Excess Capital Yield: A Better Framework for Value Investing

Voya's Large Cap Value team believes that **excess capital yield (ECY)** provides a holistic view of the amount of capital a company has available to create value. We apply our ECY framework to evaluate stocks from a relative value perspective and construct a diversified portfolio with a higher yield than the benchmark.

Authors

James Dorment, CFA
Head of Value Team and Portfolio Manager

David Zujkowski, CFA
Head of Fundamental Analytics

Executive Summary

- We believe that value investing remains relevant; however, investors need to adapt to the ever-changing environment
- Traditional valuation measures have worked over the very long term, but have come under scrutiny over the past decade
- The development of **excess capital yield (ECY)** provides a more holistic view of a companies' ability to create value
- **ECY** has generated better returns and risk efficiency relative to traditional value metrics
- The decomposition of ECY by skilled analysts is a critical, driving component of alpha
- We believe that excess capital yield is a more dynamic and effective valuation mechanism to drive a value strategy

Background

Value investing, which was first developed by Graham and Dodd in the 1920s, has struggled to remain relevant over the past decade as mega-capitalization growth stocks have broadly outperformed value stocks. At Voya, we never stopped believing in value investing but recognize that successful value investors must evolve with the changing market environment. Over the past several years, we have enhanced our large cap value strategy from a cornerstone focus on dividends to a framework we call "excess capital yield" (ECY). In our view, excess capital yield is a more dynamic and effective framework, as it carries a broader, more consistent and less volatile relative performance profile than more conventional valuation measures. To illustrate these points, we first show how ECY is calculated and incorporated into our investment process. Next, we show how it has been successful over time, both on a standalone basis and compared to other value metrics.

Origin of excess capital yield

Historically, the Voya large cap value strategy focused on dividend paying stocks, which is a popular investment philosophy, rooted in academic literature, with history telling us that the combination of steady income and capital appreciation creates the potential to deliver attractive returns over a full market cycle. This remains true today, but is not without pitfalls. More important, dividend yield is an output, not an input, which is why the Voya value team has evolved its investment philosophy to ECY. We believe that ECY provides a more holistic view of the amount of capital a company has available to create value, not just in the form of dividends but also in terms of mergers and acquisitions (M&A), share buybacks and internal investments.

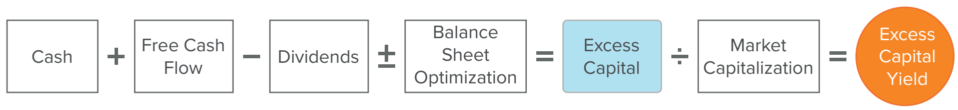
It's important to note that the ECY focus is not solely on the raw number calculated, but rather on the decomposition of excess capital. The ECY analysis sparks a debate about the state of the balance sheet, sales, margins and earnings power of a company over the next several years and a company's ability to convert those earnings into shareholder returns. ECY is not a static output; it is a dynamic, forward-looking measure that seeks to quantify the "dry powder" available to management to create value in the form of dividend growth, share repurchases, accretive M&A and/or organic investment.

The success of the Voya Large Cap Value strategy comes from the triangulation of ECY with relative value measures and the qualitative, differentiated insights from our experienced team of sector analysts.

Calculating excess capital yield

To determine excess capital, we add free cash flow to cash on the balance sheet and net out dividends. We then employ a balance sheet optimization to capture the competitive advantage afforded to companies through the state of the balance sheet. Our analysis carries out this optimization by comparing a firm's leverage to that of its peers. Firms with lower leverage have more ability to deploy capital in the pursuit of supplemental value creation, while those with higher leverage have less ability to do so. To find the yield, we divide the raw excess capital number by a company's market capitalization. This yield is the analyzed on a sector-by-sector basis. Figure 1 illustrates this calculation process.

Figure 1. Voya's method of calculating ECY

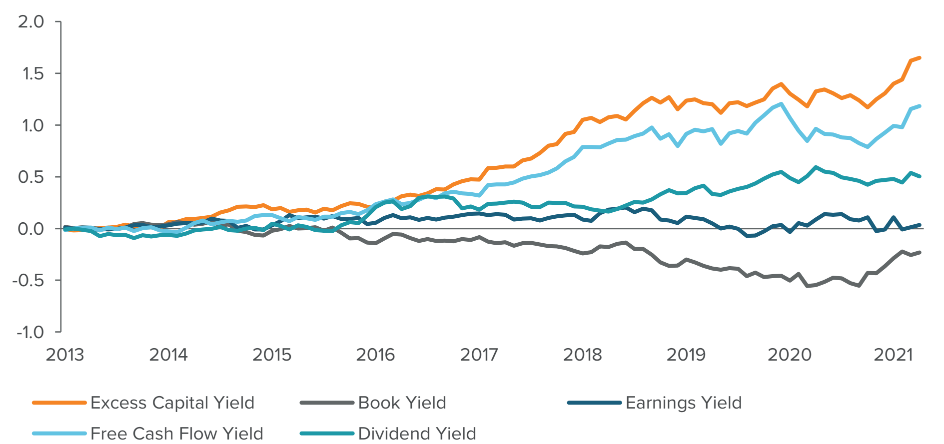


Source: Voya Investment Management

Improvement in returns relative to dividends and other value metrics...

