Harness the power of cash flow

ASX: CFLO

Betashares Global Cash Flow Kings ETF

One of the central pillars of modern financial analysis dictates that an asset's value is represented by the present value of all future cash flows. Despite this, many investors still focus primarily on reported earnings or profit as the key consideration for stock selection.

Betashares Global Cash Flow Kings ETF (ASX: CFLO) seeks to track an index comprising a globally diversified portfolio of companies that demonstrate strong free cash flow with relatively low levels of financial leverage.

Reasons to consider CFLO:

- **Outperformance potential:** Companies that generate high levels of free cash flow historically have tended to outperform broad global equity benchmarks over the medium to long term.
- **Resilience in periods of economic stress:** Companies with strong cash flows are generally better placed to service debt and less reliant on capital markets for funding needs.
- **Core global equity allocation:** CFLO provides diversified exposure to 200 global companies with similar sector and country weights to broad global equity benchmarks.

Why should investors focus on cash flows?

A company's profit, or its reported earnings, is a by-product of several assumptions and choices made by management. Earnings management is the term used to describe the ability of companies to interpret accounting principles, or use accounting policies in a way that allows them to present their financial statements in a more favourable light. This raises the question of how investors can make informed decisions and comparisons when companies employ different policies, estimates and judgement in producing financial accounts.

History has provided us with a number of examples where aggressive displays of earnings management have led to misleading or fabricated financial results – for example Enron, Worldcom or Freddie Mac.

Cash flow, on the other hand, provides a more reliable and unbiased measure of performance and financial health. Other advantages of an investment strategy focusing on cash flow include:

- **Solvency** - Companies that generate strong cash flows are better placed to service debt obligations. Solvency considerations are vitally important in today's 'higher for longer' rates environment.
- **Well placed for growth** - Companies that can generate more cash flow than they require to run their business are better equipped to participate in profitable growth opportunities than competitors that don't.
- **Self-sufficiency** - Companies generating high levels of cash flow are less reliant on capital markets to access additional funding, and therefore less likely to engage in shareholder-dilutive events. Empirical evidence suggests that companies that issue more shares via capital raising are less likely to outperform than those that do not.

While various measures of cash flows can be used, one particular metric has been an integral part of financial analysis, corporate valuation, and investment decision-making in the modern financial world – Free Cash Flow.

"Common yardsticks such as dividend yield, the ratio of price to earnings or to book value, and even growth rates have nothing to do with valuation except to the extent they provide clues to the amount and timing of cash flows into and from the business."

Warren Buffett (2000), Annual Letter to shareholders.

What is Free Cash Flow?

Free Cash Flow (FCF) is simply the cash a company generates from its business operations after also considering working capital needs and capital expenditures. It is an important metric for investors, analysts and creditors, since it represents the cash available to:

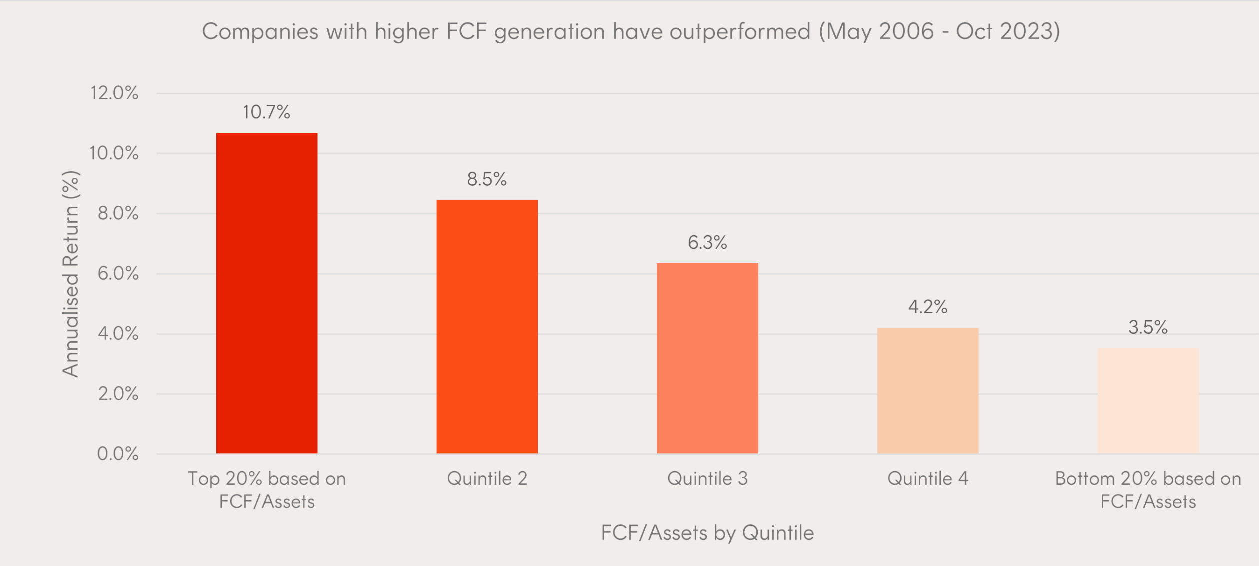
- pay dividends
- buy back shares
- pay off debt, or
- fund further investments.

