

# FREE CASH FLOW AND SHAREHOLDER YIELD

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## New Priorities for the Global Investor

William W. Priest and Lindsay H. McClelland



John Wiley & Sons, Inc.



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To  
Katherine  
Jeff, Joan, Karen, and Steve  
Amanda, Hayley, Jack, Jacob, and Spencer  
With thanks and appreciation for your affection and support.

—WWP

To Geordie, the human equivalent of Shareholder Yield.

—LHM





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**PART THREE**

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## FOREWORD

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This book—*Free Cash Flow and Shareholder Yield*—must-read for individual investors, pension and mutual fund trustees, professional money managers, and anyone interested in the growth and preservation of wealth.

In this concise and very readable book, Priest and McClelland have put together a comprehensive analysis of the present equity market and the forces that determine its future value. Readers are rewarded with a method for analyzing market trends and an investment discipline designed to both protect wealth from turbulence and to profit from it.

The goal of successful investing is to take positions on assets that exhibit discrepancies between observed prices and fundamental values. Academic researchers call these discrepancies “market anomalies” and ask if they are real or a mirage produced by a lack of understanding of the forces that drive asset prices and their returns. True anomalies are those that the operation of market forces should remove in time. Trying to identify these true anomalies gave rise to the discipline of security analysis started in 1934 by Graham & Dodd’s *Security Analysis*. Perhaps the main contribution of these pioneers was the introduction of discipline to security selection by providing guidance to the identification of hidden value.

Many things have changed since 1934. Accounting has become more complex and less informative. The capital markets have increased exponentially in size and variety of instruments traded, permitting levels of leverage impossible just a couple of

decades ago. And the world economy and its capital markets have resumed their inexorable march toward integration as the impediments created by distance and lack of communication have disappeared in the Internet age.

It is at this juncture that Priest and McClelland's timely and important book comes in. The authors have identified the fundamental drivers of future cash flows and their pricing: globalization, rising interest rates, and deflating asset bubbles. Although these drivers are discussed daily in the press and by market analysts everywhere, Priest and McClelland go beyond their mere listing. They explain how they interact to affect equity values and use their analysis to develop a coherent investment discipline. How do they do that? First, they remove the veil from accounting earnings by relying on the present value of expected free cash flows. Second, they examine the forces at work that drive the future performance of the equity market. They observe that the growth of real global GDP and its distribution determines where free cash flows will be generated. Third, they explain how inflation and interest rates determine equity pricing. They examine the dynamics of housing prices, the role of liquidity and leverage, and the jump in corporate profits experienced in recent years and conclude that things are not going to be the same in the future. In fact, they note that the present equilibrium is already changing and that its displacement can be abrupt. Their analysis leads to the unavoidable conclusion that the bursting of the housing and credit market liquidity bubbles has just begun, and that corporate profit growth is unsustainable at its present rate. They also point out the increase in the cost of capital created by higher real interest rates and the increase of risk premia but they note that, although significant, those increases would not produce a collapse of asset values because of the present equilibrium between the political and economic needs of high-saving developing countries and a "dis-saving" United States. In a final

instance, the effect of these changes on equity values seems to hinge on the balance between a slowdown in U.S. consumer spending and the incorporation of consumers from developing countries.

Priest and McClelland recommend scanning the global markets for the future sources of value to be found in companies that produce genuine free cash flow, not just reported earnings per share. They call this approach “Shareholder Yield”: the ability to return cash to shareholders via dividends and share repurchases and to pay down debt. Shareholder Yield will produce excess returns as long as it is not fully priced by the market.

Throughout his distinguished career as an investment manager, Bill Priest has acquired a deep understanding of the interrelation between the stock market and the economy and its implications for successful investing. We are fortunate that he has put his thoughts and practice into writing. I firmly believe that, to confront the challenge posed by the extraordinary size of unfunded pension liabilities of the private and public sectors without a drastic reduction of our living standards, we need a fresh approach to investment management that goes beyond the exploitation of temporary excess liquidity. I believe that, in this book, Priest and McClelland show the way out of this predicament.

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## PREFACE

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As a veteran of the investment management industry, I have studied the stock market for over 40 years. In this time, I have seen numerous booms, busts, trends, bubbles, and phases. I have seen phenomenal growth and precipitous decline. I have seen the best and the worst of the global capital markets.

Long tenure on Wall Street has given me the perspective to place each of these market events—whether positive, negative, or neutral—into context. As an investment manager, it is my task to separate the passing fads from the paradigm shifts and to use these insights to generate returns for clients. I am writing this book because I feel that a true paradigm shift is underway in today's capital markets: one that will transform the drivers of investment returns.

*Shareholder Yield* is a term you'll be hearing a lot in the following pages. In addition to being the inspiration behind this book, Shareholder Yield is one of the philosophical cornerstones of my career as an investment manager and one of the founding principles of Epoch Investment Partners, a firm that my colleagues and I established in 2004. At its most basic level, Shareholder Yield represents a specific cash flow deployment methodology. But it also represents a different way of thinking about equity market performance.

There are forces at work in today's capital markets that will redefine how smart investments are made. Investors who want to protect and grow their capital will need to know why

the investment landscape is changing and how they can capitalize on the shifting components of equity market returns. I believe that Shareholder Yield provides insights necessary to answer these questions and offers the key to understanding why the stock market's present, and its future, will be very different than the last two decades of the twentieth century.

In an attempt to convey these ideas clearly and concisely, this book is organized in the following manner. First, we assert the importance of free cash flow as today's most meaningful investment metric. Then, we present our argument for why the order of the drivers of total equity return are changing and what this means to the informed investor. We then expand this idea to introduce the concept of Shareholder Yield: the notion around which our book is based. This is followed by a discussion of several relevant events and themes in today's investment landscape, each of which can be tied back to the ideas of Shareholder Yield and free cash flow. We conclude the book by linking each of these concepts into a set of strategic recommendations that, when implemented through security selection and portfolio construction, can both preserve and grow invested capital.

If my time on Wall Street has taught me anything, it's that the rules of investing have changed before and that they will certainly change again. Therefore, in writing this book, we have been careful to approach the equity markets in a way that allows for change, yet also identifies what we believe are the enduring truths of investing. We have sought to highlight the unique opportunities of today's marketplace by employing the lasting and adaptable frameworks of free cash flow and Shareholder Yield. With any luck, this investment philosophy will prove both flexible and robust, and will serve the informed investor today, tomorrow, and beyond.



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We are also indebted to our manuscript readers Enrique Arzac, Emily Baker, Rob Brown, Doug Cliggott, and Mike Welhoelter, whose patience we tried and whose comments were invaluable in making this book a readable one. The expert assistance of Straightline was similarly indispensable, and we thank them for helping us create a polished manuscript. Our gratitude also goes out to Bill Falloon, Emilie Herman, Laura Walsh, and the rest of the team at Wiley for skillfully bringing this project to fruition.

Our research assistants were few but important. We want to thank Huma Bari, Rob Martin, and Jessica Wolf for their tireless ability to work with little notice and impossible deadlines. Without their efforts, we could not have completed our task. Special thanks go to Thomas Hu for providing an insightful and quantitatively rigorous approach to the free cash flow model, as reproduced in the Appendix.

Of course, all lapses, communication failures, and errors are our responsibility. We sincerely hope you enjoy the perspective we put forth in this book.

Wishing you a successful investment future,

W. W. P.

L. H. M.