Winning at Active Management

The Essential Role of Culture, Philosophy, and Technology

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BRIEF

Selecting companies with superior ability to generate free cash flow, and allocate it wisely - reinvesting for capital growth (internal projects, acquisitions), or return capital to owners (dividend, buybacks, debt repayment).

Free cash flow is the basic measure of value of a corporation, and successful security selection avoids relying on GAAP earnings, and instead looks to cash flow as a more valid indicator or economic profit. Academic research has demonstrated that shares of firms that report higher-quality earnings - that contain a higher cash flow component and less in the way of accounting accruals - tend to demonstrate superior returns over the long run.

The Epoch Core Model

Epoch investment partners does not take a traditional view on growth versus value style, or quantitative versus fundamental research techniques, as we do not find those distinctions especially meaningful. However, we do firmly advocate active management, and quantitative methods are part of our investment process.

Considerable effort goes into the decision to add a stock to an Epoch portfolio: developing a thorough understanding of the drivers of each company's business, and forecasts of what is likely for the future. The final choices require detailed handwork from our research analysts and portfolio managers, but in many cases the initial steps of identifying suitable companies are handed off to the Epoch Core Model. It's a quantitative tool that "casts a wide net", sorting and ranking thousands of stocks across global markets an industries on a group of factors focused on the sources and use of cash flow and company quality. The Model enables analysts to apply their skill more effectively through better anymore consistent investment process. The model also increases breadth by increasing the number of stocks an analyst can research - without diminishing the ability to apply skill by having to reduce the time spend on each idea.

Racing with the Machine

The aim is not to give over decision making to software algo, but instead recognize and incorporate the strengths of information technology and how it can inform the investment decision making process. We want the machine to serve the analyst, not the other way around.

Epoch has recently developed and built a strategy that might not have been possible without application of mass digitization of financial data and rapid computing power. It is not based on conventional quantitative models, instead, it applies our fundamental concepts of capital allocation, backed by insights of academic and market research.

In recent years, researchers have documented that profitability (return on invested capital - ROIC) exerts an important influence on stock returns. The ROIC on individual companies is idiosyncratic, but for market as whole, it tends to be consistent over fairly long periods, providing basis for an attractive strategy.

In developing the strategy, we studied ROIC at companies in MSCI World index for 10 years ended 2015. Results were encouraging: on average, 70% of the companies in the top quintile in a given year remained there in the next year, and few companies migrated from the top ranks of ROIC to the bottom over short periods. Shares of high ROIC companies tended to outperform those of less profitable firms.

Quantitative methods "collect the dots" - efficiently gathering and sorting the raw information, **while analysts and portfolio managers "connect the dots"** and conduct the security selection.

In Epoch's view, judgment can be greatly informed by technology, but technology will never be a substitute for judgment.

PREFACE

There is a saying in the stock market, which applies to life in general: **Timing is Everything**.

To be successful, **an investment firm must clear three hurdles**:

- its clients must reap superior investment performance
- its employees must find desirable long-term employment
- and its owners must ear fair financial returns

In the market for individual investors in the U.S., market share is slipping away from large old-line warehouse brokerage firms, in favor of independent investment advisers. And lately, a wave of low-cost rob-advisory.

A more recent marketing idea known as "smart beta" represents another group of semi-active products, like index funds and ETFs, they are able to delivery concise portfolios at fee rates below those of active managers.

Epoch believes that the source of value in a company is its free cash flow.

CHAPTER 2 Cultrure in Investment Management

Portfolio mathematics still have trouble in definitely distinguish luck from skill in historical results.

Values

Underlying an investment firm’s culture is a set of values - beliefs and principles that guide its employees in their work, and its leaders in their strategic decisions for the organization:

- to provide superior risk-adjusted results **using a transparent approach** based on our free cash flow philosophy
- to serve investors who seek and value Epoch’s investment approach
- to continue as a thought leader and innovator in global investment management

Bill Priest

“Clients that hire you by the numbers will fire you by the numbers, too, so we look for clients that understand and value the methodology behind our strategies”

PART II PHILOSOPHY AND METHODOLOGY

Chapter 3 The Nature of Equity Returns

Linkages

The Real Economy and the Financial Economy

Two important factors link the two aspects of the overall economy:

- the share of businesses profits in nominal GDP in the real economy, profit margins, corresponds to corporate earnings per share in financial economy
- interest rate, which underlies the valuation of financial assets

Components of Stock Returns

The return on an investment in equities can be split into three components:

- dividends received
- growth in earnings per share
- changes in valuation (PE ratio)

PE Ratios

The P is a forward-looking number, valuing shares based on expectations of where earnings are likely to be in the future.

