

Exploring the Quality Dimensions of Free Cash Flow Yield

– Danke Wang, CFA, FRM, Portfolio Manager

Pacer US Cash Cows 100 ETF (COWZ) screens for high Free Cash Flow Yield (Free Cash Flow / Enterprise Value) companies within the Russell 1000 Index. As a value factor, Free Cash Flow Yield (FCF Yield) offers investors an effective way for identifying undervalued companies. Nevertheless, the quality side of the story has not been thoroughly explored.

Key Takeaways

1. Companies boasting high FCF Yield may exhibit robust quality attributes, despite their value orientation.
2. Traditional quality strategies tend to prioritize growth-centric factors over time.
3. The Pacer US Cash Cows 100 ETF (COWZ) serves as a valuable augmentation to the portfolios of quality-focused investors.

Quality investing seeks to invest in financially sound companies characterized by strong earnings and stable balance sheets. How does this concept relate to COWZ and FCF Yield?

By expanding the FCF Yield formula with detailed components, it allows for various critical quality indicators to be uncovered. The formula encompasses fundamental metrics that provide insights into the quality of a company's financial performance, including profitability, leverage, and earnings quality.

$$FCF\ Yield = \frac{FCF}{Enterprise\ Value} = \frac{Net\ Income + Non-Cash\ Expense - Increase\ in\ Working\ Capital - Capital\ Expenditure}{Market\ Cap + Debt - Cash}$$

1. Profitability

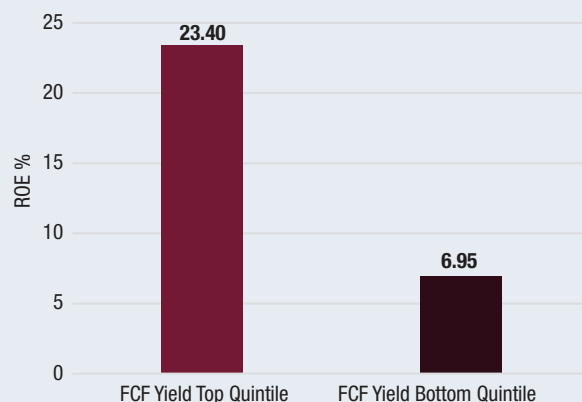
Return on Equity (ROE) is a gauge of profitability, measuring a company's net income divided by its shareholder equity. A higher ROE signifies better company quality. When examining the FCF Yield formula, net income is in the numerator and market capitalization (linked to shareholder equity) is in the denominator. This reveals a higher FCF Yield may translate to potentially elevated ROE.

The chart on the following page demonstrates that top quintile FCF Yield companies in the Russell 1000 Index exhibit higher median ROE compared to the lower yielding counterparts.

$$FCF\ Yield = \frac{Net\ Income + Non-Cash\ Expense - Increase\ in\ Working\ Capital - Capital\ Expenditure}{Market\ Cap + Debt - Cash}$$

Source: Pacer Advisors, FactSet

ROE (Median) Russell 1000 Index Top and Bottom FCF Yield Quintile
7/31/2023



2. Leverage

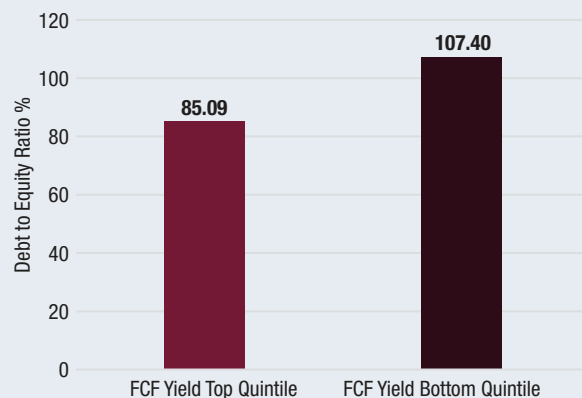
Leverage refers to the use of debt for investment and business. It can enhance shareholder value while also introducing a degree of financial risk. The most used leverage ratios include debt-to-asset and debt-to-equity. A high debt-to-equity ratio reveals a company's reliance on debt financing, which may be an indicator of increased risk. As indicated by the FCF yield formula, high amounts of debt will increase enterprise value and lower earnings yield.

