Cashflow – the key takeaways

We believe cashflow is the most important driver of shareholder returns. Quite simply, we want to buy companies that are generating strong and sustainable cashflows and are attractively valued on those cashflows.

In this video we discuss what this means for our process and what may lie ahead. Here are some of the key takeaways.

- We believe cashflow is the most important driver of shareholder returns
- In 2022, we tilted portfolios towards defensive value as the market backdrop became more cautious.
- We are positive on value.
- We remain somewhat negative on growth.

When we look at how markets are likely to perform, we look at three key variables: trend, valuation, and corporate aggression. Is there a trend that's developing in the market, either a downtrend or an uptrend? Valuation – what are the markets saying? Corporate aggression – which is a good leading indicator of market weakness.

Trends

- Right now Europe is in a tentative upward trend. North America is mixed but a much better picture than it was seven or eight months ago.
- Commodities are in a downward trend having come under a lot of pressure recently with negative headwinds.
- Economic indicators are trending downwards over general fears about the possibility of recession.

Valuation of markets

- Recovery in markets seen over the last six months or so suggests economic headwinds may be less severe than people think.
- Markets are looking cheaper than they were 18 months ago. Europe is more or less fair value. North America is less expensive than it was.
- Generally, we are trending upwards and valuation is less of a headwind than it was a year ago.

Corporate aggression

This looks at the tendency of companies to make significant investments and behave in a way that could lead to profit warnings. Aggregating the data across the whole market provides a good indicator of potential market weakness.

- North America – there was a period of significant corporate aggression towards the end of 2021, that preceded market weakness in 2022. However, this behaviour has significantly declined, which is positive for markets.

- Europe – A similar pattern was observed in Europe. However, while in North America there has been a precipitous collapse in that sort of behaviour, in Europe it is still quite elevated, which makes us cautious.

Value, momentum and growth

Value

- We had a fantastic signal for this in 2020 after the Covid selloff, and that encouraged us to shift our portfolios from growth to value in the immediate aftermath.

- Value has had a renaissance in the last year and a half, but coming off the back of a dreadful 10 year period, there's still quite a long way to make up that underperformance.

- Value is still very cheap at the moment. Therefore, we are positive about value stocks at the moment and think that there's potential for value as a style to do well.

Momentum

- Our 'momentum efficiency' measure aggregates several different indicators that tell us whether the environment's good or risky for momentum. A good score is plus four, a bad score is minus four. Currently it's between one and two. Generally, when the score is above one, momentum tends to perform very well.

- As a measure, it's therefore an ideal environment for momentum, in terms of investing in rising stocks before they peak. We think that it could perform very well over the next six months and it's therefore currently prominent in our portfolios.

Growth

- We are still quite negative on growth stocks as they continue to be relatively expensive. There was a huge surge in valuation of high-growth stocks post Covid, but since then they've come under notable pressure.

- Yet having largely excluded growth from the portfolio 12 months ago, we're now starting to look at attractive growth stocks that have good momentum, with some entering the portfolio this year.

- In North America there are quite a lot of growth stocks that are looking very attractive relative to their own history.

A good example…

A recent example of a stock we purchased for our European Dynamic Fund is the French luxury good retailer Hermes. This company generates a very high cash return on capital and has an excellent momentum score. This reflects its strong business momentum and share price momentum. The company is generating double digit organic growth and seeing improvements in its operating margins. It has a very strong balance sheet with a substantial net cash position. And finally, with all this cash, it grows its annual dividend by more than 20%.

Conclusion

All the historic evidence shows that stocks with the strongest cashflow characteristics outperform over the long term. Our investment process is flexible. We can use our market regime indicators and our secondary scores to tilt the Fund towards certain styles depending on the prevailing market conditions. We'll continue to apply the investment process with the usual discipline and rigour. This investment process has been in place for many years and our European Dynamic Fund has delivered excellent returns for investors over this period.

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