SEVENS REPORT *alpha*

3.1.18

Tom: Good afternoon, everyone. Welcome to another Sevens Report Alpha webinar. I'm really excited about today's topic. Mainly because it was serendipitous the way it came about. I'll tell the story in a minute. First, I want to introduce our guest, who will be with us from TrimTabs Asset Management, Janet Flanders Johnston. She will help us cover how they use free cash flow to generate alpha and why free cash flow can be such an alpha-generating metric to pay attention to as we pick investments.

Janet, thank you very much for joining us today,

Janet: Hi Tom. Thanks for the opportunity to talk about TrimTabs Asset Management and our ETF. I'm looking forward to sharing our methodology and how we generate alpha using free cash flow.

Tom: How we got onto this topic was a little serendipitous. Grant, who is the analyst who helps me with a lot of Alpha research, and I were looking over some of the performance of some of the things we'd sent out over the last six months and came across that list of 8% free cash flow generating stocks that we sent out several months ago. When we were reviewing the performance, as we said in the email, it was beating the S&P 500 up by 3% in what was a roaring market through the end of 2017 and is even holding up well through the current volatility. We wanted to flush this idea of free cash flow out a bit more and that led us to TrimTabs and eventually to Janet. With that said, we're going to go quickly through each of these parts, but we're going to focus on really showing why free cash flow can be an alpha-generating strategy. Janet has been nice enough to give us some of her top stock picks that they think can really outperform. So we'll get going right into it.

Goals for Today's Webinar

- Janet Flanders Johnston, CFA – Portfolio Manager at TrimTabs Asset Management
  - Introduction to TrimTabs
  - Why Free Cash Flow?
  - Additional Layers: Share Count Reduction and Strong Balance Sheets
  - An Alpha Delivering Strategy
  - Top Stock Picks

We're going to talk a little bit about TrimTabs, I imagine some of you recognize that name; I did when Grant came to me with Janet for the webinar. We're going to focus on why free cash flow is an important metric to monitor. We're also going to go more in-depth and Janet is going to explain the additional things her firm does that really turns that free cash flow metric and analysis into an alpha-generating strategy. Then we'll go over some of her top stock picks.

TrimTabs Asset Management, I recognized it and you might recognize it from their flow data. They used to do a lot, and I think still do, flow data into different mutual funds and sectors and asset classes. We used to use it a lot when I was on the buy side. They also have an asset management arm. Janet, why don't I bring you in now and why don't you tell us a little bit about TrimTabs Asset Management.

Janet: We were founded by Charles Biderman and many of your subscribers may have heard of Charles. He is a regular on CNBC with Rick Santelli. He started this research firm in the early 90s and one of the things he looked at was supply and demand factors in terms of share count and companies who are purchasing shares or doing secondary offerings and how that impacted the price of the stock. He was also an early believer in using free cash flow as a shield against corporate shenanigans in their earnings report. He founded TrimTabs Asset Management in 2011 and in 2011 we launched the first next-generation active equity multi-factor ETF.

TrimTabs Asset Management

- 25 years of experience in proprietary research, including: analysis of equity market liquidity, macroeconomic trends, and free cash flow
- Strive to deliver "smart alpha" (using active management and multi-factor models to create dependable 'all-weather' portfolios)
- Investment management services since 2011
- Family of ETFs and SMA accounts that focus on:
  - Free cash flow strength
  - Balance sheet quality
  - Share count reduction

TRIMTABS
ASSET MANAGEMENT

Tom: You mentioned the shenanigans of corporate financial reporting. For those of us who have conducted fundamental research, earnings research, going through these 10K and 10Qs can be challenging if you're trying to figure out exactly what's going on with a company. Can you go over some of the challenges you see in going over publicly available financial reports?

