

A Strategy for Investing: Momentum of Free Cash Flow (MoFCF™)

Let's assume you don't want to hire us for investing—that's perfectly fine. Instead, let's explore a strategy for investing I created years ago, called Momentum of Free Cash Flow (MoFCF™). This is not a recommendation but an example to illustrate a disciplined, equity-focused approach. We'll start with simple definitions, including the difference between Enterprise Value (EV) and Market Capitalization, then present the math for Free Cash Flow (FCF) and its momentum, and explain why it works based on what experts—not me—have found through research.

“The stock market is a device to transfer money from the ‘impatient’ to the ‘patient’.” — Warren Buffett, Chairman, Berkshire Hathaway

Definitions in Layman's Terms

Let's break down MoFCF's key terms clearly and simply, starting with the basics.

- **Free Cash Flow (FCF):** This is the cash a company has left after paying for daily operations and investments to keep growing, like new equipment or stores. Picture it as the money in your wallet after paying bills and fixing up your house—cash to pay off a loan, save, or spend. FCF is real money, not accounting profits, making it a trustworthy measure of a company's health.
- **Enterprise Value (EV):** This is the total cost of buying a company outright, including its stock price (market capitalization), plus all debts, preferred stock, and minority interests, minus cash on hand. Think of it like buying a house: you pay the market price plus any mortgage, minus cash in the safe. EV reflects the full value of a business to all stakeholders—shareholders, creditors, and others, making it ideal for value-focused strategies like MoFCF.
- **Market Capitalization:** This is just the value of a company's stock, calculated as share price times shares outstanding. It's like the market price of that house, ignoring the mortgage. Market Cap is more growth-oriented because it reflects investor expectations of future growth, often inflating valuations for high-growth companies like tech startups (e.g., Tesla in 2020 with a high price-to-earnings ratio). Unlike EV, it doesn't account for debt or cash, so it's less comprehensive for assessing overall value.
- **FCF/EV Ratio:** This is FCF divided by EV. It shows how much cash a company generates per dollar of its total value. A high ratio means the company is a cash machine relative to its full price, like a fuel-efficient car at a great deal. It's ideal for spotting undervalued companies across industries.
- **FCF/Market Cap Ratio:** This is FCF divided by Market Cap. It measures cash yield relative to stock value, emphasizing growth potential since Market Cap reflects investor optimism. While FCF/EV is value-oriented, FCF/Market Cap leans toward growth-oriented strategies, as it may favor companies with high stock valuations but overlooks debt burdens.
- **Momentum:** In MoFCF, this is the improvement in the FCF/EV ratio over time, not stock price swings. It's like a runner getting faster with training—a rising FCF/EV ratio signals a company getting stronger and more efficient.

“Systematic investing will pay off ultimately, provided that it is adhered to conscientiously and courageously under all market conditions.” — Ben Graham, Father of Value Investing

Mathematical Formulation of FCF

The FCF component of MoFCF is calculated as follows, keeping it simple:

1. **Free Cash Flow (FCF):**

$FCF = \text{Operating Cash Flow} - \text{Capital Expenditures}$

This is the cash left after running the business and investing in its future. For example, if a company generates \$100 million from operations but spends \$30 million on new factories, $FCF = \$100M - \$30M = \$70 \text{ million}$.

2. **Enterprise Value (EV):**

$EV = \text{Market Capitalization} + \text{Total Debt} + \text{Preferred Stock} + \text{Minority Interest} - \text{Cash and Cash Equivalents}$

This is the company's total value. If a company's stock is worth \$500 million (Market Cap), has \$200 million in debt, \$50 million in preferred stock, \$20 million in minority interests, and \$100 million in cash, then $EV = \$500M + \$200M + \$50M + \$20M - \$100M = \670 million .

3. **FCF/EV Ratio:**

$FCF/EV = FCF \div EV$

This shows cash yield per dollar of total value. Using the example, if FCF is \$70 million and EV is \$670 million, then $FCF/EV = \$70M \div \$670M \approx 10.45\%$. A higher ratio indicates better value.

4. **FCF/Market Cap Ratio:**

$FCF/\text{Market Cap} = FCF \div \text{Market Capitalization}$

This measures cash yield relative to stock value. Using the same example, if FCF is \$70 million and Market Cap is \$500 million, then $FCF/\text{Market Cap} = \$70M \div \$500M = 14\%$. This ratio highlights growth-oriented companies but misses debt, making it less robust than FCF/EV for MoFCF's value focus.

“Far more money has been lost by investors trying to anticipate corrections, than lost in the corrections themselves.” — Peter Lynch, Legendary Investor

Why FCF Works, According to Experts

Experts emphasize FCF's reliability for equity investing, focusing on its use in ratios like FCF/EV or FCF/Market Cap, not specifically momentum. Here's what they say:

- **James P. O'Shaughnessy** (*What Works on Wall Street*, 2016): His data shows companies with high free cash flow yields (e.g., FCF/EV or FCF/Market Cap) are attractive because cash is harder to manipulate than earnings. He notes FCF/Market Cap is often used in growth strategies, as it captures investor optimism in stock prices, while FCF/EV is preferred for value strategies like MoFCF, as it accounts for debt and cash.
- **Richard G. Sloan** (1996, *The Accounting Review*): Sloan found that cash flow metrics, like FCF, predict future stock returns better than earnings, which can be distorted by

accruals. FCF reflects actual cash, reducing risk in both value (EV-based) and growth (Market Cap-based) approaches.

