

The Critical Role of Free Cash Flow in Growth Investing

– Danke Wang, CFA, FRM, Portfolio Manager

When it comes to growth investing, sales growth is a critical factor for investors to consider, as it provides insights into a company’s business momentum and future potential.

While earnings growth is often highlighted, it cannot be sustained in the long run without corresponding sales growth. Relying exclusively on cost-cutting to improve profitability is not a viable strategy; instead, companies must achieve sales growth to ensure sustainable long-term financial performance.

Investing in stocks with strong sales growth offers several benefits:

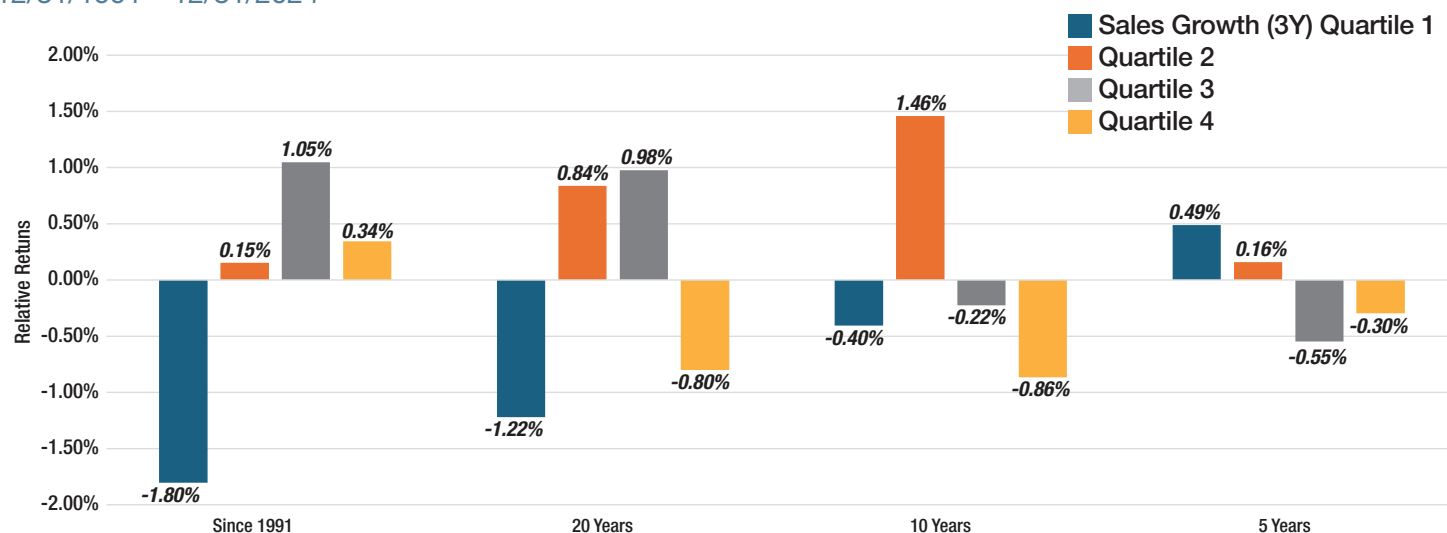
- Rapid sales growth suggests that a company is gaining market share, launching successful products, or entering new markets. This often signals a healthy and expanding business. For example, during its expansion phase, Tesla's strong sales growth in electric vehicles reflected rising consumer adoption and its market leadership, leading to significant stock appreciation despite high valuations.
- Sales growth typically precedes earnings growth. As revenue increases, companies benefit from economies of scale and improved operational efficiency, which drives higher profit over time. A prime example is Amazon, which despite its low profitability in the early days, focused heavily on growing its sales to lay the groundwork for its long-term dominance and eventual earnings growth.

While focusing on rapid top-line growth appears appealing to investors seeking long-term capital appreciation, historical performance data challenges this assumption.

For instance, when the S&P 500 is grouped into quartiles based on sales growth, the top sales growth cohort has consistently underperformed over different time periods.