To quantify the benefits of excess capital yield, we evaluated the factor performance of ECY on both a standalone basis (year-over-year and sector-by-sector) as well as relative to other valuation metrics. We evaluated the full Russell 1000 Value universe (ex-real estate investment trusts (REITS) and utilities) from 2013-2021. REITS and utilities were excluded since neither sector aspires to generate cash, thus making the ECY metric less applicable.[1] To gauge the impact of ECY, we calculated the quintile spread returns of various valuation metrics (Figure 2). Our analysis showed that excess capital yield was the strongest performing factor, followed by free cash flow yield and dividend yield.

Figure 2. Cumulative, cap-weighted quintile spread returns, R1000V ex-REITs and utilities

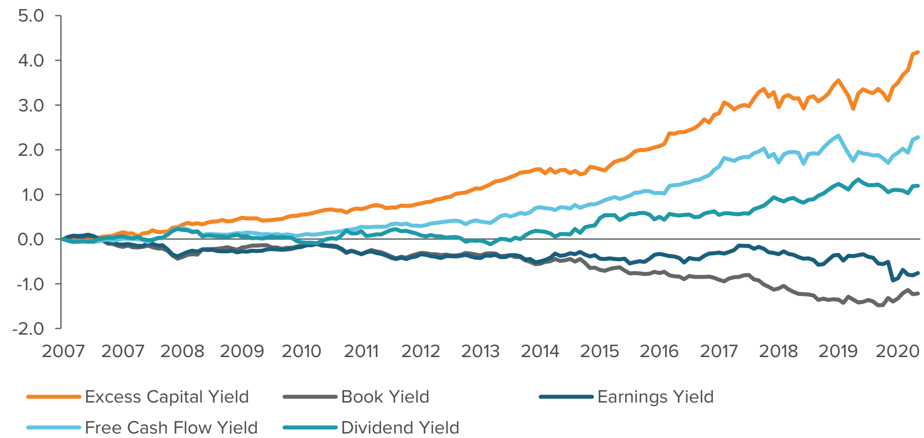


Source: FactSet, analysis by Voya Investment Management. **Past performance is no guarantee of future results.**

Next, we lengthened the history, excluding financials in addition to REITs and utilities, and evaluated the same factors. Financials were excluded due to lack of data for the sector prior to 2013. Again, excess capital yield emerged as the strongest factor (Figure 3).

[1] Our REITs and utilities analysts recognize this and therefore ECY is not a driving factor in their decision-making.

Figure 3. Cumulative, cap-weighted quintile spread returns, R1000V ex-financials, REITs and utilities



Source: FactSet, analysis by Voya Investment Management. **Past performance is no guarantee of future results.**

...with better risk efficiency

Excess capital yield also generated these superior historical returns with lower volatility resulting in the strongest Sharpe ratio compared to these other value metrics (Figure 4).

Figure 4. R1000V ex- financials, REITs and utilities — cap-weighted performance

Jan 2007–Mar 2021

	Excess capital yield	Book yield	Earnings yield	Free cash flow yield	Dividend yield
Annual excess return	6.26%	-1.78%	-1.08%	3.33%	0.01%
Annual volatility[2]	10.37%	15.14%	12.20%	10.94%	13.64%
Sharpe ratio[3]	0.60%	-0.12%	-0.09%	0.30%	0.00%

Source: FactSet, analysis by Voya Investment Management. **Past performance is no guarantee of future results.**

Behind the numbers: quality and the avoidance of value traps

At the root of a framework such as excess capital yield, there is a fundamental explanation as to why companies that exhibit an ability to generate excess capital offer fertile ground upon which our analysts can focus their efforts. It is the presence of excess capital that helps to skew the risk-reward opportunity in a stock, thus amplifying the upside of being right about the company and mitigating the downside if the thesis proves to be wrong. Said differently, it adds a quality element to the strategy and helps avoid value traps, i.e., companies that appear attractive based on conventional valuation metrics, but that present insurmountable, fundamental flaws.

To illustrate this point, we measured the correlation of ECY with profitability, high leverage, growth, momentum and beta (Figure 5). ECY was most closely correlated with high profitability, a strong quality metric; and showed a strong negative correlation to high leverage, an “anti-quality” metric.

[2] Volatility = annualized standard deviation of quintile spread returns.

[3] Sharpe ratio = (portfolio return quintile 1 minus portfolio return quintile 5)/annualized standard deviation of quintile spread returns.

