FCF Yield Increased in Six All Cap Index Sectors Through 2Q21

This report is an abridged and free version of All Cap Index & Sectors: Free Cash Flow Yield Through 2Q21, one of the reports in our quarterly series on fundamental market and sector trends, available to Pro and higher members. More free reports on the fundamental trends for the overall market and each sector are available here.

The full version of this report analyzes[1] free cash flow (FCF), enterprise value, and the trailing FCF yield for the NC 2000[2], our All Cap Index, and each of its sectors (last quarter's analysis is here). Our research is based on the latest audited financial data, which is the 2Q21 10-Q for most companies. Price data is as of 8/18/21.

These reports leverage more reliable fundamental data[3] that overcomes flaws with legacy fundamental datasets. Our Earnings Distortion factor generates substantial idiosyncratic alpha.

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NC 2000 Trailing FCF Yield Rises in 2Q21

The trailing FCF yield for the NC 2000 rose from 0.8% in 2Q20 to 1.5% as of 8/18/21. See Figure 1 in the full version of our report for the chart of FCF Yield for the NC 2000 from December 1998 thru 2Q21. Six NC 2000 sectors saw an increase in trailing FCF yield year-over-year (YoY) based on 2Q21 financial data.

Key Details on Select NC 2000 Sectors

With a 4.4% FCF Yield, investors are getting more FCF for their investment dollar in the Basic Materials sector than any other sector. On the flip side, the Utilities sector has the lowest trailing FCF yield of all NC 2000 sectors.

The Healthcare, Industrials, Telecom Services, Energy, Basic Materials, and Real Estate sectors have each seen an increase in trailing FCF yield from 2Q20 to 2Q21. Below, we highlight the Financials sector.

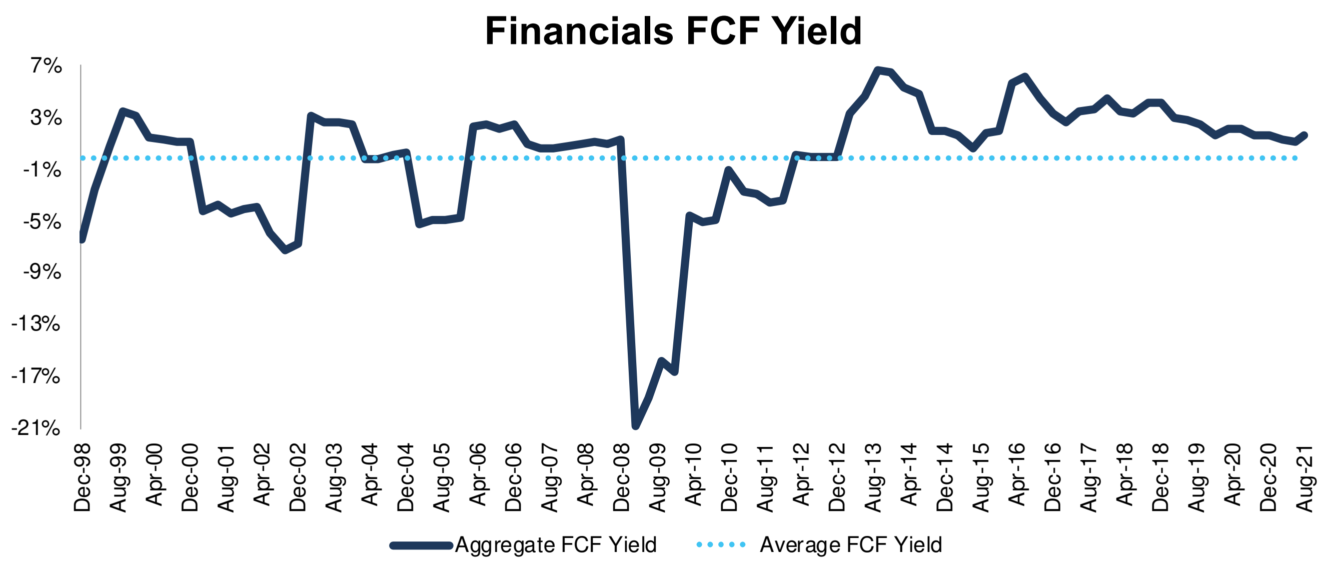
Sample Sector Analysis[4]: Financials

Figure 1 shows trailing FCF yield for the Financials sector increased from 1.6% in 2Q20 to 1.7% in 2Q21. The Financials sector FCF rose from $73.4 billion in 2Q20 to $109.1 billion in 2Q21, while enterprise value increased from $4.5 trillion in 2Q20 to $6.6 trillion in 2Q21.

