MOMENTUM OF FREE CASH FLOW (MoFCF™)

A Strategy for Equity Investing

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Let's say you don't want to hire us for investing. That's fine. Here's the strategy I built anyway.

I developed MoFCF years ago as a disciplined, equity-focused approach built around a simple premise: the most reliable signal of a company's financial health is not what it reports in earnings, but how much real cash it generates — and whether that cash generation is accelerating. Earnings can be managed. Cash flow is harder to fake.

This is not a recommendation. It's an explanation of how systematic equity investing can work when it's grounded in fundamentals rather than price momentum, sentiment, or what Jim Cramer said last Tuesday.

> *"The stock market is a device to transfer money from the impatient to the patient."*
> — Warren Buffett

The Core Concepts

Free Cash Flow

Free Cash Flow is the cash a company has left after paying for operations and capital investment — the money actually generated by running the business, not the number an accountant constructs.

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FCF = Operating Cash Flow − Capital Expenditures
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If a company generates $100 million from operations and spends $30 million on new equipment and facilities, FCF is $70 million. That $70 million is real. It can pay down debt, buy back shares, fund a dividend, or sit on the balance sheet. Richard Sloan's 1996 research in The Accounting Review demonstrated that cash flow metrics predict future stock returns better than earnings precisely because earnings are distorted by accruals. Cash is not.

Enterprise Value vs. Market Capitalization

Market Capitalization — share price times shares outstanding — measures what the stock market thinks the equity is worth. It ignores debt. It ignores cash. For a highly leveraged company, it can be deeply misleading.

Enterprise Value is the full cost of buying a company outright: market cap plus total debt plus preferred stock plus minority interests, minus cash on hand. It's the number that matters when you're evaluating whether a business is cheap or expensive relative to what it actually produces.

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EV = Market Cap + Total Debt + Preferred Stock + Minority Interest −
Cash
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MoFCF uses FCF/EV rather than FCF/Market Cap. The EV denominator accounts for the full capital structure. A company with strong free cash flow but a mountain of debt is not as attractive as the Market Cap ratio makes it appear. EV tells the truth.

Momentum — of Fundamentals, Not Price

In MoFCF, momentum has nothing to do with stock price movement. It measures the rate of improvement in the FCF/EV ratio over the prior 12 months — whether the company's cash generation, relative to its total value, is getting stronger.

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Momentum = (Current FCF/EV − Prior FCF/EV) ÷ Prior FCF/EV
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Asness, Moskowitz, and Pedersen's 2013 Journal of Finance study showed that combining value metrics like FCF/EV with momentum in improving fundamentals captures companies on an upward trajectory and enhances returns while reducing risk. Hurst, Ooi, and Pedersen's century-long study on trend-following confirmed that momentum in fundamentals works across full market cycles. MoFCF applies that principle to free cash flow specifically.

> *"Systematic investing will pay off ultimately, provided that it is adhered to conscientiously and courageously under all market conditions."*
> — Ben Graham

The Full MoFCF Formula

Applied to the Russell 1000, the strategy works as follows:

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1. FCF = Operating Cash Flow − Capital Expenditures
2. EV  = Market Cap + Total Debt + Preferred Stock
       + Minority Interest − Cash
3. FCF/EV = FCF ÷ EV
4. Momentum = (Current FCF/EV − Prior FCF/EV) ÷ Prior FCF/EV
5. Select: Top 25% by Momentum, Sector caps ≤ 30%
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Rank every company in the Russell 1000 by their FCF/EV momentum. Select the top 25% — roughly 250 companies. Cap any single sector at 30% of the portfolio to prevent concentration risk from a single industry dominating the outcome.

Walmart in 2020: The Formula in Practice

In 2020, Walmart's FCF was $25.6 billion. Market Cap approximately $350 billion, debt approximately $45 billion, cash approximately $10 billion — giving an EV of roughly $400 billion.

