

AAII STOCK IDEAS

Screening on Faber's Unique Approach to Yield Investing

Filtering for stocks with positive yields for dividends and buybacks represents a reasonable strategy to identify firms that are focused on creating value for shareholders.

BY DEREK J. HAGEMAN

To beat the street, investors could do worse than using shareholder yield as a value measure. In August's *AAII Journal*, we introduced the shareholder yield strategy of Mebane (Meb) Faber. In this article, we unveil a screening strategy developed by AAII that attempts to capture the spirit of Faber's shareholder yield investing focus.

Faber is a co-founder and the chief investment officer of Cambria Investment Management. He manages Cambria's exchange-traded funds (ETFs) and separate accounts. His research has covered a wide range of investment strategies and topics, including shareholder yield, global valuations, global asset allocation, endowment investing, venture capital and angel investing, behavioral finance and trend and momentum following. He has also written several books.

Based on information gleaned from Faber's book "Shareholder Yield" (The Idea Farm, 2013), AAII developed a screening strategy that looks for companies that are focused on creating value for shareholders by putting them first. Faber writes that investors in the 21st century must look to all of the direct and indirect ways in which companies distribute their cash to shareholders.

The approach seeks companies that pay dividends, repurchase shares and pay down debt. Together, the summation of these three variables is what Faber calls shareholder yield. It measures a firm's commitment to

shareholder-friendly practices.

In his book, Faber analyzes portfolios based on various cash flow metrics and finds that portfolios of companies with high shareholder yields outperform both broad market indexes and high dividend yield portfolios by a substantial margin.

Developing the Approach

Faber states that the most holistic way to approach the topic of yield investing is to seek companies that pay dividends, repurchase shares and pay down debt. Quantitative screens are employed to arrive at an optimal shareholder yield profile. The universe of stocks considered includes only exchange-listed, dividend-paying stocks.

Screening for firms in the universe of stocks with positive yields across dividends and buybacks represents a reasonable strategy for tracking down high shareholder yield companies. Next, we use quality and leverage characteristics to exclude risky stocks. Lastly, AAII utilizes valuation factors such as price to free cash flow per share and companies in the top quintile of shareholder yield to screen for stocks trading at attractive relative valuations.

Requiring positive free cash flow per share reduces the number of top shareholder yield stocks. As an additional measure to avoid value traps, financial leverage metrics are examined to position the Faber approach to identify the strongest shareholder yield stocks.

The filtering process begins with a broad universe of stocks with minimum market capitalization (shares outstanding times price per share) of \$200 million for the last reported fiscal quarter to help ensure a minimum level of trading liquidity.

We then apply supplemental filtering to further ensure the integrity of the companies we ultimately want to examine. The first of these filters excludes those companies traded on the over-the-counter (OTC) market. Exchanges have listing requirements that establish minimums for company size, share availability and reporting.

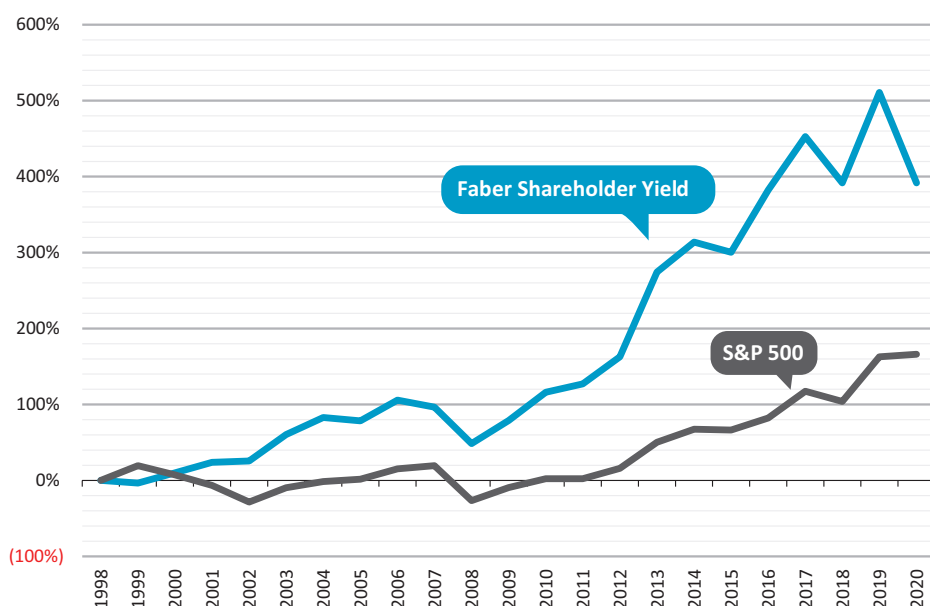
Criteria were added to exclude closed-end funds, ETFs and companies categorized by industry as investment holding companies. Real estate investment trusts (REITs) are also excluded because of their unique organizational structure and noncomparable financial statements.