Janet: I did want to take a step back. With our portfolio, we're trying to generate all-weather portfolios so they outperform in up markets and down markets. With Morningside, we collect our upside capture ratios and our downside capture ratios and our models do tend to outperform in both markets. What we have found by using free cash flow growth, when there's volatility on the downside we're sitting on mountains of cash and strong balance sheets. It's really the pairing of free cash flow growth with a strong balance sheet – that's a high quality pairing. Those types of companies are rising to the top of our list. The thing we like about free cash flow is that it's not discretionary. It is what it is. When companies are reporting their earnings, revenue accounting is all about the timing. There's a lot of discretion. But its reporting may not coincide with when the cash hits the account. Expense accounting, you can capitalize or expense. Corporations are always making decisions. Those are big ones that impact what earnings are going to look like. Intangibles can be very hard to value. Customers, trademarks, copyrights. There's so many discretionary items going into reporting.

There was an academic report in the *Financial Analyst Journal* in 2016, a survey of 400 CFOs. The results were pretty sobering. 20% said that earnings reports are intentionally distorted and that 10% of reports are distorted a significant or material amount. We believe free cash flow is a way to skirt all of the discretion and non-cash items that go into the reports.

Challenges of Corporate Financial Reporting

- **Revenue** accounting is often discretionary
- **Expense** accounting is also often open to "interpretation"
- **Intangibles** accounting, a growing balance sheet item, is largely discretionary

Tom: It's interesting you say that. I could tell you practically that makes a lot of sense. Back in a previous point in my career I was doing a lot of quarterly finance analysis on mining companies, energy companies, and you never looked at the earnings. You never looked because depreciation would massively disrupt the earnings. With all these accounting gimmicks, trying to figure out how much a stock was value or how to value a stock, you always looked at cash flow. Because of the end of the day, cash is king. That's something we all can understand in our own businesses.

You guys go a bit further in looking past just cash flow and looking at the total financial health of the company. Not just the balance sheet, but also what is going on with share count and float and things like that, correct?

Back to the Basics: Benchmarks of a Strong Company

- **Growth** (especially, cash) for shareholders
- **Transparency** for shareholders – minimizing accounting gimmicks
- Superior **balance sheets**
- **Share count reduction** utilizing free cash flow

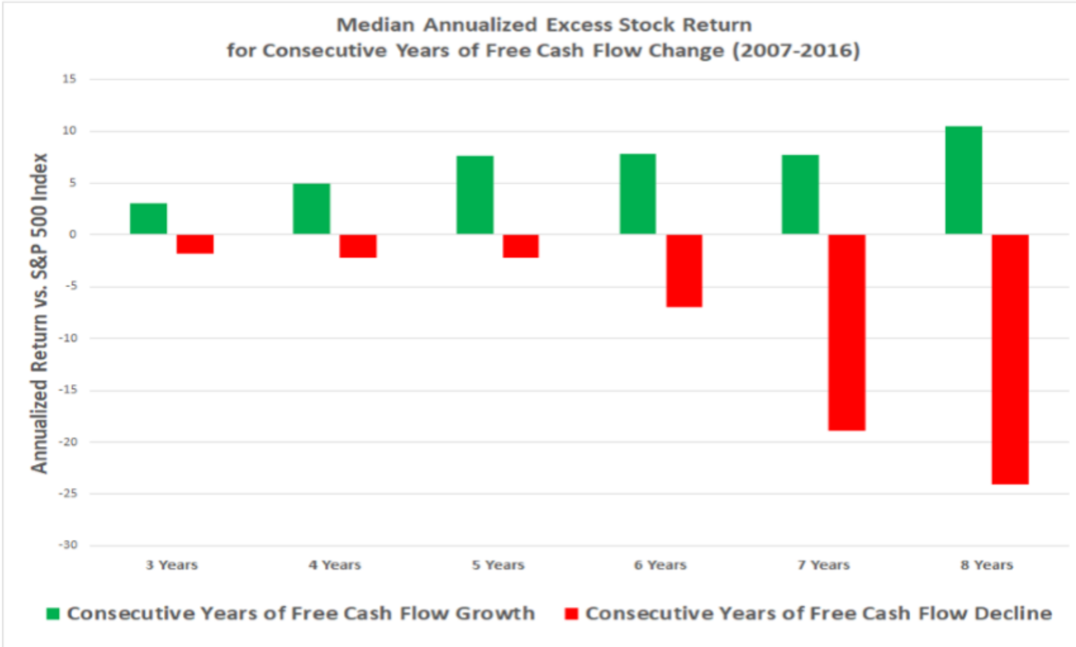
Janet: Absolutely. We're looking at the free cash flow growth and pairing it with improving balance sheets. That gets us to a quality list of companies that are growing organically. Then we look at share count reduction because we don't want our interest to be diluted. If it's getting bigger, if companies are repurchasing their stock, we like that. But we don't want to buy companies that are issuing debt, levering up their balance sheet, buying stock to financially engineer growth. We want to see them purchasing stock from free cash flow.

