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Cashflows are more important than quarterly profits

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With equity market valuations in the US at multi-year highs, it is not unusual to question whether this is sustainable. At Tacit, our belief is that equity valuations should be measured on a multiple of free cash flows generated by a company over multiple financial years, rather than on the quarterly company trading announcements, as it is growing cashflows that lead to higher equity prices. There is no doubt that certain US companies will not maintain their current lofty valuations, but there is also no doubt that the cashflows generated by certain other US companies justify their current valuations. Being selective is becoming more important.

In the current bull market, where optimism often drives share prices higher and investors chase headline earnings growth, cash flow investing provides a steadier and less risky path. While many equity investors are currently guided by rising earnings per share (EPS) figures, the reality is that EPS can be a poor indicator of a company's underlying financial soundness. Cash flow investing, by contrast, focuses on tangible liquidity and operational strength, key defences against volatility when market enthusiasm fades.

At times like these, when valuations are high and profit expectations are embedded in stock prices, the risk of disappointment grows. EPS numbers in a bull market can paint an overly flattering picture. They often rise on the back of financial engineering, such as share buybacks, cost-cutting, or temporary revenue surges. These tactics may inflate reported earnings without improving the business's ability to generate real cash. When credit conditions tighten or demand cools, companies built on these short-term boosts can quickly face funding pressure. Cash flow investors, however, look beyond accounting profit to whether a business is consistently generating surplus cash after paying for its operations and investments. This distinction matters more now than ever, because markets driven by sentiment can punish companies severely once their reported earnings momentum stalls.

Cash flow investing also provides a built-in margin of safety. Companies with steady, predictable cash flows have the resilience to reinvest, weather downturns, and return capital to shareholders even when economic growth slows. Such businesses are less dependent on capital markets to fund themselves, which reduces refinancing risk in volatile conditions. In contrast, companies that look profitable on an EPS basis but rely heavily on external financing or aggressive accounting techniques may find themselves vulnerable when liquidity tightens or investor appetite shifts. This makes cash flow metrics a more stable guide for capital allocation in a bull cycle.

Another area where cash flow investing proves its value is in valuation discipline. In buoyant markets, investors often pay too much for companies showing rapid EPS growth, assuming that earnings trends will continue indefinitely. Yet when interest rates rise or sentiment cools, valuation multiples can compress sharply. Free cash flow yield—the return an investor earns from actual cash generation—tends to provide a more grounded basis for assessing value. Companies delivering strong and sustainable cash flows can justify their market prices through fundamentals rather than through the momentum of expectations. This reduces the likelihood of sharp corrections when optimism retreats.

Ultimately, cash flow investing reduces the risk of illusions created by accounting earnings and momentum-driven markets. It keeps investors focused on business models that genuinely generate and compound value over time, regardless of short-term market psychology. As this bull market matures, the gap between reported EPS growth and real cash generation is widening for many companies. Those adhering to a cash flow-driven discipline stand to avoid the speculative excesses that often characterize late-cycle investing.

In reality no one knows when equities may fall, but by grounding our decision making in the pursuit of cashflows rather than 'profits' we hope to manage some of the risks that are inherent in equity markets at present.

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