Figure 1 shows the backtested results of the AAII Faber Shareholder Yield screening strategy compared to the performance of the S&P 500 index over the same period. Table 1 gives an idea of the type of stocks that pass the screen by

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FIGURE 1**Cumulative Returns: Faber Shareholder Yield vs. S&P 500**

showing median values for a hypothetical portfolio made up of the stocks that currently pass the screen. Table 2 lists the stocks that passed the Faber Shareholder Yield screen using data as of August 14, 2020.

Setting Up the Screening Criteria

Dividend Yield and Growth

Dividend yield measures dividend payments relative to the share price. Dividends are cash distributions that many companies pay out regularly to shareholders from earnings. It is a way for companies to reward investors and to share their profits. Dividends and their reinvestments have historically provided higher cumulative returns with lower levels of volatility versus non-dividend-paying stocks over long-term holding periods.

Faber states that while it is evident that dividends contribute a major portion of returns to an entire stock market over time, research also indicates that higher-dividend-yielding stocks have performed better than stocks with little to no yield. The dividend yield is calculated by dividing the indicated annual dividend by the current stock price. The indicated annual dividend is the anticipated cash dividend payment over the next year. It is the percentage rate of return paid on a stock in dividends. A high dividend yield indicates a low price compared to the stock's indicated dividend, meaning investors pay less per dollar of dividend.

A common test for financial strength over time is a long period of uninterrupted dividends. The Faber-inspired methodology looks for companies both currently paying a dividend and possessing a recent positive trend in dividend growth.

The first criterion specifies a positive dividend yield for the last fiscal quarter. The next filter requires a compound annual growth rate in dividends per share over a three-year period greater than 3%. A substantial upward trend of increased dividends is made possible through a company's ability to have successful revenue growth and to be able to convert revenue into earnings and cash flow.

Buyback Yield Measures Repurchases

The AAIIFaber approach requires a positive buyback yield filter for the last fiscal quarter. There is sufficient evidence that shares of companies that aggressively buy back shares have better returns. According to academic studies, stocks with high buyback yields outperform stocks with low buyback yields. When a company reduces the number of outstanding shares, investors holding the remaining shares gain a slightly larger proportional claim to the company and its profits. This allows earnings per share to expand more quickly than net income. The theory is that a share buyback is a signal to the market that management thinks the stock is undervalued, and the company is repurchasing shares at a discount.

Since share repurchases reduce the number of shares outstanding, they increase earnings, cash flow and equity attributable to each of the remaining shares and elevate the market value of those shares (all else equal). While there are a couple of ways to calculate the buyback yield, the easiest is to look at the change in the number of outstanding shares. A stock's buyback yield is determined by comparing the average shares outstanding for one fiscal period against the average shares outstanding for another fiscal period.

The percentage change in the number of shares is the buyback yield. Note that the signs are reversed, so a positive buyback yield indicates that the average number of shares outstanding have declined while a negative number indicates that the average number of shares outstanding is increasing.

Measuring a Firm's Ability to Meet Its Obligations

The risk with high levels of debt is that a company will not generate enough cash flow to cover the interest payments during challenging times. Analyzing a company's interest coverage ratio is one of the tools investors can use to determine its ability to pay its obligations and evaluate the safety of the dividend. The larger and more stable the ratio, the lower the risk of the company defaulting. In addition, the higher the ratio, the more flexibility a company has to meet its financial obligations and have money left over for dividends, expansion, etc.

