The Kings of Cash Flow

Investing in Tomorrow's Potential Winners Today

June 2011

Through proprietary, intensive, fundamental, bottom up research, Alger has determined that companies generating high levels of free cash flow represent attractive investment opportunities over time. Free cash flow is surplus cash generated from a company's operations after spending on operational expenses and capital expenditures. Free cash flow increases a company's ability to invest for future growth and is essential for paying dividends and conducting share repurchases. It also gives high-quality companies increased flexibility to pursue these corporate initiatives without becoming overly dependent on access to the capital markets.

At Alger, we believe free cash flow levels provide a more accurate representation of a company's operating fundamentals and future prospects than earnings per share which can be manipulated by accounting treatments. As such, free cash flow is one of the most important metrics we analyze, research, and utilize when evaluating companies.

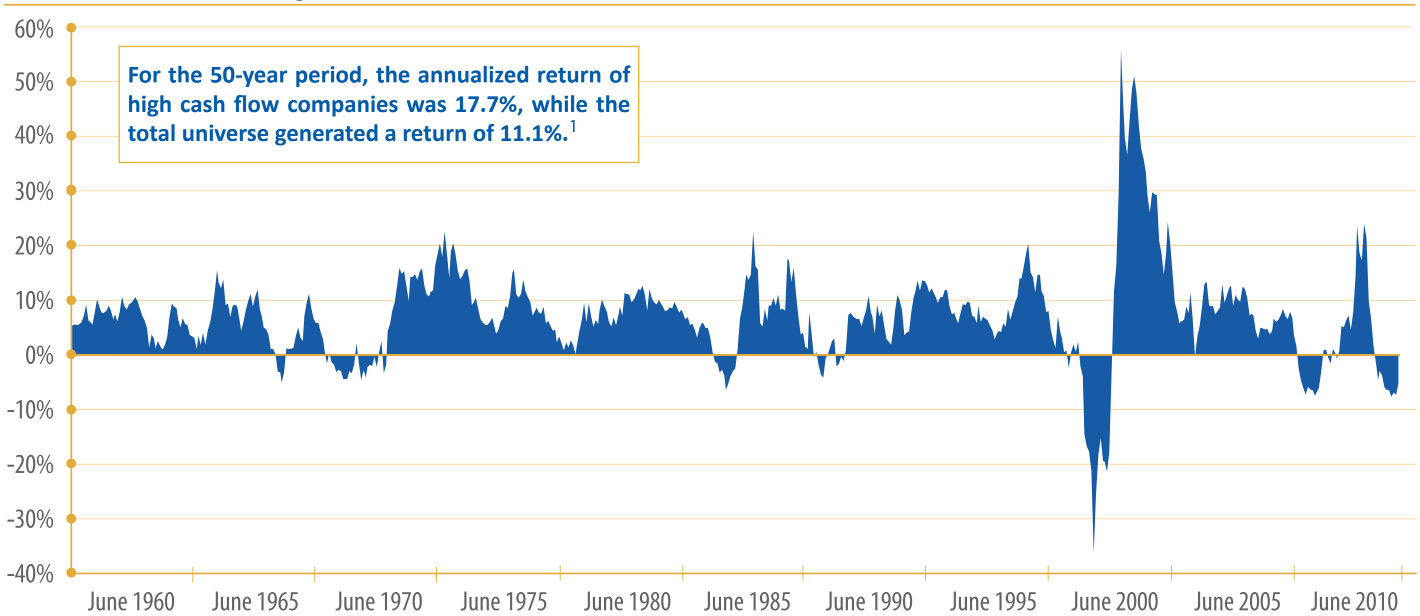
High free cash flow generation has always been a hallmark of successful companies. A common method of analyzing free cash flows is by looking at free cash flow yields. Free cash flow yields are calculated as the ratio of free cash flow per share to price per share. For this paper, we will focus on high free cash flow yields.

Companies with the highest free cash flow yields—we call them "Kings"—have historically outperformed other companies with lower free cash flow yields. This paper describes how the Kings are experiencing what may be one of their longest and most drastic periods of underperformance of the last 50 years. This recent underperformance, of course, raises the following question: would investors be well served to consider allocating funds to high free cash flow yielding equities today? We believe so.

To that end, this paper also explains why the long-term historical performance of the Kings may indicate that the companies' recent underperformance, relative to other stocks, is uncommon and is unlikely to continue.