The below chart illustrates that top FCF Yield stocks in the Russell 1000 Index exhibit lower debt-to-equity ratios compared to their low FCF Yield counterparts.

$$FCF\ Yield = \frac{FCF}{Market\ Cap + Debt - Cash}$$

Source: Pacer Advisors, FactSet

Debt-to-Equity Ratio (Median) Russell 1000 Index Top and Bottom FCF Yield Quintile
7/31/2023



3. Earnings Quality

There are several methods available for assessing the quality of a company's earnings, including considerations of earnings variability and accruals.

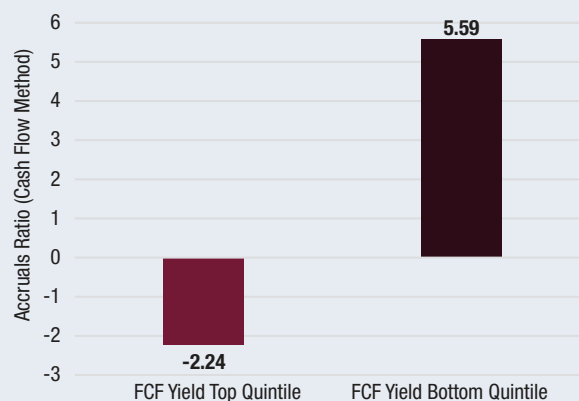
High earnings variability is generally seen as a negative indicator because it may make predicting a company's future earnings and dividend payments more difficult. Consistency in earnings is often preferred as it indicates stability and reliability. While FCF Yield is a useful metric for evaluating a company's financial health, it may not provide a comprehensive picture of a company's long-term financial stability. However, FCF Yield assesses earnings quality from a different perspective.

PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS. YOU CANNOT INVEST IN AN INDEX.

In accrual-based accounting, revenue is recognized when earned, regardless of payment receipt. For example, if a company sells a product in May, but does not receive the cash payment until September, the revenue would be recorded in Q2. The accruals ratio gauges the proportion of non-cash earnings in total profit. A high accruals ratio suggests a larger portion of non-cash earnings, possibly signaling concern. FCF, being less prone to manipulation, adjusts the non-cash earnings (by adding back the non-cash expense and subtracting the increasing in working capital), so we should expect lower accruals ratios from high FCF Yield names.

$$FCF\ Yield = \frac{Net\ Income + Non-Cash\ Expense - Increase\ in\ Working\ Capital - Capital\ Expenditure}{Market\ Cap + Debt - Cash}$$

Accruals Ratio – Cash Flow Method (Median) Russell 1000 Index Top and Bottom FCF Yield Quintile
7/31/2023

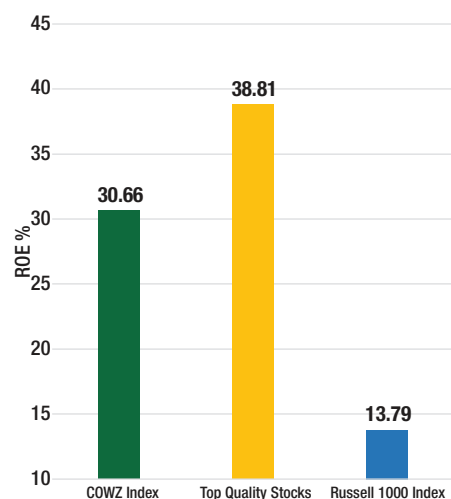


Source: Pacer Advisors, FactSet

Putting all the pieces together

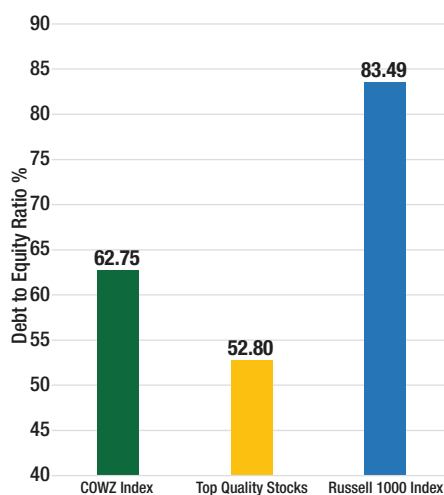
When we compare the quality characteristics of the Pacer US Cash Cows 100 Index (COWZ Index), with a basket of high quality companies (top quality stocks*), and the Russell 1000 Index, we unveil that the COWZ Index has higher return on equity (ROE) and lower leverage—on par with the top quality stocks—while exhibiting better earnings quality indicated by lower accruals ratio.