To measure financial strength, a positive interest coverage ratio for the last 12 months is required, and the interest coverage ratio must be greater than or equal to its industry median over the same period.

The interest coverage ratio, sometimes referred to as "times interest earned," determines how easily a (non-financial) company can pay its interest expenses on outstanding debt with operating earnings. The ratio is most commonly calculated by dividing a company's earnings before interest and taxes (EBIT) by its interest expenses for the same period.

To further test the financial strength of the firm, the interest coverage ratio for the end of the last fiscal year is required to be greater than or equal to zero and also to be greater than or equal to its industry median over the same period.

Debt Paydown Yield

Another component of shareholder yield is the debt paydown yield. While leverage screens do not tend to turn up promising investments, they are helpful in highlighting troubled firms.

As another measure of financial strength, the AAIL Faber screen seeks companies with stable or decreasing

levels of long-term debt. The approach looks for strong sequential change in the debt growth rate—both on a quarter-over-quarter basis (the same quarter in sequential fiscal years) and on a quarter-to-quarter basis (i.e., the first quarter to the second quarter of the same fiscal year).

The Faber strategy filters for companies with a change in debt less than or equal to zero both on a quarter-over-quarter and a quarter-to-quarter basis.

There are a couple of ways to calculate it, but the easiest is to look at the change in the long-term borrowing and debt. A stock's debt paydown yield is determined by comparing the total value of long-term debt outstanding for one fiscal period against the total value of long-term debt outstanding for another fiscal period. Paying down debt is a somewhat more unfamiliar method of improving shareholder value. Reducing the net amount of debt on a company's books not only reduces interest costs, but also increases shareholder claims on future cash flows and assets.

Generating Positive Free Cash Flow

An examination of the actual cash generated by the firm is critical for a long-term investor. A filter requiring positive free cash flow per share for the last 12 months is specified as a measure highlighting the effective management of overall company operations. This measure attempts to capture whether the passing firms generate enough cash to pay dividends, repurchase shares and pay down debt.

Free cash flow per share for the latest 12-month period is computed from the statement of cash flow as cash from operations minus capital expenditures minus dividends paid divided by average shares outstanding. The formula is free cash flow per share = (cash from operations – capital expenditures – dividends paid) ÷ average shares outstanding.

Cash flow can reveal whether a company is generating or consuming cash in its normal operations, whether it is investing for the future and whether it is rewarding investors with dividends or seeking additional capital from the equity or debt markets. Cash flow analysis often provides advance notice that a company may be facing financial trouble even though earnings and sales still look strong. Companies that generate sufficient free cash flow can expand during periods of economic expansion as well as cover expenses when sales decline during slowdowns.

Free cash flow per share measures the use or generation of cash over a period of time. Quarterly or annual figures can be used. A single quarterly figure is timelier, but it is less meaningful and subject to seasonal fluctuations. Free cash flow per share over the last four quarters (trailing 12 months) helps to capture the cash needs and generation over the course of a complete year. The

TABLE 1

Faber Shareholder Yield Portfolio Characteristics

Portfolio Characteristics (Median)	Faber Shareholder Yield	Exchange-Listed Stocks
Price-earnings ratio (X)	14.6	21.5
Price-to-book ratio (X)	1.36	1.98
Price-to-sales ratio (X)	2.18	1.92
Yield (%)	3.3	2.9
PEG Ratio (P/E to Est. Growth) (X)	2.20	2.90
Historical EPS 5-yr. growth rate (X)	12.1	7.1
Estimated EPS growth rate (X)	3.9	7.7
Market cap. (\$ million)	2,481.9	803.1
Relative price strength vs. S&P 500 (%)	(21.5)	(18.7)

Source: AAIL Stock Investor Pro/Refinitiv. Data as of 8/14/2020.

