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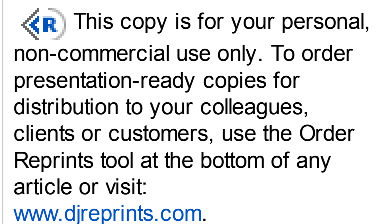
MARKET MOVERS

Cash Flow Reigns Once Again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By TOM LAURICELLA
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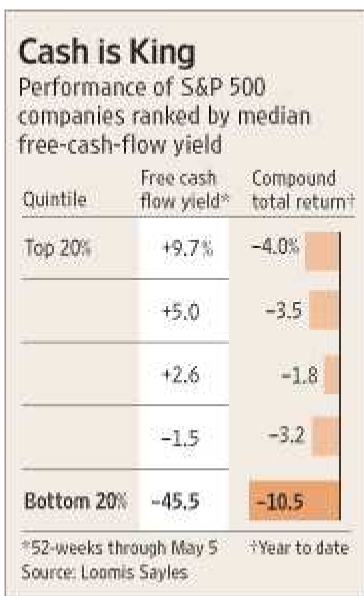
When sizing up stocks in uncertain times, it's best to follow the cash.

Last week's stock-market swoon showed how unsettled the investing landscape remains. As a result, earnings quality is coming into focus among some investment pros. When so many things can go wrong, they want to know that a dollar earned is really a dollar earned. And corporate cash flows are an important gauge of the quality of earnings.

Headline earnings numbers -- typically net income -- can be massaged by perfectly legal accounting tricks, such as changing depreciation schedules or the way revenue is recognized. Cash flows -- how much actual money a company spits out -- are by no means immune from shenanigans, but many analysts consider them a cleaner way to assess a company's health.


Cash is King
Performance of S&P 500 companies ranked by median free-cash-flow yield

Quintile	Free cash flow yield*	Compound total return†
Top 20%	+9.7%	-4.0%
	+5.0	-3.5
	+2.6	-1.8
	-1.5	-3.2
Bottom 20%	-45.5	-10.5

*52-weeks through May 5 †Year to date
Source: Loomis Sayles

There are other reasons to search out companies with strong cash flow. A company generating extra cash can avoid the costly proposition of raising money in today's unsteady markets. It also gives companies the flexibility to boost dividends or stock buybacks.

Operating cash flow is the amount of cash a company creates from its operations, unvarnished by earnings that come from things like asset sales. Free cash flow -- considered an even purer measure of a company's true profitability -- subtracts from operating cash flow the money going into capital investments. It's "as close as there is to a silver bullet when it comes to sorting out good companies from the pretenders," says David Sowerby, a portfolio manager at Loomis Sayles & Co.

Mr. Sowerby tracks free-cash-flow yield, or a company's free cash flow divided by its shares outstanding. He likes **Hewlett-Packard** Co. The computer and printer maker sports a free-cash-flow yield that is double that of the Standard & Poor's 500-stock index's 4% and has seen its cash flow grow by more than 30% over the past three years. H-P's shares are down 2.5% this year, but they are up some 9% in the past 12 months.

Among companies with weak cash flow is **Goodyear Tire & Rubber** Co. Its earnings are expected to grow 80% this year, according to Thomson Reuters. But its cash flow has been negative in part due to heavy capital expenditures. The stock is flat in 2008 and down 16% in the past year.

Cash flow isn't a new idea on Wall Street. In the past, some consultants and Wall Street firms turned it into a fad and even marketed variations of the idea as a measure of business performance.

It also isn't a perfect yardstick. Companies can goose cash flows even when it's not in their interest. For example, they might cut needed capital spending to hoard cash and in turn jeopardize future growth.

Lately, investors have focused more on other stock attributes, like a "momentum" approach. There, they buy stocks that are already going up and sell or avoid those that are falling. Lehman Brothers' quantitative-investing group says a price-momentum strategy has been one of its best performers this year, with a 2.5% gain.

But that could soon change.

"When we get into an environment where investors are willing to dip their toe into the water and go out a little bit more on the risk spectrum, the place that they're going to start dipping is in the high-quality names," says Matthew Rothman, global head of quantitative-equity strategies at Lehman.

Mr. Rothman says there are hints that quality is starting to matter more. Another Lehman strategy is one that screens stocks based on changes in their accruals -- things like unpaid bills or accounts receivable. It bets against stocks with rising accruals -- a signal cash flow might not be so healthy -- and favors stocks that generate operating cash. That strategy is up 5.6% so far this year, Lehman says, in part because it generally avoids financials.

Richard Sloan, of Barclays Global Investors, expects to see more strains on companies with rising accruals, especially those that have put large amounts of "goodwill" on their balance sheets in recent years that reflect the premiums they paid over book values in acquisitions.

Mr. Sloan points to **General Electric** Co., which shocked investors recently with weaker-than-expected earnings. He said GE experienced a growing gap between net income and cash flow. "That suggested the company had been stretching to meet its numbers," he says.

William Priest, chief investment officer of Epoch Investment Partners, favors cable company **Comcast** Corp., which is up 19% this year. It had $2.3 billion in free cash flow in 2007 and initiated a quarterly dividend earlier this year, while also committing to buying back nearly $7 billion worth of stock by the end of 2009.

Mr. Priest also likes **Davita** Inc., which provides dialysis services. It has had strong earnings growth coupled with healthy free-cash-flow gains over the years. Last week, the company announced an increase in its share-repurchase program. The stock is down 8% so far this year.

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