Positive FCF indicates a company is generating more cash than it needs to run and maintain the business, and so provides greater insight than purely profit or cash from operations.

A focus on FCF is considered appropriate for all companies and industries and is as appliable as ever with the rise of knowledge-based technology companies. In fact, Adame, Koski, and McVay (2019) concluded that not only has market response to free cash flow surprises increased over time, but even more so in newer companies with greater intangibles.

What does the academic research and evidence suggest?

The chart below illustrates the performance of global companies with varying levels of **FCF generation** (defined as FCF/Assets).



Source: Betashares, Solactive and Factset. The five equally weighted portfolios represent the Solactive GBS Developed Markets ex Australia Large & Mid Cap AUD Index constituents broken up into quintiles based on FCF generation, and rebalanced semi-annually. Data covers the period from May 2006 to October 2023. Financial companies are ranked by Net Operating Cash Flow / Assets, instead of FCF / Assets. You cannot invest directly in an Index. Past performance is not an indicator of future performance.

The results demonstrate the opportunity for meaningfully higher performance by focusing on companies generating high levels of FCF, relative to companies generating low levels of FCF. This association between FCF generation and investment performance has historically not only been strong, but also persistent over time.

There have been numerous research and academic papers that assist in explaining this outperformance potential:

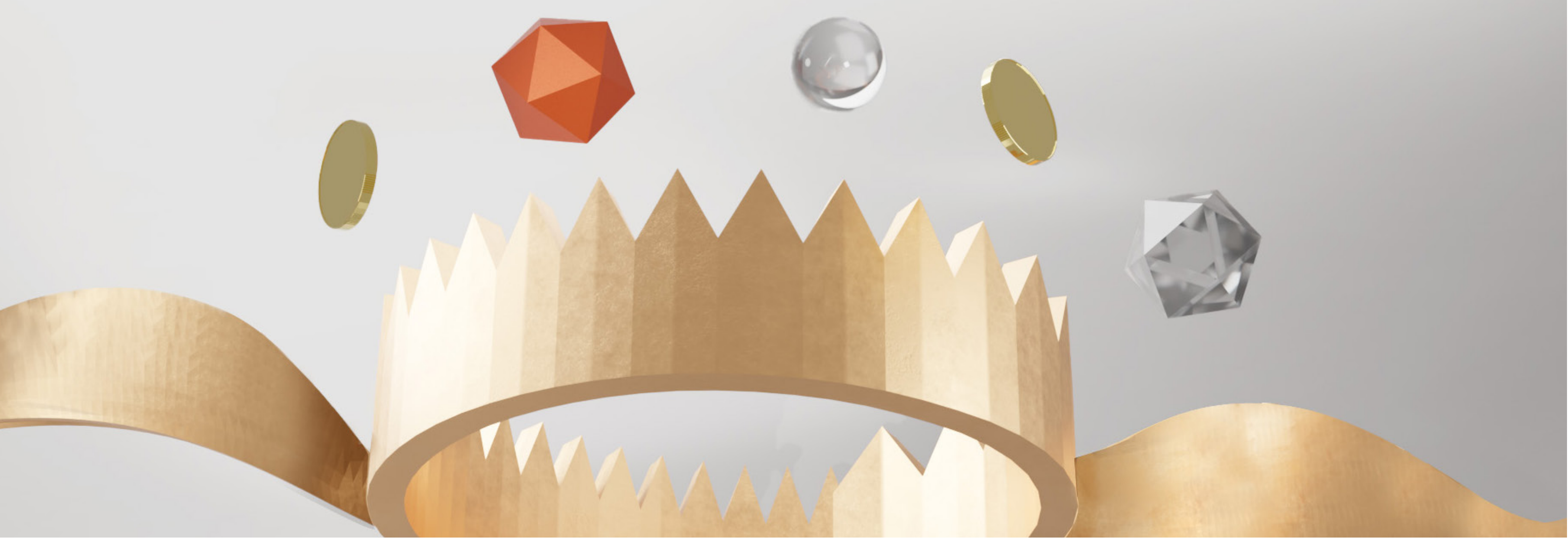
Sloan, R. G. (1996) identifies the market phenomenon known as the 'accrual anomaly', where investors fixate on reported profit rather than cash flows, despite the latter being a superior predictor of future earnings.