TABLE 2

The 30 Stocks Passing the Faber Shareholder Yield Screen (Ranked by Shareholder Yield)

Company Name (Ticker)	Closing Price (8/14) (\$)	Shareholder (%)	Yield Buy-back (%)	Dividend (%)	3-Yr Div Grth (%)	Times Interest Earned 12 Mo. (X)	Chng in Debt Grth (%)	Price-to-FCFPS (X)	Industry
Synchrony Financial (SYF)	24.93	18.1	14.6	3.5	49.6	2.3	(24.4)	1.9	Consumer Lending
Triton International (TRTN)	34.00	13.3	7.1	6.1	4.9	2.2	(8.8)	4.7	Business Support Services
Janus Henderson (JHG)	20.75	11.4	4.4	6.9	3.6	9.6	(1.1)	12.0	Investment Mgmt & Fund Oper
Masco Corp. (MAS)	57.96	10.3	9.3	0.9	8.7	6.9	(14.4)	25.5	Construct Supplies & Fixtures
M&T Bank Corp. (MTB)	109.21	9.3	5.3	4.0	13.6	4.3	(17.4)	11.5	Banks
First Hawaiian Inc. (FHB)	18.11	9.1	3.4	5.7	73.2	4.3	(100.0)	25.8	Banks
Hanover Insurance (THG)	106.51	9.1	6.6	2.4	9.2	10.4	0.0	9.0	Insurance—Prop & Casualty
Washington Federal (AFD)	24.71	8.9	5.3	3.6	12.8	2.5	0.0	20.9	Banks
Peoples Bancorp (PEBO)	22.21	8.6	2.5	6.1	27.3	2.6	(91.2)	9.6	Banks
Home Bancorp (HBCP)	25.03	8.5	4.9	3.5	27.0	2.4	0.0	9.8	Banks
Celanese Corporation (CE)	101.48	8.0	5.5	2.4	20.3	8.3	(13.2)	19.5	Chemicals—Commodity
Central Pacific Fin'l (CPF)	16.80	7.7	2.2	5.5	14.5	3.2	0.0	12.1	Banks
Provident Fin'l Servs (PFS)	14.18	7.4	0.9	6.5	9.0	2.8	(22.3)	14.7	Banks
Reliance Steel & Alum (RS)	106.32	7.4	5.1	2.4	10.1	9.9	(26.6)	6.4	Iron & Steel
CVB Financial (CVBF)	19.13	7.2	3.4	3.8	12.3	14.5	0.0	22.5	Banks
International Bcshs (IBOC)	33.82	6.8	3.6	3.3	20.5	5.3	0.0	8.2	Banks
International Paper (IP)	37.27	6.8	1.3	5.5	4.1	2.7	(6.1)	10.7	Paper Packaging
Independent Bank (INDB)	68.75	6.7	4.0	2.7	14.6	4.8	(32.5)	16.7	Banks
Cisco Systems (CSCO)	42.50	6.6	3.2	3.4	14.6	19.5	(27.3)	20.7	Commun & Networking
Regal Beloit Corp. (RBC)	97.51	6.2	4.9	1.2	7.3	5.4	(8.0)	11.0	Electrical Components & Equip
First Bancorp (NC) (FBNC)	22.08	6.1	2.8	3.3	12.9	4.5	(62.7)	13.6	Banks
Genie Energy Ltd. (GNE)	9.03	5.7	1.9	3.8	5.6	45.7	(100.0)	15.9	Utilities—Multiline
Columbia Bank Sys (COLB)	30.31	5.6	1.9	3.7	13.3	6.9	(0.6)	25.8	Banks
FirstCash Inc. (FCFS)	60.95	5.6	3.8	1.8	21.8	7.3	(21.9)	14.1	Consumer Lending
Shoe Carnival, Inc. (SCVL)	27.14	5.6	4.2	1.3	6.8	75.0	0.0	27.2	Retailers—Apparel & Accessor
Best Buy Co Inc. (BBY)	109.49	5.5	3.5	2.0	22.1	30.9	(47.9)	13.6	Retailers—Comput & Electron
Commerce Bcshs (CBSH)	60.97	5.5	3.7	1.8	10.2	5.6	(66.7)	20.2	Banks
Escalade, Inc. (ESCA)	18.49	5.5	2.5	3.0	4.4	75.8	(100.0)	11.2	Recreational Products
Steelcase Inc. (SCS)	11.40	5.4	1.9	3.5	6.5	7.0	(0.2)	6.5	Business Support Supplies
A. O. Smith Corp. (AOS)	49.76	5.3	3.4	1.9	23.3	38.2	(22.0)	28.5	Electrical Components & Equip

Source: AAIL Stock Investor Pro, Refinitiv and I/B/E/S. Data as of 8/14/2020.