[1] We calculate these metrics based on S&P Global's (SPGI) aggregation methodology, which sums the individual NC 2000 constituent values for free cash flow and enterprise value before using them to calculate the metrics. We call this the "Aggregate" methodology. Get more details in Appendices I and II.
[2] The NC 2000 consists of the largest 2000 U.S. companies by market cap in our coverage. Constituents are updated on a quarterly basis (March 31, June 30, September 30, and December 31). We exclude companies that report under IFRS and non-U.S. ADR companies.
[3] For 3rd-party reviews, including The Journal of Financial Economics, on our more reliable fundamental data, historically and prospectively, across all stocks, click here and here.
[4] The full version of this report provides analysis for every sector like what we show for this sector.

Important Disclosure Information is contained on the last page of this report.
The recipient of this report is directed to read these disclosures.

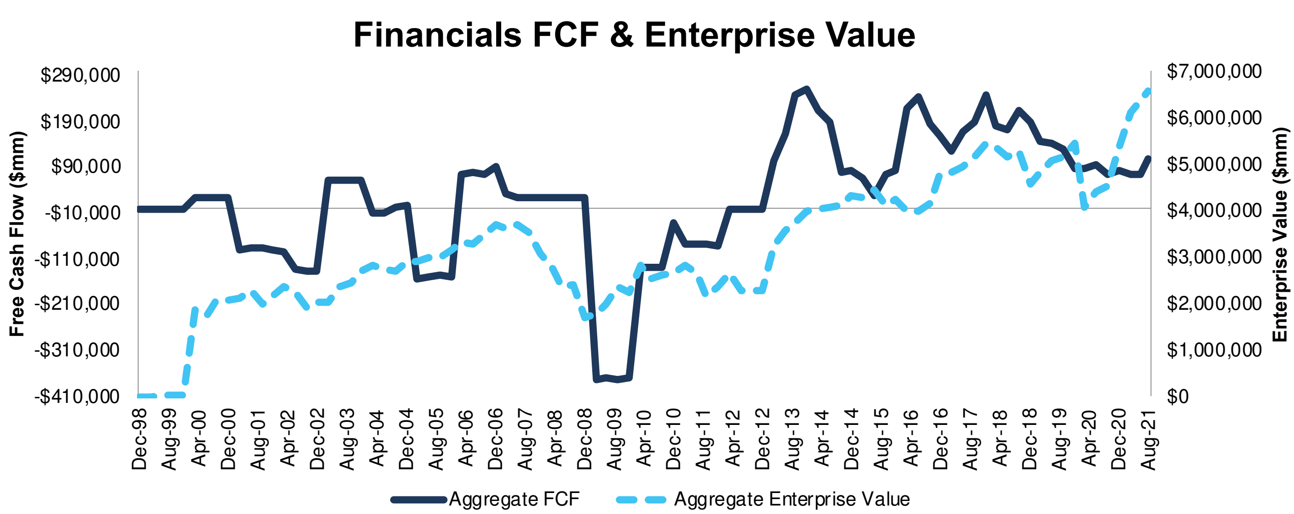
Figure 1: Financials Trailing FCF Yield: Dec 1998 – 8/18/21



Sources: New Constructs, LLC and company filings.
The August 18, 2021 measurement period uses price data as of that date and incorporates the financial data from 2Q21 10-Qs, as this is the earliest date for which all the 2Q21 10-Qs for the NC 2000 constituents were available.