S&P 500 Stocks, Relative Returns by Sales Growth Quartiles*

12/31/1991 – 12/31/2024



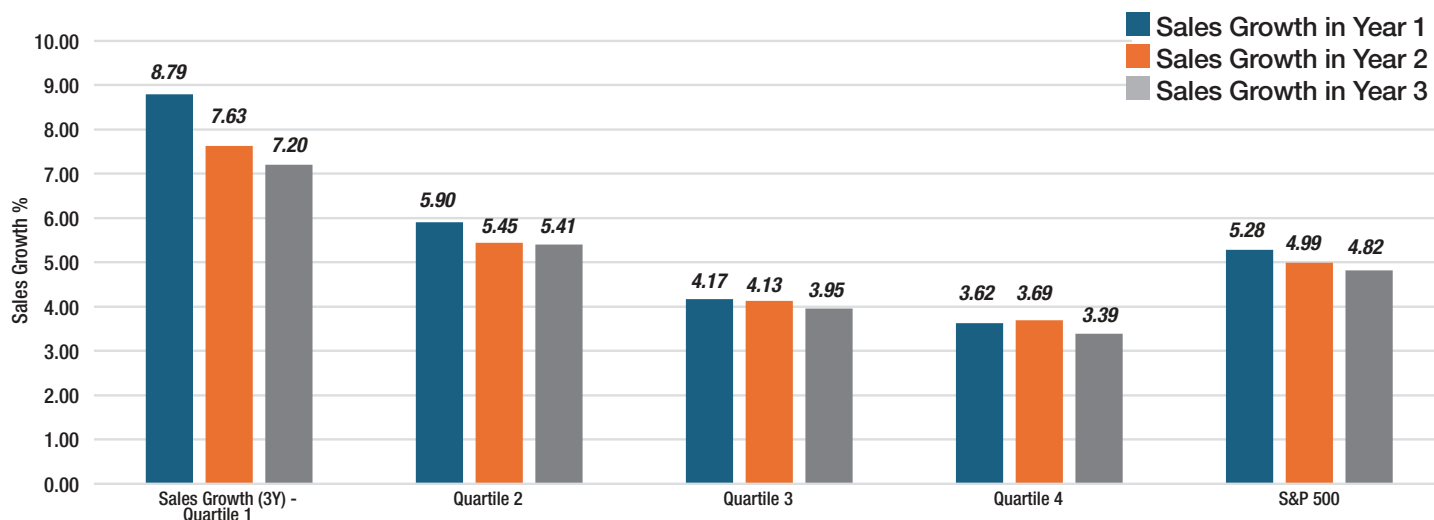
Source: FactSet, Pacer Advisors. *Quarterly data compounded to Annual Period

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

There are several potential explanations. High sales growth companies tend to trade at higher valuations, making them vulnerable to downward rerating if market sentiment turns less favorable. In addition, current high growth rates may fade over time as companies mature or face competitive pressures.

S&P 500 Stocks, Forward Yearly Sales Growth by Sales Growth Quartiles

12/31/1991 – 12/31/2024



Source: FactSet, Pacer Advisors

A recent case is PDD Holdings (Temu), which reported an 86% surge in revenue and a 156% increase in profits in its quarterly earnings. Despite these leaps, management issued a note of caution, highlighting challenges in sustaining such growth amid intense eCommerce competition. This reveals a broader issue: high revenue growth, while impressive, is often difficult to maintain, especially in industries with significant competition and pricing pressures.

The above observations demonstrate that high sales growth alone is insufficient in acting as a reliable predictor of superior stock performance.

Then, what other factors should investors consider?

Balancing Sales Growth and Profitability

The tradeoff between growth and profitability is a common theme in business operations, where growth-focused companies often experience lower free cash flow margins (FCF / Sales, the proportion of revenue converted into free cash flow) due to substantial investments in business expansion. This can be seen in companies like Tesla and Amazon. Tesla reinvested heavily during its expansion phase to scale production and penetrate global markets. Similarly, Amazon focused on scaling its eCommerce and logistics infrastructure, sacrificing near-term profitability.

Despite these short-term tradeoffs, investors frequently reward such businesses with premium valuations, confident in the promise of future profitability fueled by their current growth trajectories.

While many companies sacrifice profitability to fund growth, an increasing number of firms are successfully balancing sales growth with robust FCF generation.