ROE (Median)
as of 7/31/2023



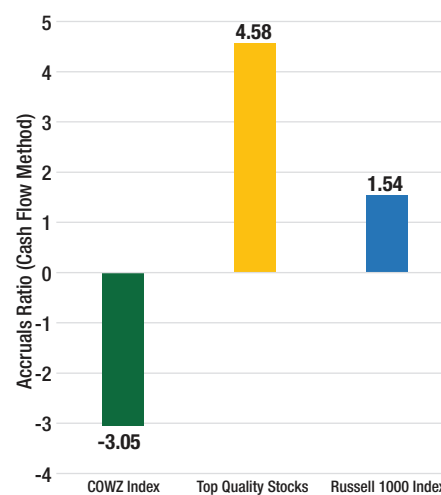
Source: Pacer Advisors, FactSet

Debt/Equity (Median)
as of 7/31/2023



Source: Pacer Advisors, FactSet

Accruals Ratio - Cash Flow Method (Median) as of 7/31/2023



Source: Pacer Advisors, FactSet

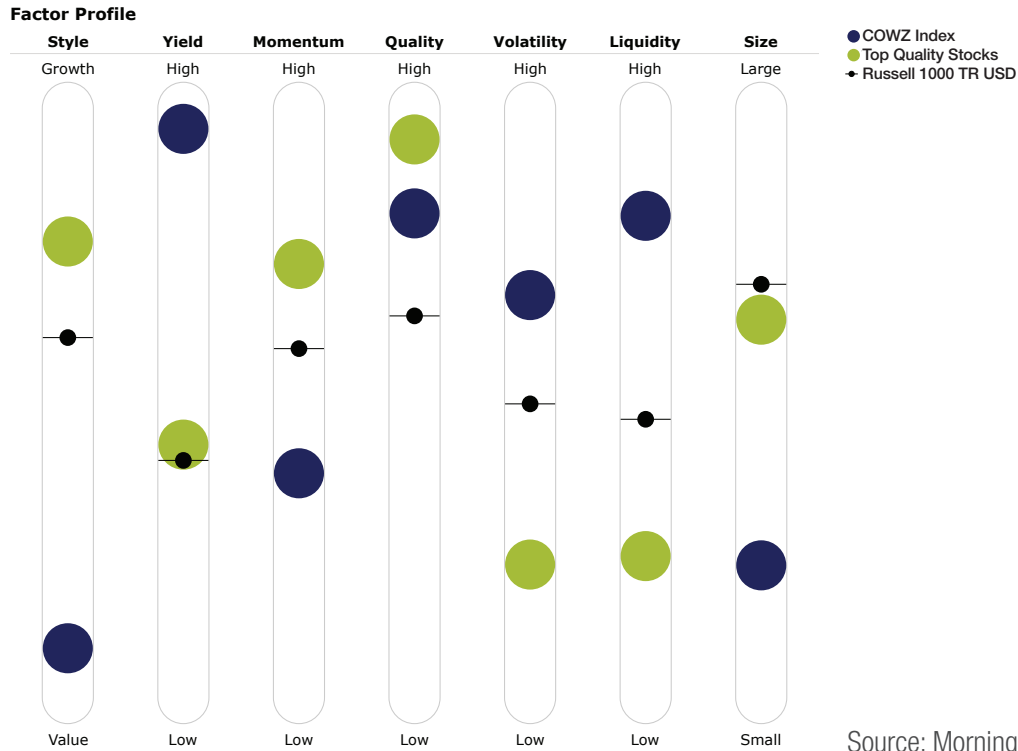
Meanwhile, the Morningstar style analysis also confirms that both the COWZ Index and top quality stocks are at the higher end of the quality factor spectrum.