Figure 2 compares the FCF and enterprise value trends for the Financials sector since 1998. We sum the individual NC 2000/sector constituent values for free cash flow and enterprise value. We call this approach the "Aggregate" methodology, and it matches S&P Global's (SPGI) methodology for these calculations.

Figure 2: Financials FCF & Enterprise Value: Dec 1998 – 8/18/21



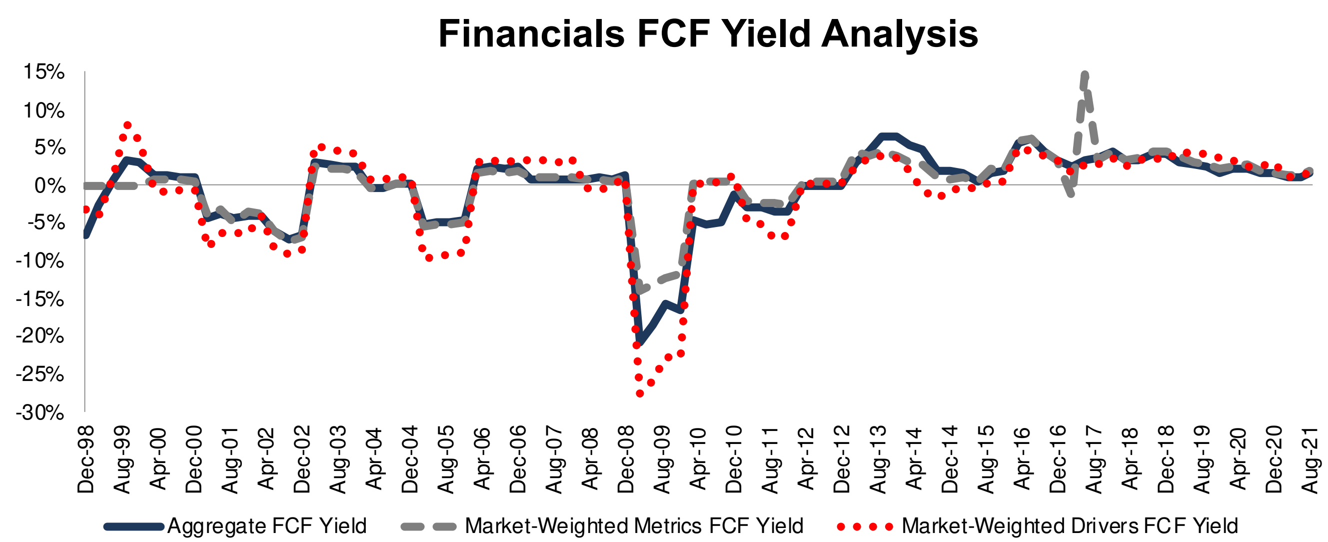
Sources: New Constructs, LLC and company filings.
The August 18, 2021 measurement period uses price data as of that date and incorporates the financial data from 2Q21 10-Qs, as this is the earliest date for which all the 2Q21 10-Qs for the NC 2000 constituents were available.

The Aggregate methodology provides a straightforward look at the entire NC 2000/sector, regardless of market cap or index weighting, and matches how S&P Global (SPGI) calculates metrics for the S&P 500.

For additional perspective, we compare the Aggregate method for free cash flow with two other market-weighted methodologies. These market-weighted methodologies add more value for ratios that do not include market values, e.g. ROIC and its drivers, but we include them here, nonetheless, for comparison. Each method has its pros and cons, which are detailed in the Appendix.

Figure 3 compares these three methods for calculating the Financials sector's trailing FCF yields.

Figure 3: Financials Trailing FCF Yield Methodologies Compared: Dec 1998 – 8/18/21



Sources: New Constructs, LLC and company filings.
The August 18, 2021 measurement period uses price data as of that date and incorporates the financial data from 2Q21 10-Qs, as this is the earliest date for which all the 2Q21 10-Qs for the NC 2000 constituents were available.

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Disclosure: David Trainer, Kyle Guske II, Alex Sword, and Matt Shuler receive no compensation to write about any specific stock, style, or theme.