Hackel K. S., Livnat J., Rai A. (2000) found that an investment strategy targeting consistent FCF generators with low financial leverage produced outperformance against the market index, even after accounting for other factors.

Houge, T., & Loughran, T. (2000) conclude that investors commit a cognitive error when valuing the information contained in current earnings, and because investors consistently underestimate the transitory nature of accruals and the long-term persistence of cash flows, the market undervalues high cash flow firms.

There are clearly some consistent themes across this research. The key takeaways in respect of developing a cash-flow oriented investment strategy include:

- Investors tend to focus too heavily on reported earnings, without fully comprehending the source of these earnings (whether it be cash or accruals).
- Cash earnings have proven to be a better predictor of future earnings than earnings derived from accruals.
- Investment strategies that target high cash flow companies have the potential to generate excess returns in the long run.



Introducing Betashares Global Cash Flow Kings ETF (ASX: CFLO)

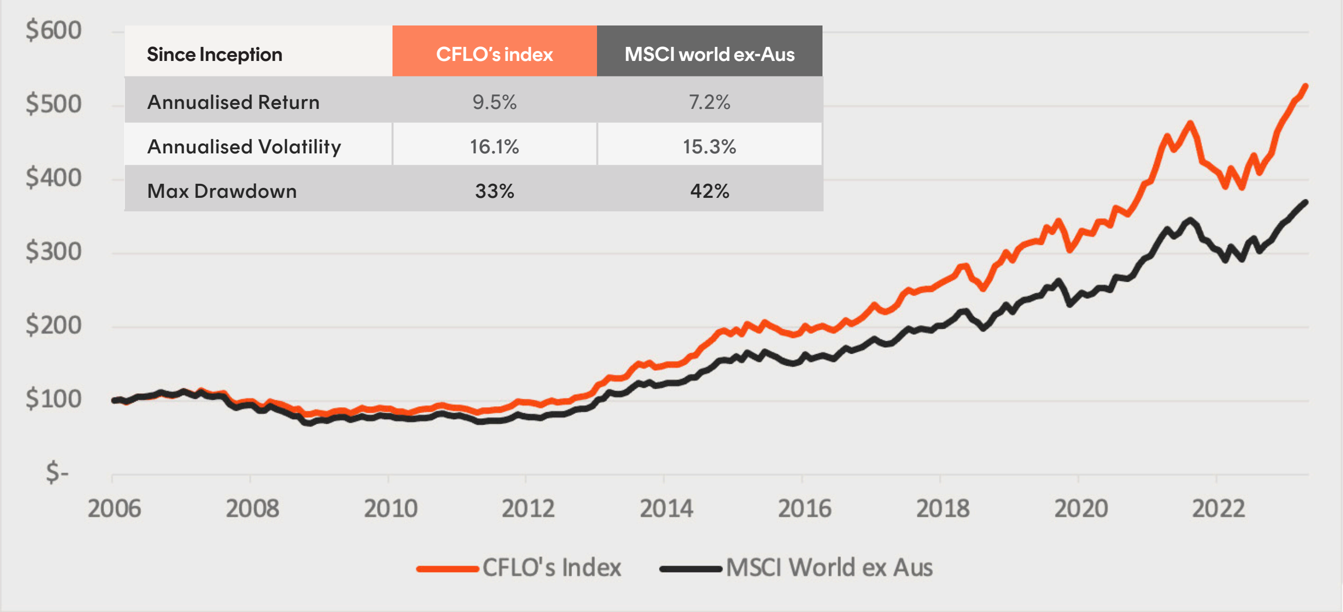
CFLO aims to track an index, before fees and expenses, that has been designed to target companies that demonstrate strong and consistent FCF generation, with emphasis placed on companies that are growing FCF in an efficient manner, that is, without taking on excessive debt.