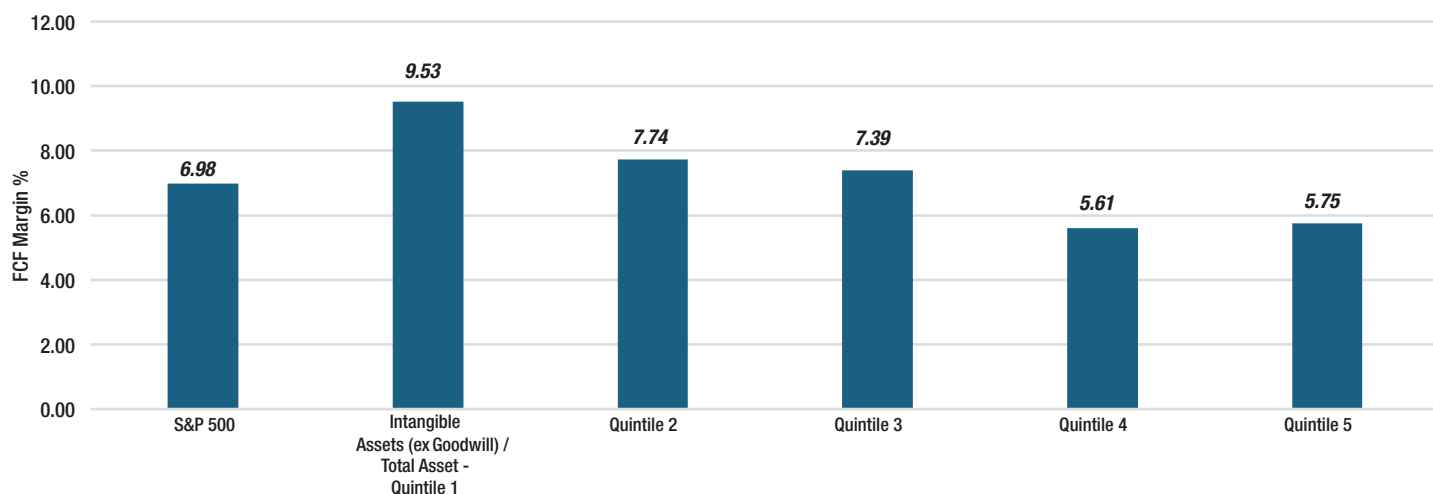
As highlighted in previous Pacer Perspective¹, five companies out of the Magnificent Seven -- Apple, Alphabet, NVIDIA, Meta, and Microsoft -- demonstrate an exceptional ability to sustain high FCF margins while achieving fast revenue growth.

⁽¹⁾Pacer Perspective March 2024: Growth Investing Illuminated Part 2: The Magnificent Seven Perspective

This remarkable ability reflects a broader trend among growth-focused companies, particularly in the past two decades: the rise of capital-light business. Capital-light businesses rely less on traditional tangible assets like buildings and machinery, but instead leverage intangible assets such as intellectual property, software, and brand equity. With minimal maintenance capital requirement on fixed assets (lower CapEx), the companies generate substantial free cash flow, which can be reinvested in growth initiatives such as research and development, marketing, business innovation, and product improvement. Such investments further fueled their strong FCF generation.² Moreover, by avoiding extensive capital investments, these businesses often carry lower levels of debt and financial leverage, enhancing their operational flexibility.

S&P 500 Stocks, FCF Margins by Quintiles of Intangibles Assets (ex Goodwill)/Total Assets