Greater optimism over prospects for the economy leads investors to raise their expectations about the size of the future profits, driving today’s prices higher and increasing P/E. Investor enthusiasm is what propelled P/E.

The Historical Makeup of Stock Earnings

Besides P/E, dividends and changes in earnings per share make contributions to returns of stock as well.

Dividends always make a positive contribution to returns. in contrast, contribution from changes in P/E tend to rise and fall significantly over short periods.

Chapter 4 The Great Investment Debate: Active or Passive Management?

Every investor should have a formal plan, in two parts:

- a philosophy or strategy for guiding the investment
- and a methodology, or set of tactics, for carrying it out

A well-designed plan includes a viewpoint on how the financial markets should react to a range of developments in the real economy, what assets to invest in or avoid, and likely range of returns a portfolio might earn, as well as benchmarks.

For **institutional investors, a reasoned investment policy statement** is often a legal requirement and part of overseer's fiduciary duty.

An investment philosophy may develop over time through trial and error, even unconsciously.

By developing an informed investment plan presumes a knowledge of financial markets that many people lack, and this shortage has created the need for an enormous industry of investment consultants, managers and advisers.

The Debate is Timeless

Over 50 years ago, Benjamin Graham: "I think the … most important reason why the investor should not be led to emphasize his selection of individual stocks, and to neglect the general level of the stock market is the fact that there is no indication that the investor can do better than the market averages by making his own selections or by taking expert advice.

Chapter 5 A more Human Description of Investors and Markets: Behavioural Finance

Loss Aversion

Mental Accounting

Minimizing Regret

Overconfidence

Extrapolation and Reversal

Chapter 6 Active versus Passive Management: The Empirical Case

Market Regimes

Correlation and Dispersion Two best statistical measures o how widely the returns of individual stocks vary from one another are correlation and dispersion.

Luck or Skill To measure the difference to an active strategy, GMO built a model that assumed investment of 5% in non-US stocks, 5% in small and madcap US stocks, and 1% in cash.

Chapter 7 The Case for Active Management

Chapter 8 Database on Active Managers' Styles and Methods

Manager Style

Free Cash Flow is the Measure of Value

Depreciation

Accruals

It might be tempting to think that the accruals even out over time, but they don't. According to George Christy, in his 2009 book Free Cash Flow, "A viable company has no "end". Every company is continually booking new accruals and modifying existing accruals and reserves. Even if there were no new accrual accounts put on the books, the world in which a company is operating is always changing as is the company itself, so the company must continually reassess and modify its accrual assumptions".

"Stock prices act as if investors "fixate" on accounting earnings, failing to distinguish fully between the different properties of the accrual and cash flow components of earnings. Consequently firms with relatively high (low) levels of accruals experience negative (positive) future abnormal stock returns that re concentrated around future earnings announcements."

There are many companies trading at nonzero prices even they do not generate positive cash flow, as well as companies produce little cash flow that trade at very high prices. TSLA is the first, AMZN is the second.

Research and Development Costs

For some companies, R&D costs pose the same challenge as depreciation expense. GAAP require that companies treat their spending on research and development as current expense. Costs of internally developed software and web site development are handled differently: they are deemed to have some ongoing value for the future, and are capitalized and amortized over the useful lives that the company estimates.

One significant variation is the treatment of R&D expense under IFRS vs. GAAP. IFRS requires companies to capitalize successful R&D efforts in some circumstances, deferring the recognition of expense, with a wide variety of results.

When more spending is capitalized, current earnings appear to be higher, less of the cost is charged against them, and future periods are left to bear the burden.

The market still have to pay close attention to earnings reports: they may be flawed, but are the primary sources of immediate information on a company's quarterly profits. A complete analysis of cash flows can't be done until a company files its full statements, typically 45 days after the end of the quarter, while quarterly earnings, prepared according to conventional accounting principles, are released within a couple of weeks.

The CFO Perspective

Companies appear to place greater weight on earnings-based measures than on cash flow. 51% companies relied on profits to measure performance, while 11% looked to cash flow metrics. The leading gauge of performance, has become total shareholder return.