CFLO's index (the Solactive Global ex-Australia Cash Flow Kings Index) selects the top 200 global companies as determined by their FCF composite score. On rebalance, the index will have the same sector weights as the developed market universe (sector neutral) and country weights will also be within +/- 10% of the universe[1].

CFLO provides:

1. Alpha potential: The charts below demonstrate the outperformance of CFLO's index since inception for the period ending 31 October 2023, 9.5% p.a. compared to 7.2% p.a. for the MSCI World Index NR (AUD).

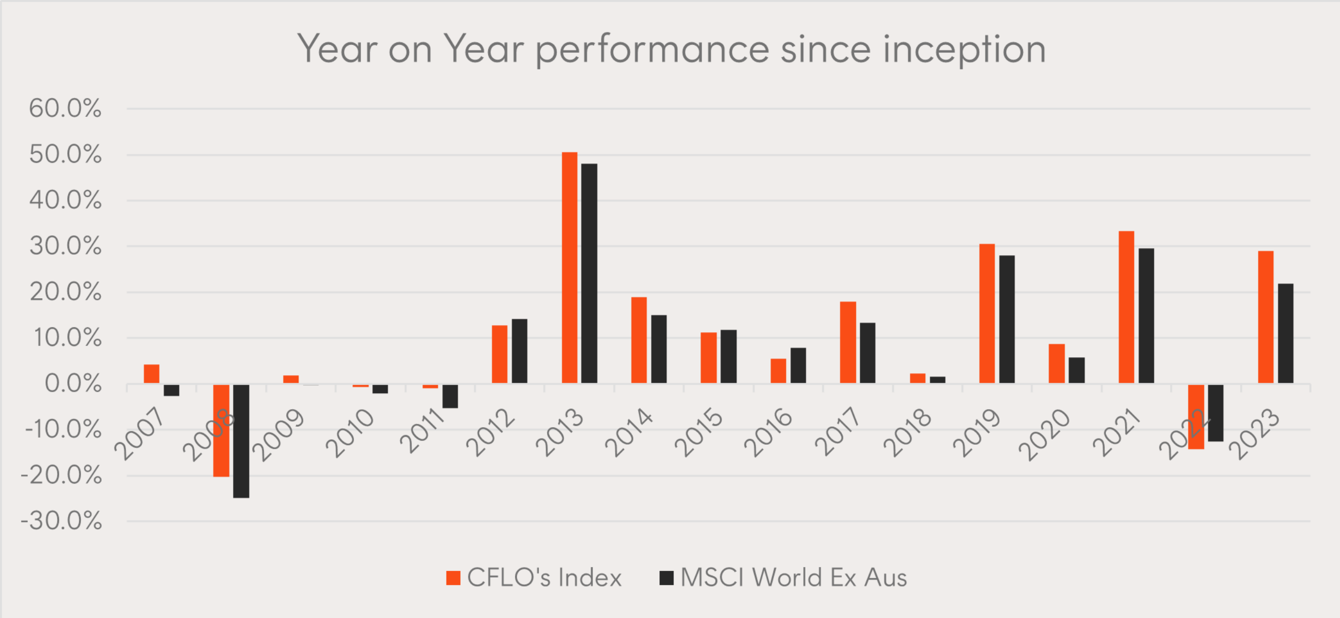
Since Inception	CFLO's index	MSCI world ex-Aus
Annualised Return	9.5%	7.2%
Annualised Volatility	16.1%	15.3%
Max Drawdown	33%	42%



Source: Bloomberg. Data as of 31 October 2023. Return, volatility and max drawdown figures for the period since common inception on 8 May 2006 until 31 October 2023. Chart shows Index performance (not actual fund performance) to illustrate the longer-term historical performance of global companies that demonstrate strong free cash flow. Doesn't take into account ETF fees and expenses of 0.40% p.a. You cannot invest directly in an Index. Past performance is not an indicator of future performance.