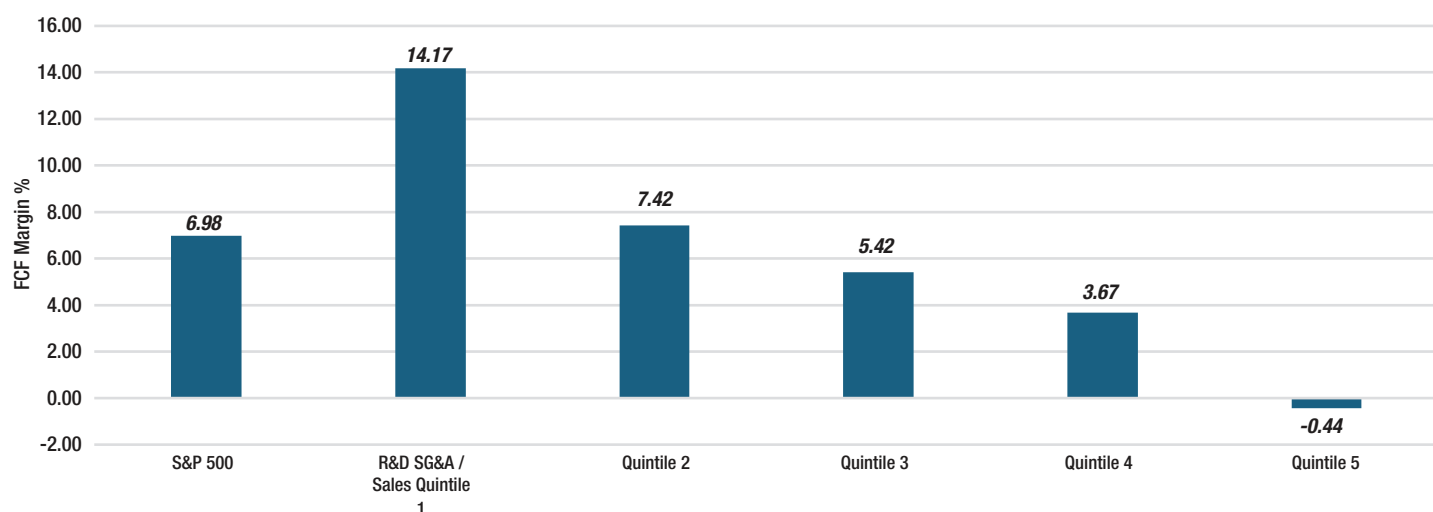
12/31/1991 – 12/31/2024



Source: FactSet, Pacer Advisors

S&P 500 Stocks, FCF Margins by Quintiles of R&D SG&A Expenses/Sales*

12/31/1991 – 12/31/2024



Source: FactSet, Pacer Advisors. *5-year average yearly R&D expenses and 30% of 5-year average SG&A expenses as the share of 5-year average sales

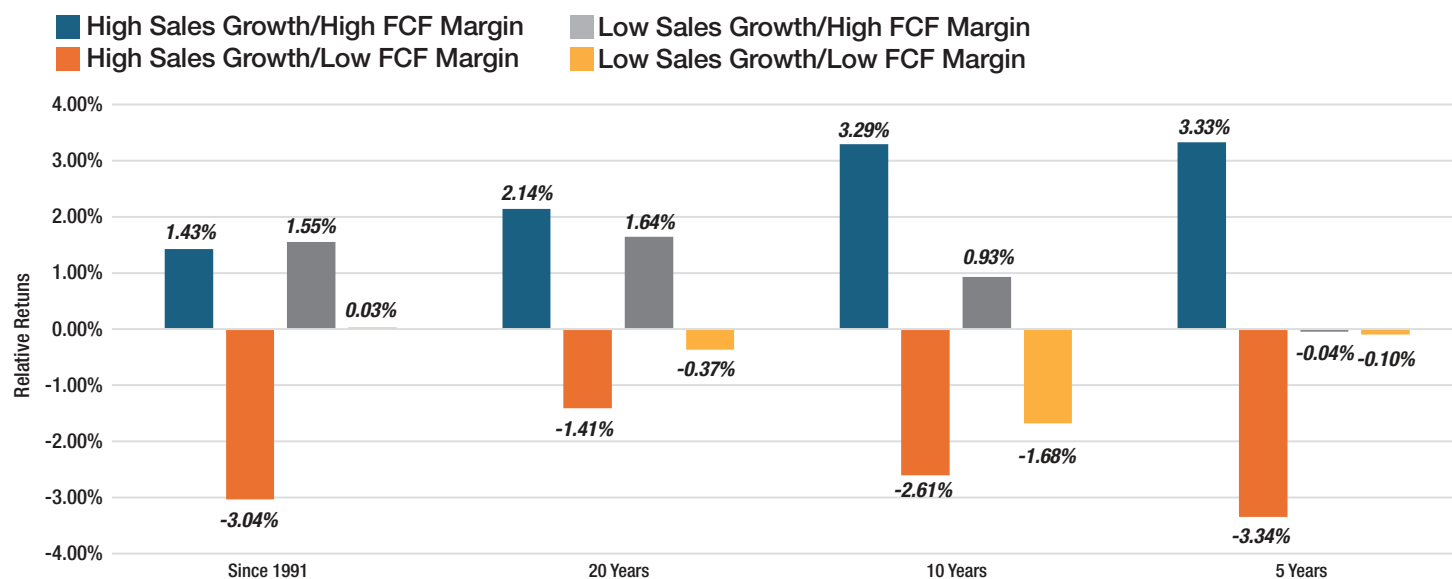
While sales growth remains an important indicator, FCF margin has emerged as an even more critical metric for evaluating growth investments. Companies that achieve both top-line growth and high FCF production demonstrate financial strength and the ability to self-finance business growth, ultimately creating sustainable value for shareholders.