Private companies placed greater emphasis on cash flows, which suggests that perhaps capital market motivation drive the focus on earnings. CFOs in the study emphasized the importance of reporting steady, predictable patterns in earnings, and how crucial meeting market expectations of quarterly earnings is to share prices, as well as to CFOs' current and futures career prospects.

CFOs were asked to provide a list of red flags for identifying poor earnings quality, "lack of correlation between earnings and cash flows was the top choice. The presence of lots of accruals and one-time charges and consistently beating analyst forecasts also scored highly. "I think if earnings are not backed by actual cash flows, then the are not good earnings."

GAAP

Financial statements shall not report an amount of cash flow per share. Neither cash flow nor any component of it is an alternative to net income as an indicator of an enterprise's performance, as reporting per share amount might imply.

Chapter 9 The Jump from Company Earnings to Stock Prices

A company's history is often the best guide to its future, and deciphering past results and building them into a forecast of cash flows and then into a prospective valuation, is the beginning of investment process.

P/E, P/B, etc. -

Jack Treynor

"needless to say, if the analyst insists on being provided with a single number so simply related to market value, then he is delegating away to whoever provides that number most of the real task of security analysis.

Chapter 10 Epoch’s Investment Philosophy

First, we respectfully depart from the theoretical arguments of MPT, and substitute the observations of behavioural finance.

Second, we believe that the reliance by corporate managements, as well as by many investors, on backward-looking financial measures derived from GAAP financial statements distorts the financial picture many companies present. Moreover, accounting-based investment decisions can give risk to their own category of mispricings and inefficiencies.

Accordingly, we believe that cash flow is the origin of value in stocks, and that forecasts of cash flows should be the basis of security selection.

We emphasize the importance of management’ decisions in allocating their available cash flows - either by adding value to their business through capital reinvestment, or returning capital to owners through share repurchase and dividends.

The Starting Point: Generating Free Cash Flow

Epoch seeks to invest in companies with business models that are transparent, and can be really understood from the sources and uses of their free cash flow.

We define free cash flow as: **cash provided by company’s operations, less planned capex and cash taxes**. Management can thus deploy this uncommitted can at its discretion.

Allocation of free cash flow:

- reinvesting capital in business through corporate acquisition and
- capital spending on internal projects
- distributing to owners through dividends,
- buying back shares,
- repaying debt

Of the companies we choose and research and monitor, we fully investigate their capital allocation process.

If they are sound businesses but seem too expensive at the current price, we monitor their progress until their share prices move to a point where we think they can be capitalized upon.

Trends in Capital Allocation

Prior to 2005, free cash flow invested in capital expenditures and acquisitions swamped distributions to shareholders in dividends and share buybacks. More recently, cash flow allocation has been more balanced.

Dividends

For the companies in S&P 500, 94% distributed dividends to shareholders in 1980, paying out 40% of annual earnings. Through 1980s and 1990s, the share of companies paying dividends fell steadily. It hit bottom at 70% in 2002, but has since recovered. 83% in 2015.

Share Repurchase

During past 10 years, distributions through dividends have been surpassed by repurchases.

Debt Buydowns

We see debt repayments as a constructive application of free cash flow

PART III TECHNOLOGY

Chapter 13 The Epoch Core Model

Epoch manages a variety of equity strategies, differing by markets and by size of companies. What the have in common, is the firm's active investment philosophy, which selects companies on their ability to generate free cash flow and allocate that capital wisely.

Considerable effort goes in to the decision to add a stock to the portfolios. A part o the process is a thorough understanding of the drivers of each company's business, and forecasts of what is likely for the future. Every sector has its own set of economics, and within sectors, companies business models can vary widely.

Each fundamental research analysts is responsible for maintaining complete financial models for 100 or so companies per sector.

Epoch Core Mode, developed in 2007, is a powerful quantitative tool that casts a wide net, sorting through and ranking thousands of stocks across global markets and industries, examining a group of factors focused on the sources and uses of cash flow, as well as company quality.

Factors in Epoch Core Model

The model does not apply in-depth knowledge of companies' business models or the industries they operate in. Rather it looks through financial statements to identify and rank a large number of companies with a preliminary set of desired financial and valuation characteristics. By ranking individual companies against their peer groups, the model remains flexible and adaptable to a range of market environments.

Historical free cash flow yield

Forward looking free cash flow

Leverage: comapies with large debt loads are committed to pay out cash flow in higher fixed interest charges
Accruals and Earnings quality

We like to think of Epoch's combined fundamental and quantitative investment process as being a mile wide, and a mile deep.