*top 100 highest quality stocks within the Russell 1000 Index following the MSCI quality factors (including ROE, Debt-to-Equity, Earnings Variability)

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Morningstar Factor Profile

as of 6/30/2023



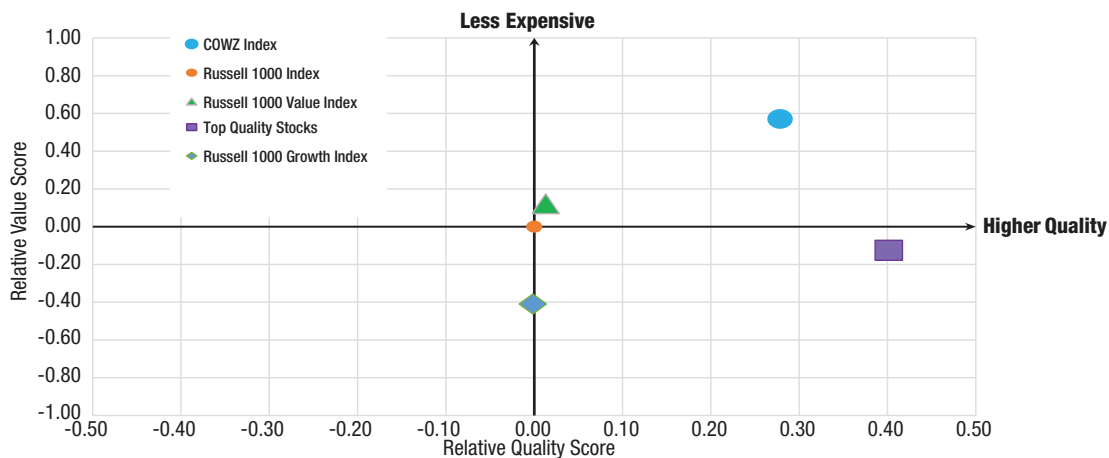
While the COWZ Index and top quality stocks share similar quality attributes, their divergent performances warrant scrutiny. Year-to-date as of 7/31/2023, the top quality stocks outperformed the COWZ Index by 8%. What have we overlooked?

An observation worth mentioning in the Morningstar style analysis is that in the value-growth style alignment, the COWZ Index leans toward the value segment, whereas the top quality stocks exhibit a stronger growth tilt relative to the broad benchmark.

In a different study, when isolating quality and valuation, and placing them on the x and y axis, we identify the relative position of the COWZ Index, top quality stocks, and other value and growth benchmarks. As shown below, the COWZ Index stands on the cheaper side with higher quality, while top quality stocks show higher quality but also trade at a valuation premium relative to the market.

Relative Value and Quality Scores

as of 7/31/2023



Source: Pacer Advisors, FactSet

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We further calculated the 52-week correlation with the Russell 1000 Growth Index based on excess returns. By the end of July, the number for top quality stocks is positive, while the COWZ Index has a negative correlation with growth. Over the long term, top quality stocks exhibit a historical tendency to correlate more with growth than with value.

52-week weekly excess return correlation against the Russell 1000 Index as of 7/31/2023

Top Quality Stocks	COWZ Index	Russell 1000 Growth Index	Russell 1000 Value Index
0.36	-0.69	1.00	-1.00

Source: Pacer Advisors, Bloomberg

52-week weekly excess return correlation against the Russell 1000 Index 12/31/1999 - 7/31/2023

- Top Quality Stocks
- Russell 1000 Growth Index
- Russell 1000 Value Index



Source: Pacer Advisors, Bloomberg

Regarding year-to-date performance, top quality stocks demonstrate a higher beta against the growth benchmark as evident below. According to the R-squared, approximately 85% of the top quality stocks return can be attributed to the performance of the Russell 1000 Growth Index. So, in 2023, quality has been largely driven by growth outperforming value.

