



Free cash flow can be used to predict the performance of the Dow.

The recent market crash, which was spurred on by the global financial crisis, has generated a significant change in the makeup of the Dow 30 Industrials Composite Index. Since October 2008, three companies—**General Motors Corp. (Pink Sheets: GMGMQ)**, **Citigroup Inc. (NYSE: C)**, and **American International Group Inc. (NYSE: AIG)**—have been removed from the venerable index. They were replaced by three new ones: **Kraft Foods Inc. (NYSE: KFT)**, **The Travelers Cos. Inc. (NYSE: TRV)**, and **Cisco Systems Inc. (NASDAQ: CSCO)**.

Given these significant changes, I decided to do some research on the current and 10-year historical cash-flow metrics for the 26 nonfinancial Dow components. My first stop was to take a look at the aggregated data for the 26 members. What I discovered is that the aggregated annualized free cash flow for the 26 hit its all-time high in the period ended April 30, 2008. Aggregated cash flow from operations on a trailing 12-month basis for the 10-year period hit its all-time high in the period ended July 31, 2008. The all-time highs for annualized revenue, EBITDA, and earnings each occurred in the 12 months ended Oct. 31, 2008.

Since peaking at various times in 2008, the declines in the aggregated data metrics for the 26 nonfinancial members of the Dow have accelerated to the downside. They were led by free cash flow—which experienced an 18% decline, its worst in 10 years—in the 12 months ended April 30, 2009, as compared to the same period in 2008. Cash flow from operations declining 11.25%

and revenue declining 2.83% also established records for rate of decline over the 10-year period. The annualized drop in earnings and EBITDA for the same period was also the worst since the periods ended Jan. 31, 2003 and July 31, 2002, respectively.

Next, I checked the various members. I found that 17 of the 26 nonfinancial members of the Dow 30 had declining annualized free cash flow in their 12 months ended April 30, 2009. During the 10 years, there was only one period in which the Dow had more members (18) who generated negative free cash flow, and that was for the 12 months ended June 30, 2005. For the following 12 months, the 26 nonfinancial Dow members generated a negative return. During the most recent period, two of the components—**Alcoa Inc. (NYSE: AA)** and **The Boeing Co. (NYSE: BA)**—actually generated negative free cash flow and negative cash flow from operations over the latest 12 months.

There were actually seven of the components, which increased both their free cash flow and cash flow from operations. Only four of the 26 Dow nonfinancial components, including **Verizon Communications Inc. (NYSE: VZ)**, **Wal-Mart Stores Inc. (NYSE: WMT)**, **AT&T Inc. (NYSE: T)**, and **Kraft Foods** were able to increase FCF, CFO, and revenue over their latest 12 months.

The free cash-flow metrics have proved to be a predictor of accelerating or decelerating

earnings, EBITDA, and revenue. They have also been very accurate at predicting share price performance for the aggregated share price performance of the 26 Dow nonfinancial components over the last 10 years.

For example, during the 10-year period beginning in 1999 through 2008, the Dow had two periods in which its annualized free cash-flow-growth rates fell to below 1%. The first was for the period ended July 31, 2000, and the second was for the 12 months ended July 31, 2005. The aggregate market cap of the 26 Dow components fell by 38% for the 12 months ended July 31, 2001, and it fell by 2% in the 12 months ended July 31, 2006.

Based on this statistical data, and the fact that the Dow recently rallied back to its high for 2009, the probability is high that the Dow 30 and the other major indexes, including the S&P 500 and the NASDAQ 100, have likely seen their highs for 2009. **E**

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Dow Nonfinancial Components With Growing Free Cash Flow and Cash Flow From Operations				
Company	Symbol	FCF %	CFFO %	Rev %
Kraft Foods	KFT	19.06	15.96	14.87
Cisco Systems	CSCO	2.35	1.27	-1.72
IBM	IBM	21.50	9.94	-0.41
Pfizer	PFE	24.69	17.77	-1.40
AT&T	T	8.74	6.39	2.61
Verizon	VZ	29.20	3.90	5.69
Wal-Mart	WMT	42.19	3.61	4.38