AAII Faber strategy requires positive free cash flow per share for the end of the last fiscal year.

Price to Free Cash Flow

A filter requiring a price-to-free-cash-flow ratio less than or equal to the average price-to-free-cash-flow ratio of the universe of stocks is used to signal a potentially undervalued stock based on a company's ability to generate cash.

The price-to-free-cash-flow ratio is calculated by dividing the current stock price by free cash flow per share for the last four fiscal quarters (trailing 12 months). The formula is price ÷ free cash flow per share 12m.

Net Payout Yield

A stock's net payout yield is the sum of its dividend yield and buyback yield and shows what percentage of total cash the company is paying out to shareholders, either in the form of a cash dividend or as cash used to repurchase its shares. Thus, if a company is paying a 5% dividend yield and has a buyback yield of 10%, its net payout yield would be 15%. The theory is that stocks with higher net payout yields are more attractive than those with lower ones. [Note: AAIL uses the percentage change in shares outstanding (buyback yield) plus the dividend yield to calculate a shareholder yield, which is a component of our Value Grade.]

What It Takes: Faber Shareholder Yield Criteria

- » Companies that trade on the over-the-counter (OTC) market are excluded.
- » Closed-end funds, exchange-traded funds (ETFs), investment holding companies and real estate investment trusts (REITs) industries are excluded.
- » Market capitalization for the latest fiscal quarter (Q1) is greater than or equal to \$200 million.
- » The dividend yield is greater than zero for the latest fiscal quarter (Q1).
- » The buyback yield is greater than zero for the latest fiscal quarter (Q1).
- » The three-year growth rate in dividends per share is greater than 3%.
- » The times interest earned ratio for the last 12 months is positive.
- » The times interest earned ratio for the last 12 months is greater than or equal to the industry's times interest earned ratio for the same period.
- » The times interest earned ratio for the last fiscal year is greater than or equal to zero.
- » The times interest earned ratio for the last fiscal year is greater than or equal to the industry's times interest earned ratio for the same period.
- » The long-term debt for the latest fiscal quarter (Q1) is less than or equal to the long-term debt for the prior-year quarter (Q5).
- » The long-term debt for the latest fiscal quarter (Q1) is less than or equal to the long-term debt for the prior quarter (Q2).
- » The free cash flow per share ratio for the last 12 months is positive.
- » The free cash flow per share ratio for the last fiscal year is positive.
- » The price-to-free-cash-flow ratio must be less than or equal to the average price-to-free-cash-flow ratio for the entire database.
- » The shareholder yield for the latest fiscal quarter (Q1) must be in the top 20% of the entire database (percent rank greater than 80).

The AAI Faber approach includes a final requirement restricting the results to those companies in the top quintile of net payout yield. Faber's shareholder yield approach has the potential benefit of investing in classic value companies that are also buying back their stock and reducing their debt.

Unlike other valuation measures, net payout yield is inversely related with value, with higher net payout yields implying more attractive valuations. Because the buyback yield is the change in the number of shares outstanding, the net payout yield can be either positive or negative. A negative net payout yield would occur when the percentage increase in the number of shares outstanding exceeds the dividend yield. If no dividend is paid, net payout yield will be negative if the number of outstanding shares increases.

Summing It Up

AAII's Faber Shareholder Yield strategy employs our interpretation of Faber's quantitative methodology to discover U.S.-listed companies that show strong characteristics in returning free cash flow to their shareholders. Faber notes that positive free cash flow has long been emphasized by investors as a key predictor of a company's strength. Companies that pay cash dividends, one indication of strong free cash flow, have historically outperformed the broader market. However, focusing strictly on dividend payments misses two key indicators of strong free cash flow: net share repurchases and net debt pay-down. Faber believes that a focus on all three factors helps identify companies that offer strong free cash flow characteristics. ■

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