Beta (Daily Returns) Against the Russell 1000 Growth Index 12/30/2022 - 7/31/2023

Top Quality Stocks	COWZ Index	Russell 1000 Growth Index	Russell 1000 Value Index
0.80	0.62	1.00	0.60

Source: Pacer Advisors, Bloomberg

Top Quality Stocks vs Russell 1000 Growth Daily Returns

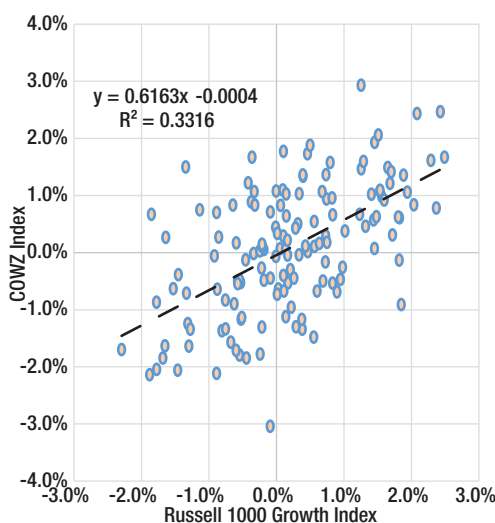
12/30/2022 - 7/31/2023



Source: Pacer Advisors, Bloomberg

COWZ Index vs Russell 1000 Growth Daily Returns

12/30/2022 - 7/31/2023



Source: Pacer Advisors, Bloomberg

Russell 1000 Value Index vs Russell 1000 Growth Daily Returns



Source: Pacer Advisors, Bloomberg

However, in 2022 when value stocks led the market, top quality stocks trailed behind COWZ Index. Going back further, during growth-dominated periods, top quality stocks surpassed the Russell 1000 Value Index by an average of 10.68%, while during value-dominated periods, top quality stocks experienced an average underperformance of more than 6%.

Average yearly returns relative to Russell 1000 Value

12/31/1999 – 12/30/2022

	In years when growth outperformed	In years when value outperformed
Top Quality Stocks relative to Russell 1000 Value Index	10.68%	-6.07%

Source: Pacer Advisors, Bloomberg

The affinity between quality and growth comes with another argument if not concern. Quality may appear expensive, yet it may benefit from multiple expansions when investors seek safe companies during market turmoil. However, it could fall out of favor when valuations are stretched while investors can find better deals elsewhere.

In contrast, the COWZ Index tends to trade at attractive valuations and presently stands at a substantial discount to both the S&P 500 Index and top quality stocks, while still offering high-quality exposure. Below underscores the contrast in valuation metrics, revealing the COWZ Index's attractive forward PE of 10.76 compared to top quality stocks's 23.25 and the S&P 500 Index's 20.91.