Excess Returns of Kings Relative to Broad Market*

Figure 1



Source: Empirical Research Partners

* The broad market, as measured by Empirical Research Partners, consists of the largest 750 stocks by market cap plus the constituents of the S&P 500 not already included in the largest 750. Returns are based on 12-month forward basis. The most recent period depicted by this chart, therefore, started June of 2010

Inspired by Change, Driven by Growth.

Long Live the Kings

We believe that a company's ability to generate more cash than is required to fund current operations is a hallmark of a superior investment opportunity. Furthermore, it is difficult to characterize a company generating significant excess cash as anything less than successful.

The Kings have a long history of outperforming the market, as illustrated in Figure 1. The graph depicts the performance of the highest quintile of free cash flow yielding stocks relative to the broad market over the past 50 years on a rolling 12-month forward basis[2]. Performance was calculated for each 12-month time period from the beginning of each month during the 50-year time frame. For this paper, we define the broad market as the largest 750 stocks by market cap plus the constituents of the S&P 500 Index not already included in the largest 750.

While it may not be surprising that the Kings have historically outperformed the market, it may come as a surprise that they have done so in 85% of the 12-month periods during the 50-year time frame. Their average 12-month excess return has been 6.9%. In comparison, outperforming the market 55% of the time is generally considered superior, so investing in the Kings has clearly been a successful strategy.

During the past 50 years, the Kings have had only seven periods of underperformance that lasted on average 13.4 months, which we believe illustrates the long-term attractiveness of high free cash flow yielding companies. The most recent forward 12-month data, which covers the period that ended May of this year, illustrates the recent sharp reversal from positive to negative excess returns for the Kings (see Figure 1). The forward 12-month excess return of the Kings has collapsed from its peak of +23.9% for the twelve-month period ended February 2010 to its most recent level of -5.3%. The -5.3% return was more than 12% below the historical excess return average of 6.9%.

To better understand the more recent relative performance of the Kings we should also look at the past eleven months. (Figure 1 shows performance based on 12-month forward basis returns, so it does not include the performance of the past 11 months). The average monthly excess return of high cash flow companies during the past eleven months was -0.11%, which falls well below the historical average monthly excess return of 0.51%. The continuation and the depth of the underperformance of the Kings imply that we are experiencing what may prove to be one of their starkest periods of underperformance in terms of both duration and severity. The historical infrequency of cash flow Kings trailing the broad market and the nature of the Kings' recent underperformance suggests that the companies may be overdue to once again outperform the broad market.

Why the Kings Are Underperforming

As of early June 2011, cash on corporate balance sheets had climbed to $1.91 trillion, which is a 36% increase from the first quarter of 2009, according to the Federal Reserve. During the 2008 financial crisis, companies were rewarded for holding significant cash reserves; however, since the U.S. has emerged from the depths of the financial turmoil, this no longer seems to be the case. We believe the following factors may be contributing to this abnormal situation:

1) Investors believe that current free cash flow yields are unsustainably high because corporate earnings will decline due to a worsening economy.

2) Investors are frustrated by the growing stockpile of cash on corporate balance sheets and believe it is an indication that management teams are growing more skeptical about the trajectory of the economic recovery. In other words, company managers may believe a lack of attractive investment opportunities for their cash exists. In a similar manner, investors may suspect that company executives are hoarding cash because of fears that a weak economy may make financing through capital markets or banks difficult and create a need for enterprises to self finance operations.

3) Investors are uncertain about the severity and timing of potential changes in tax policies, including dividend taxation.

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What the Future Holds

At Alger, free cash flow generation is a telling indicator of high-quality companies. Currently, we maintain a positive view regarding future corporate profit growth and we believe that current levels of free cash flow yields are sustainable. We foresee these high-quality growth franchises continuing to expand in 2011 and rewarding their shareholders in numerous ways.