⁽²⁾Pacer Perspective November 2023: Investing in the Intangible Economy: Free Cash Flow as the Answer

When analyzing S&P 500 companies by segmenting them into four groups based on their sales growth and FCF margins, we observed that a combination of strong FCF generation and better-than-average revenue growth (High Sales Growth/High FCF Margin group) has consistently delivered good performances for investors.³ This is particularly evident in their relative performance over the past decade, where companies excelling in both metrics outperformed their peers.

S&P 500 Stocks, Relative Returns by Groups based on Sales Growth and FCF Margin*

12/31/1991 – 12/31/2024

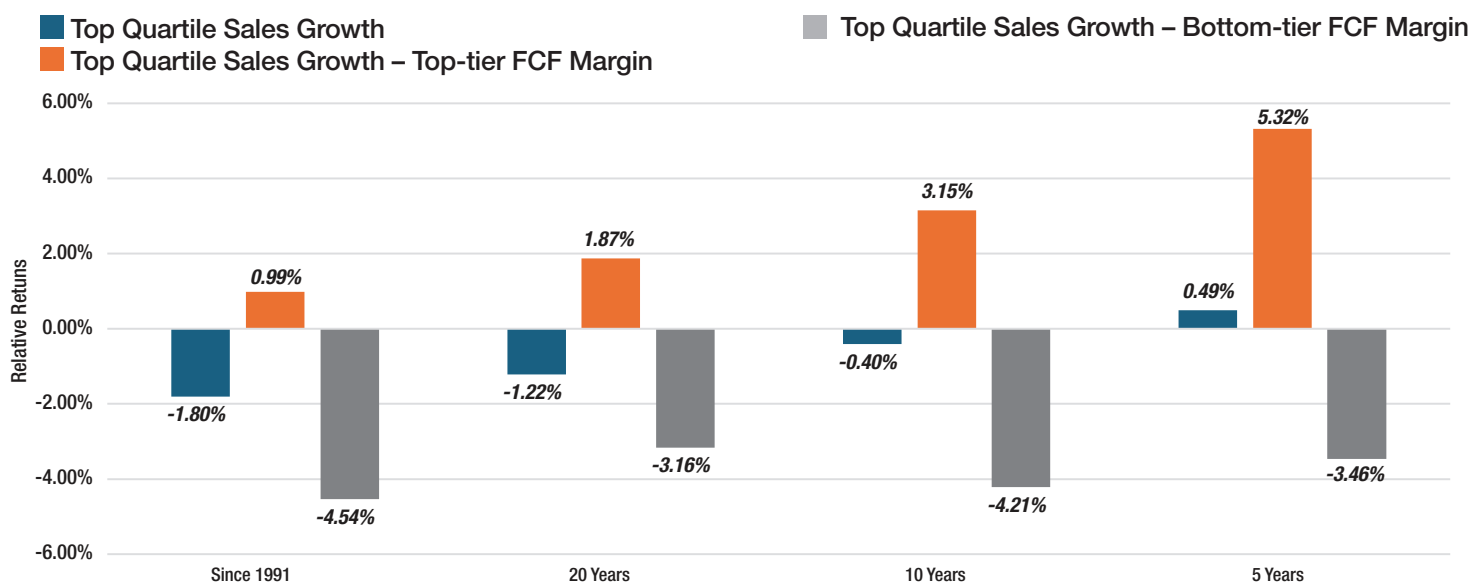


Source: FactSet, Pacer Advisors. *Quarterly data compounded to Annual Period

Furthermore, the importance of FCF generation is especially pronounced among high-sales-growth companies. While the top quartile of sales growth companies in the S&P 500 Index often underperformed overall, those with top-tier FCF margins within this group delivered positive relative returns against the market benchmark. Conversely, high-growth companies with weak FCF generation (falling in the bottom tier of FCF margins) tended to lag, highlighting the pitfalls of prioritizing revenue expansion without sufficient cash flow.