Forward PE Ratios

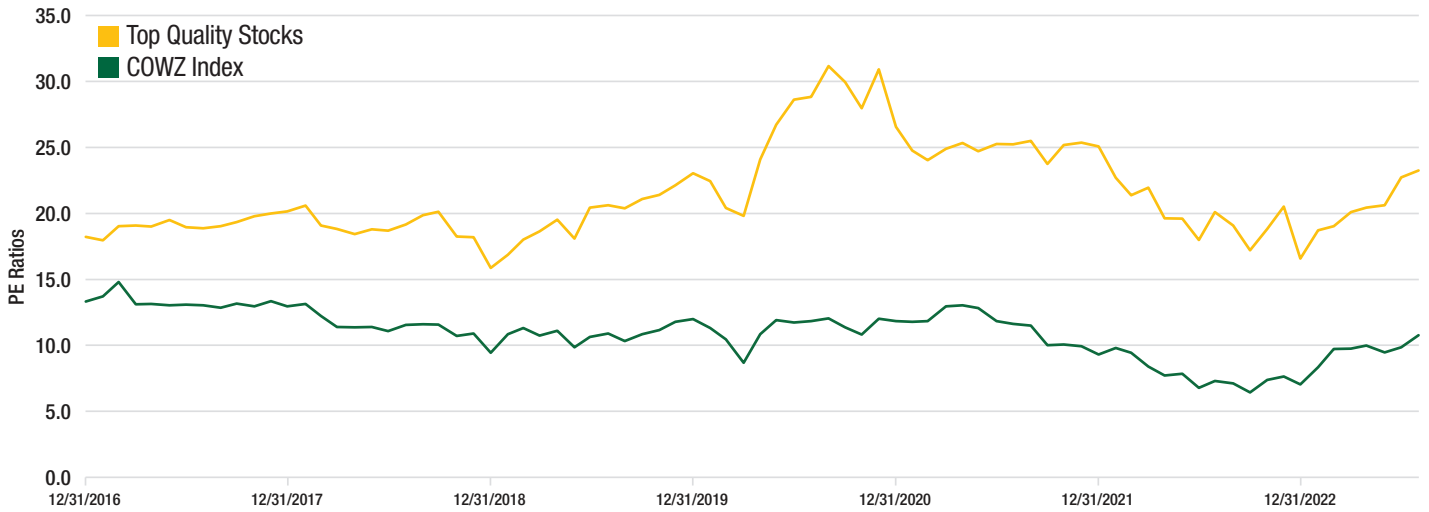
as of 7/31/2023

COWZ Index	Top Quality Stocks	S&P 500 Index
10.76	23.25	20.91

Source: Pacer Advisors, Bloomberg

Forward PE Ratios

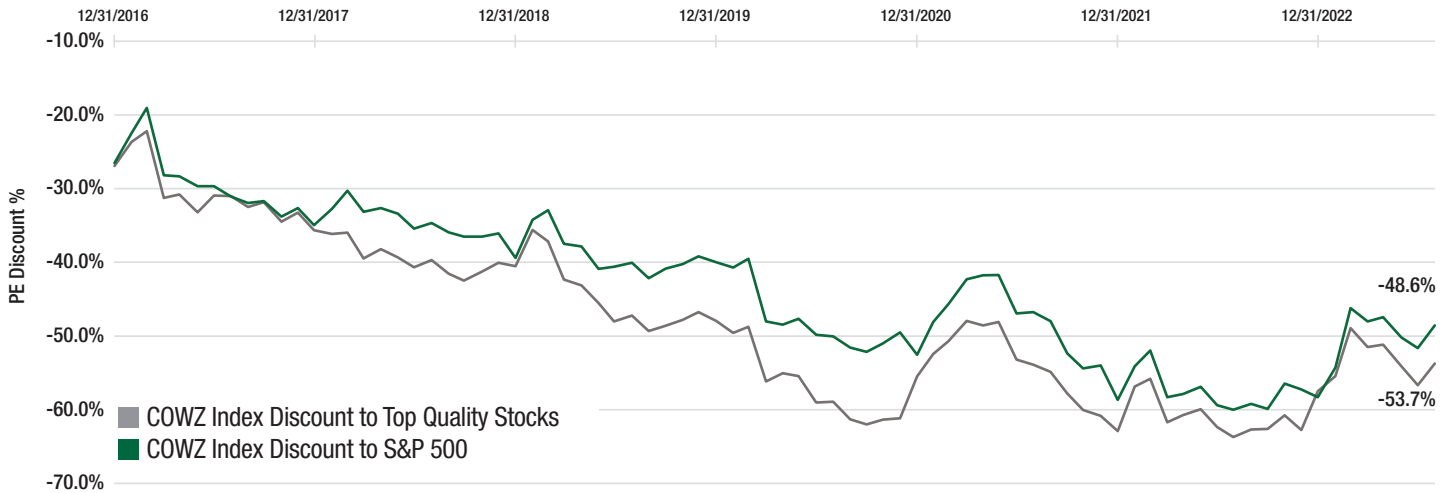
12/31/2016 - 7/31/2023



Source: Pacer Advisors, FactSet, Bloomberg

Forward PE Discount

12/31/2016 - 7/31/2023



Source: Pacer Advisors, FactSet, Bloomberg

For investors seeking high-quality companies, COWZ emerges as a compelling addition to traditional quality strategies. It serves to mitigate the impact of high valuation multiples and smooth out the turbulence of growth and value market cycles. The interplay of quality and value aligns COWZ as a valuable option for investors striving to navigate the intricacies of the market and capitalize on the potential of high-quality investments.



Pacer US Cash Cows 100 ETF

Is a strategy driven exchange traded fund that aims to provide capital appreciation over time by screening the Russell 1000 for the top 100 companies based on free cash flow yield.