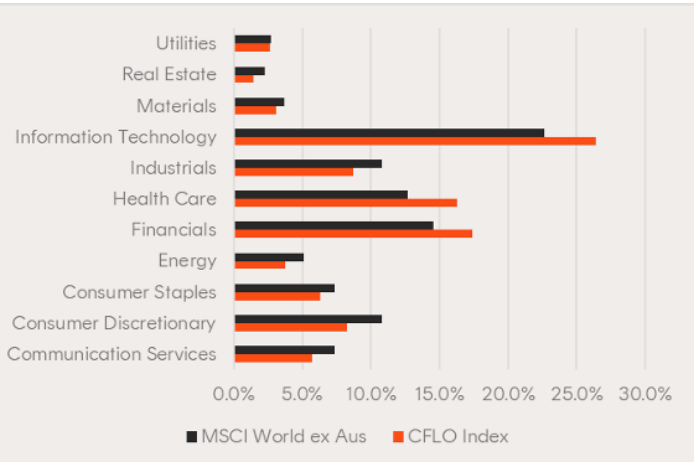
[1] Further details on the index methodology are available in the PDS and index methodology document, both of which you can access on the CFLO fund page.

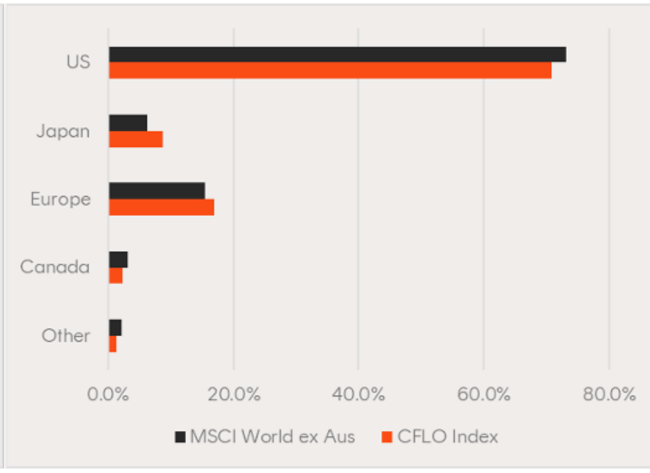
2. Robust performance over the market cycle: As well as historical outperformance over the time period since inception, CFLO's index has been consistent over shorter periods, outperforming in 13 of the 17 calendar years since inception. In years of underperformance, the performance gap has generally been small (average of -1.5%). Notably, CFLO's index has outperformed in all bar one year when the MSCI World Index NR (AUD) return was negative, and had a maximum drawdown of 33% versus 42% for the broader index.



Source: Bloomberg. Data as of 31 October 2023. Annual calendar year total returns shown, with 2023 year data ending 31 October 2023. Chart shows Index performance (not actual fund performance), and doesn't take into account ETF fees and expenses of 0.40% p.a. You cannot invest directly in an Index. Past performance is not an indicator of future performance.

3. A diversified core global equity allocation: The fund offers diversified exposure to 200 global companies with similar sector and country weights to broad global equity benchmarks. CFLO's index controls for sector and country exposures to provide a more balanced global equity profile without large over or underweights.





Source: Bloomberg. Data as of 31 October 2023. Sectors are defined by GICS classifications. You cannot invest directly in an Index. Past performance is not an indicator of future performance.

Portfolio implementation

Investors may consider CFLO:

- as a single core exposure to global (developed market) equities,
- to use alongside an existing low-cost, passive global equity exposure to improve the overall fundamentals of a portfolio while retaining a strong cost focus, and
- to replace or blend with existing active global equity funds to lower overall management costs.

CFLO is designed to provide a convenient, transparent and cost-effective way for Australian investors to gain diversified global exposure to companies delivering strong FCF with relatively low levels of financial leverage - and hence potential for outperformance over the medium to long term. You can invest in CFLO on the ASX at a management fee of 0.40% p.a.[2] or just $40/year for every $10,000 invested.

Bibliography

Adame, K., Koski, J., & McVay, S. (2019). "Why Are Investors Paying More Attention to Free Cash Flows", University of Washington, working paper.

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Sloan, R. (1996). "Do stock prices fully reflect information in accruals and cash flows about future earnings?", The Accounting Review, 71(3), 289-315.

Hackel, K. S., Livnat, J., & Rai, A. (2000). "A Free Cash Flow Investment Anomaly", Journal of Accounting, Auditing & Finance, 15(1), 1-24.

There are risks associated with investment in the Fund, including market risk, international investment risk, non-traditional index methodology risk and currency risk. Investment value can go up and down. An investment in the Fund should only be made after considering your particular circumstances, including your tolerance for risk. For more information on risks and other features of the Fund, please see the Product Disclosure Statement and Target Market Determination, both available at www.betashares.com.au.

[2] Other costs, such as transaction costs, may apply. Refer to the PDS for more information.