Metric	2019	2020	Change
FCF	$21.2B	$25.6B	+$4.4B
EV	~$400B	~$400B	Stable
FCF/EV	5.3%	6.4%	+1.1 pts
MoFCF Momentum	—	20.75%	Top quartile

A momentum of 20.75% — FCF/EV improving from 5.3% to 6.4% — would have placed Walmart in the top quartile of the Russell 1000 during the COVID-19 downturn. The company was investing in e-commerce, generating real cash, and its fundamental trajectory was strengthening while the broader market panicked. MoFCF would have flagged it. A purely price-momentum strategy, reacting to the March 2020 selloff, would have missed it or sold it.

> *"Far more money has been lost by investors trying to anticipate corrections than lost in the corrections themselves."*
> — Peter Lynch

The Layer MoFCF Alone Cannot See

Free cash flow is harder to manipulate than earnings. That's true and it's one of MoFCF's core strengths. But "harder" is not "impossible."

Enron reported strong operating cash flows for years by structuring financing arrangements that moved debt off-balance-sheet and disguised borrowing as operating activity. The FCF numbers looked reasonable. The company was rotten. A pure FCF-based strategy, without a fraud filter, would not have caught it — at least not until it was too late.

This is why I layer the Beneish M-Score onto MoFCF as a screening step before any position is entered.

What the M-Score Does

Messod Daniel Beneish's 1999 model uses eight financial ratios — each comparing the current year to the prior year — to detect the specific patterns that appear in financial statements before

earnings manipulation becomes public. It correctly identifies manipulators in 76% of cases. Cornell students used an early version to flag Enron in 1998, when the stock was at $48. The model was right.

The formula produces a single score. Above -1.78 signals likely manipulation. Below -1.78 is low risk. The single heaviest-weighted variable — Total Accruals to Total Assets, carrying a coefficient of 4.679 — captures exactly the gap between reported earnings and real cash generation. A company booking income it hasn't collected, capitalizing expenses it should be recognizing, or deferring costs to inflate current-period results will show up here.

How the Two Models Work Together

MoFCF finds the companies worth buying: strong and improving free cash flow relative to total enterprise value. The M-Score filters out the ones that may be manufacturing those numbers.

A company with strong MoFCF momentum and a clean M-Score — below -1.78 — is a company generating real cash, with no statistical evidence of manipulation, on an improving fundamental trajectory. That's the target.

A company with strong MoFCF momentum and an elevated M-Score is a warning. The FCF looks good on paper. The forensic accounting model says look closer. In practice, that's a position we don't take.

The MoFCF + M-Score selection process
Step 1 — MoFCF screen: Rank Russell 1000 by FCF/EV momentum. Select top 25%.
Step 2 — M-Score filter: Run Beneish M-Score on every candidate. Exclude any company scoring above -1.78.
Step 3 — Sector caps: No single sector exceeds 30% of the final portfolio.
Step 4 — Hold: Rebalance annually. Do not react to price movement.
Result: Companies with accelerating real cash generation and no statistical evidence of financial manipulation.

James O'Shaughnessy's research in What Works on Wall Street demonstrates that high FCF yield strategies deliver strong long-term returns precisely because cash is harder to manipulate than earnings. The M-Score makes that premise more rigorous. It doesn't assume the cash flow numbers are clean — it verifies them forensically before a position is entered.

> *"A market downturn doesn't bother us. It is an opportunity to increase our ownership of great companies with great management at good prices."*
>
> — Warren Buffett

Why This Is Hard to Do Yourself

The strategy is conceptually straightforward. The execution is not. Parsing financials for thousands of companies, calculating FCF/EV and its momentum, running M-Score ratios across the full Russell 1000, adjusting for outliers, managing sector caps, and rebalancing annually without reacting to noise — that is a significant operational undertaking.

The discipline problem is just as real as the data problem. Momentum strategies require holding companies that are improving fundamentally even when the stock price is dropping. Most investors cannot do that without a framework enforcing the discipline. The strategy works because of systematic adherence, not because of any single brilliant call.

Reddit and financial television are not a substitute. They are the opposite of what this strategy requires. Crowd-driven tips are price momentum without fundamentals. MoFCF is fundamentals without price momentum. Those are different bets, and they perform differently over time.

> *"Individuals who cannot master their emotions are ill-suited to profit from the investment process."*
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> — Ben Graham

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