Figure 4: S&P 500 Free Cash Flow & Free Cash Flow Yield**



Sources: New Constructs, LLC

Figure 5 presents the specific values for Free Cash Flow, Enterprise Value and FCF Yield for the S&P 500 over the past five years.

**Figure 5: S&P 500 Free Cash Flow, Enterprise Value & Free Cash Flow Yield**

	FYE -4	FYE -3	FYE -2	FYE -1	Last Fiscal Year End	Current
Free Cash Flow	(\$437,922)	(\$842,137)	(\$499,024)	(\$12,052)	\$154,559	\$154,559
Enterprise Value	\$11,895,595	\$12,831,584	\$11,536,050	\$9,561,970	\$11,341,413	\$12,003,425
FCF Yield	-3.7%	-6.6%	-4.3%	-0.1%	1.4%	1.3%

Sources: New Constructs, LLC

## **Conclusion**

Our back-testing shows that our measure of Free-Cash-Flow offers investors a better measure of profitability, which can result in improved portfolio performance.

This report shows that data quality can improve securities analysis. What we believe to be a more accurate measure of Free Cash Flow results in analysis with greater utility and, potentially, improved portfolio performance. Analyzing all available financial information is key to creating models with more meaningful results.

**Figure 6: Companies with 5yr Average Free Cash Flow Yield > 10%**

	<b>5-Yr Avg FCF Yield</b>	<b>3-Yr Avg FCF Yield</b>	<b>2-Yr Avg FCF Yield</b>	<b>Current FCF Yield</b>
PHS	389%	7%	16%	6%
MNY	139%	230%	158%	2%
RAI	119%	28%	38%	16%
MAA	68%	132%	163%	0%
T	56%	116%	140%	23%
CI	54%	8%	7%	-36%
ET	38%	78%	115%	15%
HB	37%	62%	76%	223%
S	35%	54%	88%	164%
CXW	32%	8%	8%	5%
TKR	26%	66%	-19%	-13%
DQE	20%	10%	12%	13%
HPC	19%	27%	36%	5%
SCI	19%	18%	17%	-2%
CRE	18%	17%	18%	13%
CHTT	18%	4%	0%	4%
ROK	16%	19%	7%	1%
AN	15%	7%	3%	7%
NHI	13%	10%	9%	7%
STK	13%	10%	12%	12%
TXU	12%	20%	26%	4%
SFI	12%	16%	48%	-2%
BOH	12%	15%	16%	12%
RBK	11%	6%	7%	4%
TNB	11%	10%	10%	10%
R	11%	13%	8%	3%
HOT	11%	8%	10%	7%
NHC	11%	19%	14%	4%
LYO	11%	4%	5%	3%
TNM	11%	20%	12%	5%
AF	10%	16%	16%	9%
JCP	10%	8%	2%	5%
JOE	10%	5%	3%	2%
HAS	10%	15%	18%	13%

Sources: New Constructs, LLC

## **New Constructs™ – Profile**

New Constructs™ is a specialty equity research firm. Our main activity is delivering to clients an integrated research platform that maximizes the analytical value of financial data. This platform offers clients a suite of interactive analytical tools, along with traditional equity research and raw data services. All of our products are customizable. Our primary goal is to empower clients to achieve better investment performance.

Our main products are MaxVal™, MaxStrategy™ and MaxData™. These research tools are delivered via [www.newconstructs.com](http://www.newconstructs.com). MaxVal is a DCF-based, equity valuation model that allows clients to define their own forecasts and forecast drivers. MaxStrategy is a stock screening/ranking tool that enables clients to analyze stocks based on many metrics, several unique to our platform. Both MaxVal & MaxStrategy are integrated with MaxData, our proprietary financial database. Unlike many other research firms, we do not buy our raw material - corporate financial data - from commercial vendors. Rather, we source it ourselves to create MaxData.

The key advantage provided by MaxData is that it delivers data drawn directly from SEC filings, including the *Notes to the Financial Statements*. We can cost-effectively deliver any reported data point. We believe our capabilities in this area are unmatched.

MaxData provides a scalable approach to the time-consuming task of collecting and modeling data. It enables our research analysts to gather and analyze corporate filings more efficiently and accurately than any manual process. MaxData can implement any valuation methodology requested by clients. For example, our MaxVal models provide both a high-integrity economic analysis as well as a traditional GAAP accounting analysis.

The result is a research platform that empowers better investment performance.

Our clients are professional investors, research firms, consulting firms and publicly listed corporations. We also partner with colleges and business schools. Our products may also be of interest to active individual investors.

