Free Cash Flow

There are many metrics investors use to evaluate stocks. These include price-to-earnings ratio, price-to-book ratio, dividend yield, and return on equity. However, the metric which seems to most correlate with a stock's future performance and the one our investment committee relies on the most is free cash flow.

This is a vital metric for investors seeking to gauge a company's financial health and potential for growth. Unlike other financial indicators, free cash flow provides a clearer picture of a company's ability to generate cash after accounting for operating expenses and capital expenditures.

While earnings can be manipulated through accounting practices, free cash flow represents the actual cash generated by a company. It reflects how much cash the business has available to reinvest in growth opportunities, return to shareholders through dividends, pay off debt, or weather economic downturns. Companies with consistently positive free cash flow are better positioned to sustain growth over the long term. Positive free cash flow indicates a company can fund its operations and investments without relying heavily on external financing, reducing the risk of financial distress.

Free cash flow is ultimately what drives shareholder value. Companies that generate excess cash can reinvest in their business to drive growth, initiate share buybacks to enhance shareholder returns, or distribute dividends to reward investors. By focusing on free cash flow, investors can identify companies that efficiently allocate capital to maximize shareholder value.

Free cash flow can be used to evaluate a company's valuation relative to its peers or the broader market. By comparing a company's free cash flow yield (free cash flow divided by market capitalization) to its competitors, investors can identify undervalued or overvalued stocks. The Russel 1000 is an index of the country's largest 1000 public companies. Since 1992 if you only invested in the 100 companies with the prior year's highest free cash flow yield you would have averaged a 17.28% return. Conversely if you only invested in the 100 companies with the prior year's lowest free cash flow yield you would have only averaged 3.3%.

Source: Pacer Financial Inc.

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