Tom: Leveraging up and issuing debt to repurchase stock has been a popular trick, especially the last couple of years with rates so low. I think we've seen a lot of companies doing that, much more so than we're used to.

Janet: A large percentage of the stock buy backs. So we want to make sure we get that cash cushion.

Tom: This slide is easily the most important slide of the whole presentation because it very clearly shows you how much of a differentiating factor free cash flow change – positive free cash flow change, or negative free cash flow change – can make in performance versus the S&P 500. Just look at this. For the number of consecutive years that a company is growing free cash flow, the outperformance over the S&P 500 just continues to grow. Almost as powerful in this slide, is if I own a stock and free cash flow is declining, the amount of underperformance that occurs is quasi-scary. I imagine your experience has shown you the same thing in practical terms.

The Power of Cash Flow



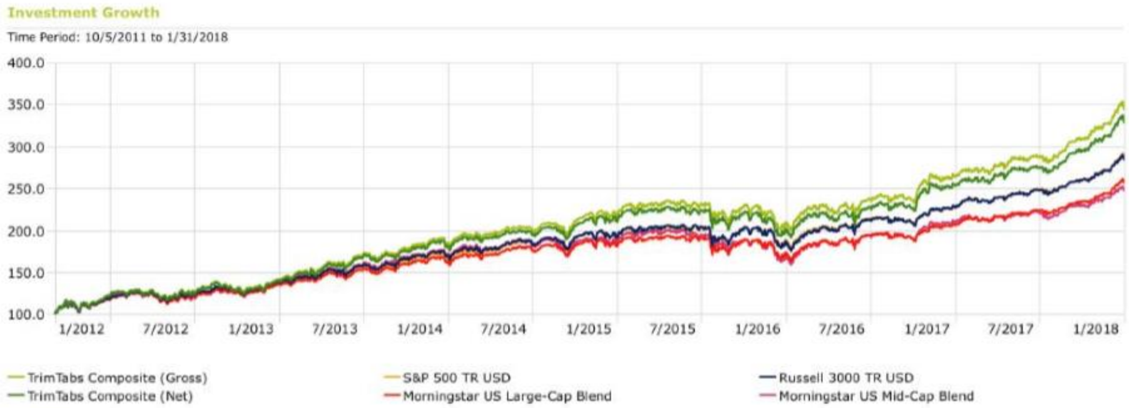
Janet: Absolutely.

Tom: To a point, how difficult is it for you guys to really drill into these filings and these reports and get a really good idea of free cash flow? I imagine it's more difficult than just looking at the 10Q and trying to subtract some things out. I imagine you guys take it a step further.

Janet: We have Bloomberg and our models are very robust. We have a quant that is constantly refining and automating and doing further studies in terms of our model. Basically, we start with the Russell 3000 names, we take the 1500 most liquid and with our programs and models and technology we're able to very quickly rank all of these companies and look at how the individual companies rank within each variable. Once we get that list, there are often a lot of companies tied or closely ranked and that's where the active management comes in.

We view, as portfolio managers, ourselves as pilots. We try to factor in things the computer model can't anticipate. For instance, if there's a sector that ranks well but maybe there's a lot of disruptive technology – retail would be the one that comes to the top of the list. Amazon is being very disruptive in this sector. Many retail companies screen well on our models, but we'll take a deeper dive to make sure we think they're well-positioned to outperform and that we're not overexposed to that sector.