S&P 500 Top Sales Growth Stocks, Relative Returns by High and Low FCF Margin*

12/31/1991 – 12/31/2024



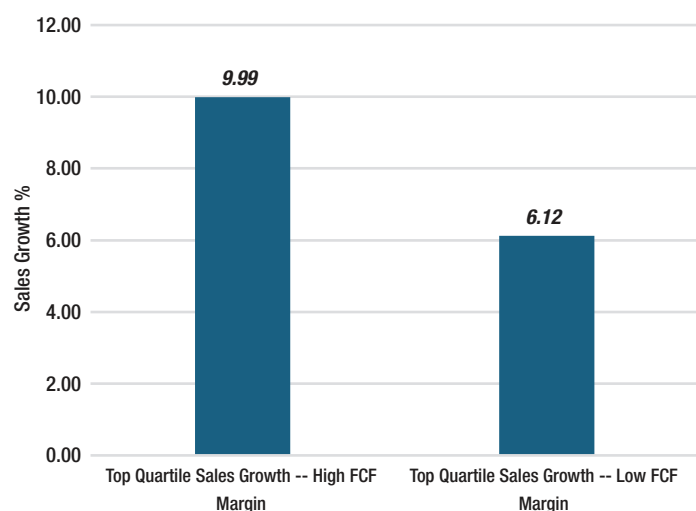
Source: FactSet, Pacer Advisors. *Quarterly data compounded to Annual Period

³Pacer Perspective March 2024: Growth Investing Illuminated Part 2: The Magnificent Seven Perspective

In addition, it is essential to note, however, that prioritizing cash flow generation does not mean sacrificing sales growth. Previous research⁴ highlighted that companies with high FCF margins tend to maintain faster growth than peers. As shown in the chart, among high-sales-growth companies, those with the highest FCF margins actually delivered faster forward three-year sales growth. This dynamic again highlights that disciplined financial management, as reflected in robust FCF generation, can coexist with—or even support—accelerated top-line growth.

S&P 500 Top Sales Growth Stocks, Forward 3-Year Sales Growth by High and Low FCF Margin

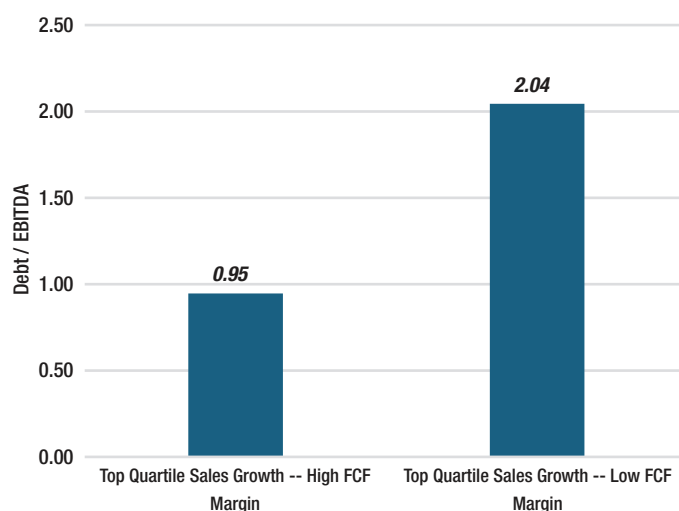
12/31/1991 – 12/31/2024



Source: FactSet, Pacer Advisors

S&P 500 Top Sales Growth Stocks, Debt-to-EBITDA Ratios by High and Low FCF Margin