- **Tim Loughran and Jay W. Wellman** (2011, *Financial Analysts Journal*): Their research shows firms with high FCF/EV ratios deliver strong long-term returns, as cash signals financial health. They note FCF/Market Cap can highlight growth firms but may overlook debt burdens, favoring speculative sectors like tech.

For example, during the 2008 financial crisis, Johnson & Johnson's robust FCF supported its stability, making it a standout for FCF-based strategies, whether using EV or Market Cap.

Mathematical Formulation of Momentum

The momentum component measures the improvement in the FCF/EV ratio, inspired by Charlie Munger's 200-week moving average for price trends, adapted to a 12-month period for fundamentals to balance responsiveness and stability.

1. Momentum of FCF/EV:

$$\text{Momentum} = (\text{Current FCF/EV} - \text{Previous FCF/EV}) \div \text{Previous FCF/EV}$$

This calculates the percentage change in FCF/EV over 12 months, smoothed to avoid noise. For example, if last year's FCF/EV was 8% and this year's is 10.45%, then $\text{Momentum} = (10.45\% - 8\%) \div 8\% = 30.63\%$. A positive number shows improving strength.

"History has shown that equities are the best way to build long-term wealth." — Shelby M.C. Davis, Legendary Investor

Why Momentum Works, According to Experts

While experts focus on FCF, momentum in fundamentals is supported by research, though not explicitly as "MoFCF." Here's what they say:

- **Clifford S. Asness, Tobias J. Moskowitz, and Lasse Heje Pedersen** (2013, *Journal of Finance*): Their study, "Value and Momentum Everywhere," shows combining value metrics (like FCF/EV) with momentum (improving ratios) captures companies on an upward trajectory, enhancing returns and reducing risk.
- **Brian Hurst, Yao Hua Ooi, and Lasse Heje Pedersen** (2017, *Journal of Portfolio Management*): Their century-long study on trend-following found momentum in fundamentals, like FCF/EV, works across market cycles by identifying firms with strengthening performance.

Combining FCF and Momentum: The MoFCF Strategy

MoFCF combines FCF and momentum into a disciplined equity strategy. Here's how it works, with the full formula:

Start with the FCF building block:

$FCF = \text{Operating Cash Flow} - \text{Capital Expenditures}$

Then calculate:

$EV = \text{Market Capitalization} + \text{Total Debt} + \text{Preferred Stock} + \text{Minority Interest} - \text{Cash and Cash Equivalents}$

Derive:

$FCF/EV = FCF \div EV$

(Note: Using $FCF/\text{Market Cap} = FCF \div \text{Market Capitalization}$ would make the strategy more growth-oriented, favoring high-valuation firms like tech startups, but misses debt, which MoFCF avoids for value focus.)

Add momentum:

$\text{Momentum} = (\text{Current } FCF/EV - \text{Previous } FCF/EV) \div \text{Previous } FCF/EV$

Apply to large-cap stocks (e.g., Russell 1000), rank by momentum, select the top 25% (~250 companies), and cap sectors at 30% to manage risk.

Complete MoFCF Formula:

MoFCF Selection = Top 25% by Momentum of FCF/EV, with Sector Caps $\leq 30\%$

Where:

- $FCF = \text{Operating Cash Flow} - \text{Capital Expenditures}$
- $EV = \text{Market Capitalization} + \text{Total Debt} + \text{Preferred Stock} + \text{Minority Interest} - \text{Cash and Cash Equivalents}$
- $FCF/EV = FCF \div EV$
- $\text{Momentum} = (\text{Current } FCF/EV - \text{Previous } FCF/EV) \div \text{Previous } FCF/EV$

Example: Walmart in 2020

In 2020, Walmart's FCF was \$25.6 billion, with an EV of ~\$400 billion (Market Cap ~\$350 billion, debt ~\$45 billion, cash ~\$10 billion). $FCF/EV = \$25.6B \div \$400B \approx 6.4\%$. $FCF/\text{Market Cap} = \$25.6B \div \$350B \approx 7.3\%$. From 2019 to 2020, FCF/EV rose from 5.3% to 6.4%, giving a momentum of $(6.4\% - 5.3\%) \div 5.3\% \approx 20.75\%$. MoFCF's FCF/EV focus flagged Walmart as a top pick for its value and stability during the COVID-19 slump, as it invested in e-commerce. Using FCF/Market Cap would have leaned toward growth signals but ignored debt, less suitable for MoFCF's value approach. Calculating this across thousands of companies—parsing financials, adjusting for anomalies, and staying disciplined—requires expertise, often leading investors to think, "I can't do this myself."

"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, Chairman, Berkshire Hathaway

A Word of Caution

If you're getting stock tips from CNBC's Jim Cramer or similar entertainers, my advice is to be careful. They're in the business of grabbing attention, not doing the deep analysis MoFCF requires. Likewise, if your investment ideas come from online forums like Reddit or social media, be cautious—crowd-driven tips often lack rigor and can lead to impulsive decisions. In

other words, do your own homework. Strategies like MoFCF demand time, data, and discipline, which is why professional management is often the smarter choice.

“Individuals who cannot master their emotions are ill-suited to profit from the investment process.” — Ben Graham, Father of Value Investing

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