Focusing on Free Cash Flow – Along with Balance Sheet Ratios and Share Count Reduction – DELIVERS ALPHA



Performance

Time Period: 10/5/2011 to 1/31/2018 Source Data: Daily Return Calculation Benchmark: Russell 3000 TR USD

	Annualized Return	Cumulative Return	Excess Return	Std Dev	Information Ratio (arith)	Beta	Sharpe Ratio (arith)
TrimTabs Composite (Gross)	21.57	244.09	3.56	16.90	1.00	1.01	1.92
TrimTabs Composite (Net)	20.67	228.29	2.66	17.06	0.75	1.02	1.82
Russell 3000 TR USD	18.01	185.16	0.00	15.82	—	1.00	1.69
S&P 500 TR USD	18.15	187.28	0.14	15.45	0.17	0.97	1.75
Morningstar US Large-Cap Blend	16.09	156.99	-1.92	15.32	-2.91	0.97	1.55
Morningstar US Mid-Cap Blend	15.41	147.60	-2.60	16.77	-1.10	1.03	1.36

We are also very focused on tax considerations, even though we were up 27% last year, we did not generate a capital gain for our shareholders. We'll also factor in things like legislation, political or regulatory risks. With the tax reform, many of the financial companies are going to be big winners and the stocks are starting to reflect that. It won't be in their earnings numbers until the second quarter. Whereas utilities really aren't going to benefit at all from tax reform. They're regulated, they'll have to pass the extra cash down to their customers. For instance, Facebook, which has very large cash flow, we think there's a lot of regulatory risk because of the Russians using their platform in the election. We sold it.

Mostly we're just there to guide the portfolio, but we do take a look at other things that our model can't anticipate for us.

Tom: Do you guys look at the statistics and do you weight – because the return numbers we've put up on the screen imply that the more consecutive years of cash flow growth the greater outperformance. Do you guys have any qualifier where you're not even going to look at a name unless it's been growing cash flow for three years or five years? Or if it immediately becomes consecutive is it eligible?

Janet: We don't have a qualifier because we rank all of our stocks relative to all the other stocks in the universe. We do rank based on longer-term cash flow growth and short-term.

Tom: In your experience, the more consistent the cash flow growth the better the chances that you're going to get outperformance. So that's a pretty big characteristic that you want to look for when you're considering investments, even if it's an advisor going through a list of stocks.

Janet: That's why we look at both time periods. If there's something that's happening now that's dramatically changing a business that will be picked up in the shorter term number. But the longer term number gets a better idea consistently.

Tom: This slide that we're showing just reinforces the fact that using free cash flow as that foundation of the individual company analysis can lead to outperformance. The more consistent that cash flow growth, the better the outperformance over the longer term.

Now I'd like to shift gears a little and be able to pick your brain about some of the names and specific stock picks you sent to us. People will have some fodder to go back and consider for their clients. We'll start with Zoetis (ZTS).

Janet: Zoetis has been out for five years. It's the only pure play, publicly traded company in animal medications and vaccinations. They're the market share leader for companion animals, horses, livestock, poultry. It's a global company. Very consistent performer.

Tom: I imagine the macro-tide is positive. I feel like every couple months I'll see on CNBC or Fox News they talk about the amount of money Americans are spending on their pets and animals. It just seems to continue to go up every single year. Would you say there's a rising tide helping this name?

Top U.S. Stock Picks

- Zoetis (ZTS): pure play in animal medicine and vaccinations
- Walmart (WMT): online disruption
- Nvidia (NVDA): powering state of the art technologies
- Match Group (MTCH): monetizing leading online dating platforms
- Myriad Genetics (MYGN): leader in personalized medicine

Janet: There is a rising tide. I think it's a play on people spending more on their pets, but I think it's also a play on synchronized global growth as emerging economies consume more chicken and more meat. In some sense, it's a play on the emergence of China and other countries.

Tom: Walmart (WMT), should be interesting to talk about given last week. Obviously, the earnings were a little disappointing, but talk to me about Walmart and what you guys are seeing there, especially with that's going on with their online improvements.