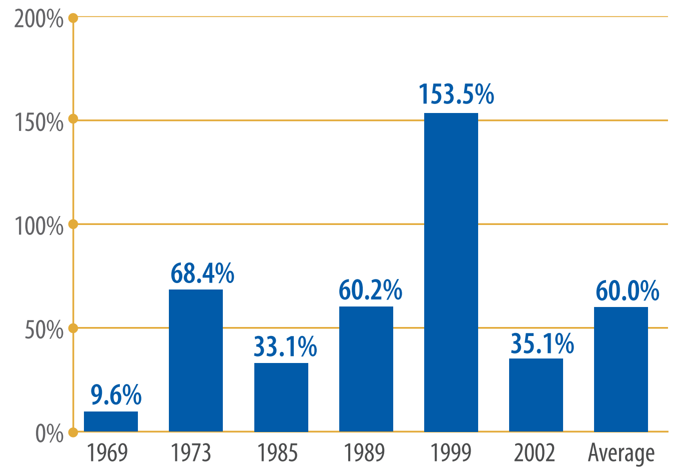
We are already seeing signs that these sophisticated capital allocators are beginning to loosen their purse strings and put their cash to work through capital investments to fund organic growth, increased dividends, share repurchases, and acquisitions. These types of activities benefit shareholders and are a clear indication to Alger that corporate America sees growth opportunities ahead.

In addition to enriching shareholders directly through cash payments that augment organic growth, high free cash flow yielding companies are more likely to be acquisition targets than other companies. It is clear that corporate managers also understand the benefits of owning the Kings, which further confirms the benefits to investors of evaluating stocks through a free cash flow lens. The Kings, furthermore, are led by chief executive officers with successful track records.

The Cream Always Rises to the Top

We are in extraordinary times, with many questions regarding our future, but one thing that we believe is irrefutable: if companies can generate high levels of free cash flow, they will survive, thrive and deliver strong returns to their shareholders. History can help guide our expectations here too. Since 1969, each period of underperformance has been followed by the Kings outperforming the market by approximately 60% on a cumulative basis (see Figure 2).[3]

5-Year Cumulative Excess Returns Following Periods of Kings' Underperformance[4] Figure 2



Source: Empirical Research Partners. Returns are excess of broad market. The broad market, as measured by Empirical Research Partners, consists of the largest 750 stocks by market cap plus the constituents of the S&P 500 Index not already included in the largest 750. Average is calculated by equally weighting each 5-year period.

When investors return to equities, we believe they will seek out these high-quality companies that are poised for growth. Companies that are positioned for success and are able to exploit high free cash flows will be very attractive targets for individual, institutional, and corporate investors alike.

[1] Calculated by geometrically linking returns over the 50-year period.

[2] 12-month forward basis performance implies performance that occurred during the 12 month period following a specified date. For example, the 12-month forward basis performance for September 1960 includes the period of time from the beginning of September 1960 until the end of August 1961.

[3] Calculated by geometrically linking returns during periods when high cash flow companies outperformed the broad market.

[4] The performance of the broad market and of high cash flow companies for the five year periods reflected in Figure 2 are: 1969: -14.6%, -5.0%; 1973: 11.1%, 79.5%; 1985: 64.7%, 97.8%; 1989: 58.8%, 119.0%; 1999: 32.1%, 185.6%; 2002: 124.1%, 159.2%. The average return of the overall market for those periods was 46.0% and for high cash flow companies 106.0%.

Additional Performance Data

Cumulative Returns Following Periods of Kings' Underperformance

	1 Year Data			3 Year Data			5 Year Data		
	Kings	Broad Market	Excess	Kings	Broad Market	Excess	Kings	Broad Market	Excess
1969	-23.6%	-24.7%	1.1%	15.3%	11.6%	3.7%	-5.0%	-14.6%	9.6%
1973	-11.0%	-15.3%	4.3%	40.4%	1.1%	39.3%	79.5%	11.1%	68.4%
1985	18.7%	17.8%	0.9%	76.8%	46.3%	30.5%	97.8%	64.7%	33.1%
1989	-9.8%	-10.7%	0.9%	61.8%	40.4%	21.4%	119.0%	58.8%	60.2%
1999	8.3%	-3.2%	11.5%	69.6%	-13.3%	83.0%	185.6%	32.1%	153.5%
2002	45.0%	41.8%	3.2%	117.2%	84.2%	33.0%	159.2%	124.1%	35.1%
Average	4.6%	1.0%	3.6%	63.5%	28.4%	35.2%	106.0%	46.0%	60.0%

Trailing Returns of Kings Relative to Broad Market as of May 31, 2011

	Kings	Broad Market	Excess
1 Year	27.5%	32.8%	-5.3%
3 Year	8.1%	5.3%	2.8%
5 Year	7.9%	6.5%	1.4%
10 Year	14.0%	7.4%	6.6%
50 Year	17.7%	11.1%	6.6%