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The Free Cash Flow/Small-Cap Anomaly

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Among small-capitalization firms, defined as those having market values below $2 billion, some are consistent free cash flow generators, have low financial leverage, and sell at low free cash flow multiples. Presented herein is an investment strategy that selects such securities into a "long" portfolio with returns that outperform the market index, returns of similar-sized securities, returns of firms with similar book-to-market-value ratios, and returns of similar-risk (beta) securities.

The finance literature at the beginning of the 1980s documented the existence of higher abnormal returns to small-capitalization stocks than to their larger counterparts.[1] Indeed, the financial markets immediately capitalized on this research by offering funds specializing in small-cap securities. Although the performance of small-cap companies has not always been better than that of large firms (a notable example is during the market crash of October 1987), recent studies continued to document the importance of size in determining security returns.[2]

Another anomaly that has recently attracted attention is the use of cash flows in security valuation. In particular, several authors have recommended the use of free cash flows in portfolio selection.[3] Others have documented the information content of cash from operations (and components of cash flows) beyond earnings in explaining the cross-sectional variation of security returns.[4]

The purpose of this study is to combine these two anomalies into a single portfolio strategy that selects small firms that have, among other logical criteria, low free cash flow multiples. The investment strategy takes a "long" position in securities of small firms that have shown a consistent ability to generate free cash flows, that have low financial leverage, and that are selling at a low free cash flow multiple. Although these firms are small, they are unlikely to be in their embryonic or initial growth stages; instead, they typically operate in a stable business environment but are likely mispriced by the market because of lower earnings than expected. Thus, investors "overreact" to negative earnings or to negative earnings prospects, instead of looking at these firms' strong free cash flows.

This investment strategy is intuitively appealing because it combines the benefits of growth and value investing. Prior studies indicate that small firms are likely to grow at a faster rate than large firms, but they are also likely to be exposed to greater risks, be less diversified (which implies greater operating risk), and have a greater financial risk than large firms. The selection of small firms with low operating and financial risks seems to reduce the inherent risk of small-firm investments.

The results of this study indicate that it is possible to construct a portfolio of small firms that outperforms the market portfolio, as well as portfolios of other firms of similar size, book-to-market ratios, and systematic risk.

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FREE CASH FLOW: THEORY, DEFINITION, AND ESTIMATION TECHNIQUES

Assume that the market value of a firm is the discounted present value of future dividends; that is,

$$P_t = \sum_{\tau=1}^{\infty} (1+r)^{-\tau} E[d_{t+\tau} | Z_t], \quad (1)$$

where P_t is the market value of the firm at the end of period t, r is the required rate of return on investment in the firm, d_t is dividend at period t (can be positive or negative, as in the case of new investments by owners), Z_t is the information available to market participants at the end of period t, and $E[.]$ is the expectation operator.

The identity of sources and uses of cash flows

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