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Performance

as of 8/31/23

Ticker	Total Expenses	Fund Inception		Total Returns (%) as of 8/31/23			Total Returns (%) as of 6/30/23				
				1 Month	3 Month	YTD	1 Year	3 Year	5 Year	Since Fund Inception	
Pacer US Cash Cows 100 ETF	COWZ	0.49%	12/16/16	NAV	-0.40	15.15	11.09	13.50	23.83	12.47	12.78
				Market Price	-0.39	15.23	11.05	13.49	23.75	12.28	12.74
Pacer US Cash Cows 100 Index					-0.37	15.30	11.48	14.00	24.42	12.94	13.24

Returns less than 1 year are cumulative. Returns greater than 1 year are annualized.

Performance quoted represents past performance and does not guarantee future results. Investment return and principal value will fluctuate, so shares may be worth more or less when redeemed or sold. Current performance may be lower or higher than the performance quoted. Visit <http://www.paceretfs.com> for the most recent month-end performance. Index returns are for illustrative purposes only. Index performance does not reflect any management fees, transaction costs, or expenses. You cannot invest directly in an index.

NAV (net asset value) is the value of one share of the Fund calculated daily. The NAV return is based on the NAV of the Fund. It may not reflect the actual return for the investor.

Market Price is the price investors can buy and sell ETF shares for in the stock market and is used to calculate market return. It is based on the price at the listed exchange market close. This is when NAV is determined for most ETFs. If shares trade at another time, the return may differ. Market and NAV returns assume that dividends and capital gain distributions have been reinvested in the Fund at Market Price and NAV respectively.

Correlation: Correlation (or correlation coefficient) is a statistical measure of the strength of a linear relationship between two variables.

Beta: Beta is a statistic that measures the expected increase or decrease of an individual stock price in proportion to movements of the benchmark.

R-Squared: R-Squared (R^2 or the coefficient of determination) is a statistical measure in a regression model that determines the proportion of variance in the dependent variable that can be explained by the independent variable.

Regression: A regression is a statistical technique that relates a dependent variable to one or more independent (explanatory) variables.

Working Capital: Working capital is a measure of a company's liquidity and short-term financial health, calculated as the difference between current assets and current liabilities.

Receivable: Accounts receivable are the balance of money due to a firm for goods or services delivered or used but not yet paid for by customers.

Net income: Net income refers to the amount an individual or business makes after deducting costs, allowances and taxes.

Capital expenditure: Capital expenditure is money a company uses to purchase, maintain, or expand fixed assets.

Return on equity (ROE): Return on equity is a financial ratio that measures the performance of a company based on its shareholders' equity outstanding, calculated by net income divided by its total shareholders' equity.

Debt-to-Equity: The debt-to-equity ratio indicates how much debt a company is using to finance its assets relative to the value of shareholders' equity.

Debt-to-Asset: The debt-to-asset ratio is a leverage ratio that defines how much debt a company owns compared to its assets.

Accruals Ratio - Cash Flow Method: The calculation takes the difference between net income and the sum of operating and investing cash flows divided by the beginning and ending period average net operating assets. Net operating assets are a business's operating assets minus its operating liabilities.

Quality score: The Quality Score is calculated based on the S&P quality index methodology.

<https://www.spglobal.com/spdji/en/indices/dividends-factors/sp-500-quality-index/#overview>

Value score: The Value Score is calculated based on the S&P style index methodology.

<https://www.spglobal.com/spdji/en/indices/dividends-factors/sp-500-value/#overview>

Free Cash Flow (FCF): A company's cash flow from operations minus capital expenditures (expenses, interest, taxes, and long-term investments)

Free Cash Flow Yield: FCF/EV. Measures a company's total free cash flow relative to its enterprise value. This is an internal statistic and does not constitute investor yield.

P/E: price-to-earnings ratio is the ratio for valuing a company that measures its current share price relative to its earnings per share (EPS).

Forward P/E: Forward price-to-earnings is a version of the ratio of price-to-earnings (P/E) that uses forecasted earnings for the P/E calculation.

Russell 1000 Index: is a market-capitalization weighted index representing the top 1000 large-cap stocks in the Russell 3000 Index.

Russell 1000 Value Index: is a market-capitalization weighted index representing approximately 1000 large- and mid-cap value stocks in the Russell 3000 Index.

Russell 1000 Growth Index: is a market-capitalization weighted index representing approximately 1000 large- and mid-cap growth stocks in the Russell 3000 Index.

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