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By William W. Priest, CEO

The Ongoing Importance of Free Cash Flow and Globalization

As we enter the new year, it is important to reflect on what drives today's equity market returns and how we, as informed investors, can capitalize on these trends. At Epoch, we believe that a successful analysis of the current investment landscape must take two ideas into account: 1) capital allocation based on a free cash flow model and 2) the rapid pace of globalization. In 2006 and beyond, these concepts will prove essential to the informed investor.

We have a positive outlook for the performance of the markets in 2006, largely because of the encouraging trends we have observed in the area of capital allocation. In today's marketplace, capital is being used more and more efficiently. This is because the increasingly popular model for capital allocation is a free cash flow model, as opposed to the earnings model that has been favored in years past. Through the use of a finance metric (free cash flow) rather than an accounting metric (P/E), it is easier to accurately identify those firms most likely to utilize their free cash flow intelligently for shareholder value creation. Therefore, we believe the widespread use of cash flow models will continue to dominate capital allocation options because of the clarity with which these models can determine the most efficient and beneficial deployment of cash.

To better understand the power and accuracy of the free cash flow model, consider the following scenario. As interest rates increase or remain stable in coming years, P/E ratios will show a corresponding decline or stability. Therefore, to the extent that equities deliver positive returns, these returns will out of necessity be driven by the growth in the overall economy plus dividend yield, which are the "real phenomena" contributing to total return. The cash flow model uses these "real phenomena" as its primary investment criteria. The earnings model, however, uses "pricing multipliers" such as P/E which, as we have seen, no longer provide an adequate assessment of an investment's worthiness.

So how does the free cash flow model work, and what does its growing popularity mean for investors in 2006? When making investment decisions, it is important to remember that a company has only five real options when considering how to use its cash. The first two options, acquisitions and internal capital projects, require that the return on incremental capital deployed by management exceed the average return on capital currently earned. If this criterion cannot be met, then the cash should be returned to shareholders by means of the three remaining options for free cash flow use: cash

dividends, share buybacks and debt reduction. Together, we define these three options as shareholder yield.

In a separate paper available on our website, www.eipny.com, we make the argument for shareholder yield on a global scale. At Epoch, we have created a fund specifically for this purpose in the U.S., and a similar fund will soon be offered through CI Funds in Canada. With these funds, it is our goal to assemble a portfolio of companies that offers superior shareholder yield (including direct dividends, share repurchases, and debt reductions) plus operating earnings growth. In this manner, we will be able to deliver performance superior to that of the broad-based equity market.

Besides paying close attention to capital allocation through the free cash flow model, Epoch is also focused on the highly global nature of today's equity markets. Now more than ever, globalization is coming at investors with remarkable speed and power. Barring unproductive behavior from governments in the form of import quotas on tariffs, global growth should continue and exceed the forecasts of most pundits. Real growth, productivity, and profitability should continue to rise in 2006. The reason for this lies in the addition of three billion new capitalists to our world since the fall of the Berlin Wall in 1989. These newcomers have brought little capital with them, but plenty of available labor. Emerging countries have large labor pools and low wages whereas the developed countries have capital and technology. Therefore, the relationship between capital and labor is in the process of undergoing the greatest change in the history of the modern world. This new trading paradigm is being worked out in the globalization process, and the investment opportunities contained therein are endless.

For these reasons, Epoch's investment strategy is a global one. Because our portfolios offer an international scope, the investor can capture the benefits inherent in globalization: productivity, profits, and less inflation than would otherwise be the case. The result of this global philosophy is broader diversification, which leads to higher returns and lower volatility than portfolios that take only a regional perspective.

There are many trends and drivers that impacted the equity markets in 2005 that can also help to guide our investment decisions in 2006. Among the most important of these trends and drivers are increasingly efficient capital allocation through a free cash flow model, and the undeniable impact of globalization. With these factors in mind, Epoch is confident that 2006 will be a year that offers a wide range of exciting and productive investment opportunities.



Epoch Investment Partners, Inc.

NEW YORK
640 Fifth Avenue, 18th floor
New York, NY 10019
Main: 212-303-7200
Fax: 212-202-4948