12/31/1991 – 12/31/2024



Source: FactSet, Pacer Advisors

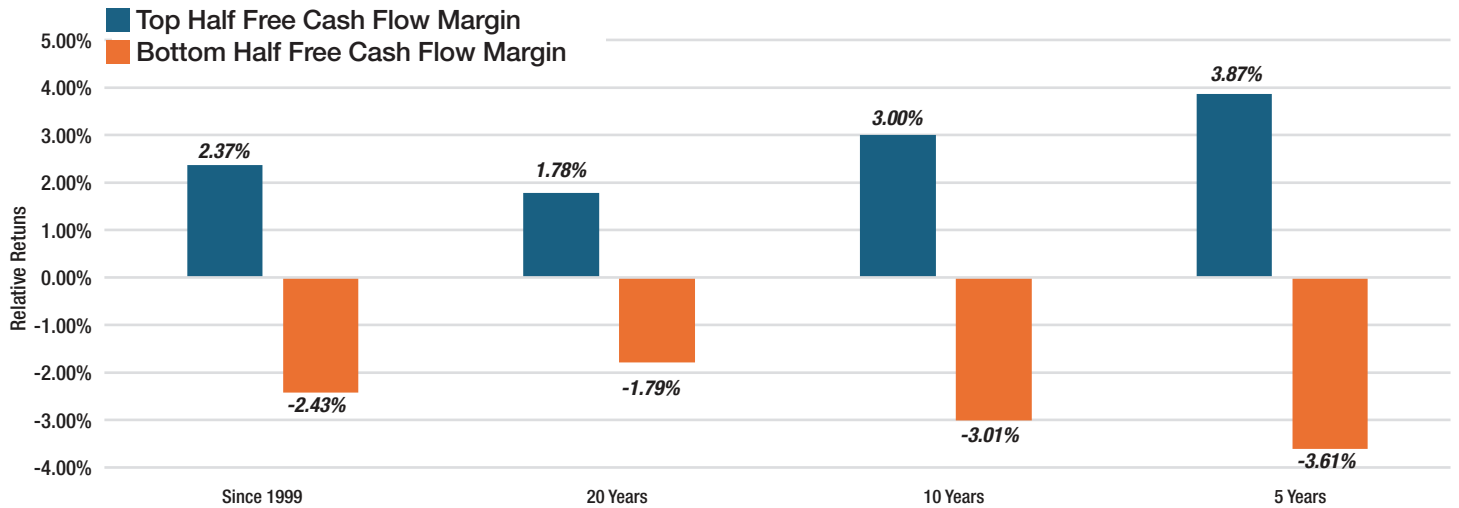
On the other hand, companies that prioritize aggressive sales growth at the expense of free cash flow often rely on higher levels of leverage, which increases their financial risk. In contrast, high FCF margin companies reinvest their free cash flow to drive growth while minimizing their reliance on external funding. By maintaining strong cash flow margins, these businesses can deliver faster growth with lower financial risk, ultimately creating sustainable value for investors over the long term.

For investors looking to capitalize on the combination of growth and financial profitability, the Pacer Nasdaq-100 Top 50 Cash Cows Growth Leaders ETF (QQQG) is potentially a compelling solution. QQQG focuses on companies within the NASDAQ-100 Index that exhibit robust free cash flow generation (Higher FCF Margins). Historically, stocks with top-half FCF margins are quite competitive and have outperformed the rest of the NASDAQ-100 Index stocks over various time frames.

⁽⁴⁾Pacer Perspective October 2023: Growth Investing Illuminated: The “take-one” on Free Cash Flow Margin

NASDAQ-100 Stocks, Relative Returns by High and Low FCF Margin*

12/31/1999 – 12/31/2024



Source: FactSet, Pacer Advisors. *Quarterly data compounded to Annual Period

By targeting growth companies with high FCF margin, QQQG provides investors with an opportunity to benefit from businesses that efficiently manage operations while self-funding their growth initiatives. This strategic focus makes QQQG an attractive option for those seeking sustainable value creation and long-term capital appreciation.

PACER NASDAQ-100
TOP 50 CASH COWS
GROWTH LEADERS
ETF

QQQG

Pacer Nasdaq-100 Top 50 Cash Cows Growth Leaders ETF

Is a strategy-driven exchange traded fund that aims to provide exposure to top growth companies in the Nasdaq-100 Index by screening for above average free cash flow margins.

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

Free Cash Flow Margin: the FCF margin is a ratio that compares a company's free cash flow to its sales to understand the proportion of revenue that becomes free cash flow (FCF).

R&D Expense: Research and development expenses are direct expenditures relating to a company's efforts to develop, design, and enhance its products, services, technologies, or processes.

SG&A Expense: Selling, general, and administrative expenses includes all non-production expenses incurred by a company in any given period. It includes expenses such as accounting, management salaries, travel, advertising and marketing.

S&P 500 Price Return Index is a broad measure of U.S. large cap stocks, and does not include the reinvestment of dividends.

Nasdaq-100 Index is a globally recognized index that tracks the performance of 100 of the largest non-financial companies listed on the Nasdaq Stock Market®, encompassing a diverse range of industries and sectors.

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