For further information, contact:

David Trainer  
[david.trainer@newconstructs.com](mailto:david.trainer@newconstructs.com)  
(615) 599-4462

## ***REGULATORY REQUIRED DISCLOSURES***

---

### **Analyst Certification**

I, David Trainer, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issue(s) as of the date of this report. I further certify that no part of my compensation was, is, or will be directly, or indirectly, related to the specific recommendations or views contained in this research report.

### **SOLEIL SECURITIES IMPORTANT DISCLOSURE INFORMATION**

Soleil Securities Corporation, in order to provide its clients with research independent from investment-banking conflicts, has contracted with the publisher and/or author of this report. Soleil Securities Corporation does not provide investment banking services.

Soleil Securities Corporation has entered into a subscription and redistribution agreement with the publisher of this report. The opinions, forecasts, and recommendations contained in this report are those of the analyst preparing the report and are based upon the information available to them as of the date of the report. The analysts are basing their opinions upon information they have received from sources they believe to be accurate and reliable and the completeness and/or accuracy is neither implied nor guaranteed. The opinions and recommendations are subject to change without notice. Soleil Securities Corporation has no obligation to continue to provide this research product and no such obligation is implied or guaranteed. The report is provided to the institutional clients of Soleil Securities Corporation for informational purposes only and is not an offer or a solicitation for the purchase or sale of any financial instrument.

### **Soleil Rating Key:**

Buy: In the analyst's opinion the stock will outperform the general market over the next twelve months. Hold: In the analyst's opinion the stock will be in line with the general market over the next twelve months. Sell: In the analyst's opinion, the stock will underperform the general market over the next twelve months.

## ***DISCLAIMERS***

---

The information and opinions presented in this report are provided to you for information purposes only and are not to be used or considered as an offer or solicitation of an offer to buy or sell securities or other financial instruments. New Constructs™, LLC, and/or its subsidiaries or affiliates (collectively, "New Constructs") have not taken any steps to ensure that the securities referred to in this report are suitable for any particular investor and nothing in this report constitutes investment, legal, accounting or tax advice. This report includes general information that does not take into account your individual circumstance, financial situation or needs, nor does it represent a personal recommendation to you. The investments or services contained or referred to in this report may not be suitable for you and it is recommended that you consult an independent investment advisor if you are in doubt about any such investments or investment services.

Information and opinions presented in this report have been obtained or derived from sources believed by New Constructs to be reliable, but New Constructs makes no representation as to their accuracy, authority, usefulness, reliability, timeliness or completeness. New Constructs accepts no liability for loss arising from the use of the information presented in this report, and New Constructs makes no warranty as to results that may be obtained from the information presented in this report. Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty,

express or implied, is made regarding future performance. Information and opinions contained in this report reflect a judgment at its original date of publication by New Constructs and are subject to change without notice. New Constructs may have issued, and may in the future issue, other reports that are inconsistent with, and reach different conclusions from, the information presented in this report. Those reports reflect the different assumptions, views and analytical methods of the analysts who prepared them and New Constructs is under no obligation to insure that such other reports are brought to the attention of any recipient of this report.

This report was originally issued by New Constructs for distribution to its professional and institutional investor customers. Recipients who are not professionals or institutional investor customers of New Constructs should seek the advice of their independent financial advisor prior to taking any investment decision based on this report or for any necessary explanation of its contents.

This report is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or which would be subject New Constructs to any registration or licensing requirement within such jurisdiction.

This report may provide the addresses of websites. Except to the extent to which the report refers to New Constructs own website material, New Constructs has not reviewed the linked site and takes no responsibility for the content therein. Such address or hyperlink (including addresses or hyperlinks to New Constructs own website material) is provided solely for your convenience and the information and content of the linked site do not in any way form part of this report. Accessing such websites or following such hyperlink through this report shall be at your own risk.

All material in this report is the property of, and under copyright, to New Constructs. None of the contents, nor any copy of it, may be altered in any way, copied, or distributed or transmitted to any other party without the prior express written consent of New Constructs. All trademarks, service marks and logos used in this report are trademarks or service marks or registered trademarks or service marks of New Constructs.

New Constructs is an independent organization with no financial ties or management ties to the companies it covers. None of the members of New Constructs' management team or Board of Directors holds a seat on the Board of Directors of any of the companies New Constructs covers. New Constructs does not perform any investment or merchant banking functions and does not operate a trading desk. New Constructs' Stock Ownership Policy prevents any of its employees from having an ownership position in a covered company that is equal to or greater than 1% of its outstanding stock.

Copyright New Constructs, LLC 2003, 2004. All rights reserved.