Janet: They were down 15% last quarter based on Q4 earnings. They really stumbled over the holidays in their online execution. From what I understand, they couldn't keep up with the demand. They hadn't sourced enough inventory and they couldn't get it out to keep up with the orders. I believe that if anyone can sort out supply and inventory management issues it's Walmart. They've been doing this for a long, long time. They have a very smart leader of their online division. He's very well-respected. He sold a couple companies that he built up; he's got a really big following.

Tom: Was he the guy from Jet?

Janet: Yes. So I think they've got the right person and it's interesting they've got an advantage because they don't' have to build warehouses. They can use their stores and the logistics and a lot of infrastructure they already have in place. When I hear companies are stumbling because they can't keep up with demand, but you know they have the ability to meet it and they didn't take their guidance down of 40% growth. I think it's a good opportunity to buy it.

Tom: You answered my next question. I was going to ask if you were still bullish on the name and it sounds like yes and this may be an opportunity. So that's definitely something to consider there.

Nvidia (NVDA), a popular tech name. I'm sure people are aware of it. If I could interject for a second before letting you speak about it. Do you guys have a valuation screen that you consider where if a name gets too expensive compared to the sector will it result in you taking profits? Or is that not big into consideration?

Janet: It's secondary. Nvidia is a name we have trimmed over time because we've owned it for a long time. We have 100 positions in our portfolio. We occasionally trim when a position gets way out of whack in terms of weighting. We will sometimes trim it when we're buying new positions and pair it with a loss that we may be selling.

Nvidia is at the top of the food chain in terms of consumer processes. Their cloud data center business is growing over 100% year-over-year, they are a leading provider in terms of computer gaming processors. Their processes are well-suited for artificial intelligence applications, autonomous vehicles, blockchain technology. We really believe it's the leader in terms of driving these future technologies that are going to be increasing productivity.

Tom: It's obviously had a great run. But a lot of the things you mentioned there are growth areas of the economy and certainly have a tremendous potential.

The next one surprised me because I hadn't thought of this name as a big free cash flow generator but clearly I'm wrong. Match Group (MTCH), Match.com the dating site. Tell us what you like about that.

Janet: They, by far, are the market share leader in online dating. They own Tinder, Match, OKCupid, along with a portfolio of smaller properties. What they're starting to do is monetize Tinder. They have 3.5 million subscribers on Tinder. The app for Tinder, when it was launched, was the number one app on iPhones over the holidays it briefly lost that spot and starting in January it reclaimed its spot. They're also starting to sell more advertisements on their dating sites. They have two or three different subscriptions on Tinder that people can purchase. They're really moving toward successfully monetizing their properties.

Tom: That's always positive, being the biggest mover. Just out of interest, what's their biggest expense? Is it mostly technology or is it advertising? I know they're advertising a ton. I imagine it's probably IT, but just wondering.

Janet: I would have to look. I think it's a high-margin business.

Tom: That's the crux of what I'm wondering. There's not a ton of cost it would seem. No real hard infrastructure cost. That's an interesting choice.

Going into the healthcare biotech space: Myriad Genetics (MYGN).

Janet: Myriad is an interesting play to me. They're not that many publicly traded plays on personalized medicine. They have a couple of new products that are growing really fast and then a stable batch of more mature products. They're the market share leader in hereditary cancer tests. This testing gives a lot of information in terms of how to treat a particular person's cancer. They have three new products that are very interesting.

One is if someone is diagnosed with prostate cancer they have a test that based on the genes and the type of cancer, can tell the physician how fast the cancer will grow and if it will metastasize or not. They also have a product on the psychiatric side where if you suffer from depression they can narrow down from a field of 29 drugs to the three that will work best for you with based on your genes. They'll also tell you which ones won't work and why and which ones might but they don't know. The reason why this has the potential to be a blockbuster product is with psychiatric drugs, there's such a long time before you know if it works. If someone is suicidal and very depressed, they don't necessarily have eight weeks to sort out if the drug is working or not. That product grew 40%. It was launched late last year and very strong growth numbers in Q4.

Tom: Is there consumer a element to it as well or is it mostly all physician-driven as far as this testing?