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Appendix: Analyzing Trailing FCF Yield with Different Weighting Methodologies

We derive the metrics above by summing the individual NC 2000/sector constituent values for free cash flow and enterprise value to calculate trailing FCF yield. We call this approach the “Aggregate” methodology.

The Aggregate methodology provides a straightforward look at the entire NC 2000/sector, regardless of market cap or index weighting, and matches how S&P Global (SPGI) calculates metrics for the S&P 500.

For additional perspective, we compare the Aggregate method for free cash flow with two other market-weighted methodologies. These market-weighted methodologies add more value for ratios that do not include market values, e.g. ROIC and its drivers, but we include them here, nonetheless, for comparison:

1. **Market-weighted metrics** – calculated by market-cap-weighting the trailing FCF yield for the individual companies relative to their sector or the overall NC 2000in each period. Details:
    a. Company weight equals the company’s market cap divided by the market cap of the NC 2000/ its sector
    b. We multiply each company’s trailing FCF yield by its weight
    c. NC 2000/Sector trailing FCF yield equals the sum of the weighted trailing FCF yields for all the companies in NC 2000/sector
2. **Market-weighted drivers** – calculated by market-cap-weighting the FCF and enterprise value for the individual companies in each sector in each period. Details:
    a. Company weight equals the company’s market cap divided by the market cap of the NC 2000/ its sector
    b. We multiply each company’s free cash flow and enterprise value by its weight
    c. We sum the weighted FCF and weighted enterprise value for each company in the NC 2000/each sector to determine each sector’s weighted FCF and weighted enterprise value
    d. NC 2000/Sector trailing FCF yield equals weighted NC 2000/sector FCF divided by weighted NC 2000/sector enterprise value

Each methodology has its pros and cons, as outlined below:

Aggregate method

Pros:

- A straightforward look at the entire NC 2000/sector, regardless of company size or weighting in any indices.
- Matches how S&P Global calculates metrics for the NC 2000.

Cons:

- Vulnerable to impact of companies entering/exiting the group of companies, which could unduly affect aggregate values. Also susceptible to outliers in any one period.

Market-weighted metrics method

Pros:

- Accounts for a firm’s market cap relative to the NC 2000/sector and weights its metrics accordingly.

Cons:

- Vulnerable to outlier results from a single company disproportionately impacting the overall trailing FCF yield.

Market-weighted drivers method

Pros:

- Accounts for a firm’s market cap relative to the NC 2000/sector and weights its free cash flow and enterprise value accordingly.
- Mitigates the disproportionate impact of outlier results from one company on the overall results.

Cons:

- More volatile as it adds emphasis to large changes in FCF and enterprise value for heavily weighted companies.

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Key quotes from the paper:

- "[New Constructs'] *Total Adjustments* differs significantly from the items identified and excluded from Compustat's adjusted earnings measures. For example… 50% to 70% of the variation in *Total Adjustments* is not explained by *S&P Global's (SPGI) Adjustments* individually." – pp. 14, 1st para.
- "A final source of differences [between New Constructs' and S&P Global's data] is due to data collection oversights…we identified cases where Compustat did not collect information relating to firms' income that is useful in assessing core earnings." – pp. 16, 2nd para.

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Key quotes from the paper:

- "…an accurate calculation of ROIC requires more diligence than often occurs in some of the common, off-the-shelf ROIC calculations. Only by scouring the footnotes and the MD&A [as New Constructs does] can investors get an accurate calculation of ROIC." – pp. 8, 5th para.
- "The majority of the difference…comes from New Constructs' machine learning approach, which leverages technology to calculate ROIC by applying accounting adjustments that may be buried deeply in the footnotes across thousands of companies." – pp. 4, 2nd para.

Superior Stock Ratings

Robo-Analysts' stock ratings outperform those from human analysts as shown in this paper from Indiana's Kelley School of Business. Bloomberg features the paper here.

Key quotes from the paper:

- "the portfolios formed following the buy recommendations of Robo-Analysts earn abnormal returns that are statistically and economically significant." – pp. 6, 3rd para.
- "Our results ultimately suggest that Robo-Analysts are a valuable, alternative information intermediary to traditional sell-side analysts." – pp. 20, 3rd para.

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