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Easy Money

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The recent decline of some high-flying stocks does not come as much of a surprise to us. We didn't try to forecast exactly when it would happen, but high valuations, mediocre financials and tightening credit (i.e. interest rates going up) increase the odds of poor performance. You don't need to know the precise date when an active volcano will erupt to know it's probably a bad idea to lurk around one.

If we look at the US equity market, the performance of money losing companies from the start of the year up to the end of August has been an outstanding 18.4%. These are companies that have negative free cash flows which essentially means that they don't make enough money from daily operations to fund their growth.

Negative free cash flows are not always a bad thing. For a fast-growing company with a large addressable market, re-investing as much cash as possible back into the business is often the best decision. This was the state of Netflix and other fast-growing companies about 8 years ago.

Low interest rates made it easy for these companies to tap the capital markets to fund their exponential growth. Eight years ago when Tacit was founded, we were more heavily invested in these types of companies because we understood that low interest rates would act as a catalyst for growth.

In the latter months of 2016, we started trimming our holdings of these fast growers because of high valuations and signs of interest rates rising. In the process, we reduced our returns but also substantially reduced our risk.

The biggest risk facing companies with negative free cash flows is that they depend on the willingness of investors to keep funding their growth. Take Netflix for example, most families in the UK have a subscription allowing them to watch TV shows and movies on demand without adverts from meerkats telling them to compare insurance.

However, Netflix funds its growth by regularly issuing new shares and bonds. This means the company will struggle to produce new TV shows and movies if its share price falls or bond investors become less keen. Lack of free cash flows and high valuations increase the riskiness of the stock.

The recent stellar performance of companies with negative free cash flows is not sustainable. The accounting profit usually talked about in the press is often just a paper profit which can be exaggerated. A company uses cash to pay employee salaries, pay dividends to investors and grow its business. Any company that has to constantly tap the capital markets to grow is inherently riskier, especially now that interest rates are rising.

At this stage of the economic cycle, we avoid companies with negative free cash flows and focus on stable businesses which have lower growth potentials but don't depend on friendly markets to maintain their growth.