Janet: I think it's physician-driven. The thing that would hurt the stock is if there are reimbursement issues. Insurance companies are being aggressive in terms of the different types of procedures and tests that they will pay for in terms of personalized medicine.

Tom: That's true. I imagine that's a risk for virtually everything in the healthcare-provider space these days. Everyone is at the mercy of the insurance companies and what they're willing to pick up. Definitely an interesting story there.

Japan. Moving a bit internationally. Japan is your favorite country broadly for investment and then you have two specific names you like as well: Nomura and Oriental Land.

Top U.S. Stock Picks

- Zoetis (ZTS): pure play in animal medicine and vaccinations
- Walmart (WMT): online disruption
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Janet: We like japan based on the synchronized global growth, which we're seeing everywhere. Consumer confidence is improving. Leading economic indicators are improving. Japan's GDP has been increasing. We see interesting indicators. For instance, machine tool orders were up 48% year-over-year, 2.6% month-to-month. Tourism is up 400% over the last year. They've had an unemployment gap. They need more workers than they have. They're letting immigrants come in. Women, for the first time, are going to work. We're seeing women going to work in droves to fill the positions. We think part of it is due to strength in Asia, part of it is due to restructuring of some of their manufacturing sector and some of their other companies. They are a leader in industrial robotics. For instance, as China's population is aging they are buying more robotics.

The two companies that I highlighted, Nomura is the largest Japanese brokerage firm. The numbers that stand out to me, Japanese consumers are sitting on 51% cash earning interest. They only own 11% in Japanese equities. At the same time, we're seeing large and small companies beating their earnings expectations. We're seeing strong growth. We are seeing a little bit of inflation at below target, but it's slightly increasing. We think that's enough to get them off of their cash.

Tom: Would you advocate buying Japan from an ETF form if somebody couldn't transact these two specific names? In general, would you be supportive of a broad long of Japan?

Janet: We have an international ETF and it's the same basis as our domestic ETF. We're overweight Japan in that ETF. We own all the names that I'm highlighting today,

Tom: Fantastic.

The final name is global healthcare stock Indivior.

Janet: Indivior was just fast-tracked and they got approval with the FDA for a monthly shot of Suboxone. If you leave rehab on Suboxone, you're over 70% less likely to die of an overdose. If you're put on Suboxone when you're detoxing, you're 25% more likely to stay in treatment. I've seen studies from the

NIH that suggest that rehabilitation places that don't offer their patients Suboxone probably shouldn't be in business. Having the monthly shot solves a lot of the compliance issues that the industry has been concerned with just giving someone a handful of this stuff for a month. It saves lives and with the epidemic I think the bottom line is how do you save lives. This is the company with the answer.

Tom: Looks like it trades in London. Do they have an ADR in the states or would you have to buy it on the pink sheets?

Janet: You would have to buy it in London, it doesn't trade here.

Tom: Fantastic. That basically wraps up our half hour, but before I let you go, we put Alan Rubenfeld's name up here. If anyone is interested in learning more about TrimTabs and the various ETFs that they have out there that have performed very well, there is the information. Janet, I assume if any advisors want to speak with you specifically, I imagine they can get in touch with you as well, right?

Janet: Absolutely.

Tom: Thank you very much for joining us. This was great seeing the power of focusing on free cash flow, especially as you said at the beginning for an all-weather strategy, which is becoming a bit more important given the volatility we've seen in the markets. We'd love to have you back on anytime.

Janet: Thank you so much, tom. I appreciate it.

Tom: have a great day. Any everybody, the slides and the transcript will be coming out shortly along with that free cash flow screen that we talked about in the email. The next Alpha issue will hit your inboxes on Tuesday morning. Have a great rest of the day. Janet, thank you. And we'll talk to you all soon.

Contact Information

Alan Rubenfeld

Director of Sales

TrimTabs Asset Management, LLC

+1 (212) 217-2514

alan.rubenfeld@trimtabsfunds.com

@trimtabsadvisor

TrimTabs Asset Management

www.trimtabsfunds.com