Figure 5. Correlation of ECY and other valuation metrics with Axioma style factors

15-year period

Metric	Profitability	Leverage	Growth	Momentum	Beta
Excess capital yield	0.30	-0.54	0.05	-0.02	-0.01
Book yield	-0.28	-0.17	-0.16	-0.22	0.12
Earnings yield	0.21	-0.11	0.07	-0.04	-0.06
EBIT/EV	0.25	-0.14	-0.07	-0.15	-0.06
Earnings yield NTM	0.07	-0.00	-0.01	-0.16	0.03
Free cash flow yield	0.11	-0.07	-0.10	-0.06	-0.04
Dividend yield	-0.14	0.18	-0.35	-0.11	-0.20

Source: Correlation analysis by Voya Investment Management, based on factors provided by Axioma Inc. Data range: 12/29/2006 To 3/31/2021. **Past performance is no guarantee of future results.**

Robust and persistent results

As with any back-test, one needs to examine the methodology used, the breadth and depth of the analysis and whether the results are robust and show some persistence across multiple market regimes. At Voya, our quantitative research team employs a highly disciplined and rigorous approach in identifying potential alpha drivers, but also in testing their validity across a myriad of scenarios. In addition to the results above, we examined the performance of each metric on year-by-year and sector-by-sector bases to evaluate the breadth and depth of ECY with similar results (see Appendix).

While these results are encouraging, the framework of excess capital yield was not built just upon a strong back-test. Rather, it is a truly “quantamental” metric, initially created to provide a holistic, forward-looking view of the capital that management has at its disposal to create value.

Summary

The success of ECY is linked to two key features:

1. **Alpha:** as demonstrated in this primer, ECY historically has exhibited stronger and more consistent factor performance than traditional measures of valuation

2. **Framework:** the components of ECY provide analysts with insights into what levers a company has at its disposal to generate future earnings

The second feature is vital, and while this qualitative element is hard to capture numerically, we would be remiss if we failed to note that ECY is much more than a screen that can be used by rigid, quantitatively focused strategies. The true value-add comes from the experience of our fundamental analysts, who have the skill and knowledge needed to decompose the number and interpret its meaning in the context of their respective sectors.

In our view, a proper value-oriented strategy should be both dynamic, i.e., capable of accounting for differences across businesses and market regimes; as well as flexible, i.e., complementary to the individual approach utilized by fundamental analysts. The success of the Voya Large Cap Value strategy is a direct result of this philosophy, and is linked to both excess capital yield and the manner in which we are able to practically apply ECY and triangulate it against both other relative value measures and the qualitative, differentiated insights from our experience team of sector analysts.

The benefit of focusing on excess capital yield comes not from the metric itself, but from the analysis and conversation it sparks.

Appendix: calendar year returns

Figure 6. Cap-weighted performance, R1000V ex-REITs and utilities

Jan 2007–Mar 2021

Year	Excess capital yield	Book yield	Earnings yield	Free cash flow yield	Dividend yield
2013	0.75	3.30	1.73	(0.76)	(6.56)
2014	15.55	(7.74)	(2.13)	13.51	4.31
2015	(1.06)	(4.82)	3.59	(2.84)	9.23
2016	15.15	3.47	5.93	13.09	4.90
2017	21.86	(5.42)	(1.70)	24.31	(1.81)
2018	16.42	(8.71)	(2.98)	9.44	7.77
2019	(3.37)	0.13	(1.97)	(3.77)	8.20
2020	(10.89)	5.48	(2.10)	(22.55)	(4.32)
2021*	4.80	8.50	1.76	2.75	(1.98)

Source: FactSet, analysis by Voya Investment Management

* 2021 through March only, rebalanced monthly. **Past performance is no guarantee of future results.**

Figure 7. Cap-weighted performance, R1000V ex-financials, REITs and utilities

Jan 2007–Mar 2021

Year	Excess capital yield	Book yield	Earnings yield	Free cash flow yield	Dividend yield
2007	16.36	(17.72)	(12.23)	1.57	6.70
2008	20.56	(26.91)	(23.92)	21.62	15.36
2009	8.56	52.91	26.20	(29.86)	(32.98)
2010	(5.05)	8.29	16.42	(7.09)	(14.61)
2011	10.86	(17.50)	(14.88)	16.50	21.04
2012	0.80	7.35	5.21	(2.00)	(9.98)
2013	1.06	3.34	2.83	(1.09)	(10.93)
2014	15.29	(9.13)	(1.90)	16.16	11.24
2015	(0.96)	(9.91)	2.26	9.09	15.06
2016	14.52	2.78	9.01	3.87	(3.02)
2017	19.54	(2.45)	3.29	20.53	(1.19)
2018	17.01	(12.47)	(3.06)	12.30	16.36
2019	(8.45)	2.70	3.70	10.03	8.31
2020	(12.51)	6.06	(16.43)	(26.64)	(7.79)
2021*	3.49	10.63	7.51	1.90	(2.63)

Source: FactSet, analysis by Voya Investment Management

* 2021 through March only, rebalanced monthly. **Past performance is no guarantee of future results.**

Figure 8. R1000V cap-weighted, quintile spread return by sector

Jan 2007–Mar 2021

Sector	Excess capital yield	Book yield	Earnings yield	Free cash flow yield	Dividend yield
Communication services	1.00%	-0.58%	-0.66%	-1.02%	0.89%
Consumer discretionary	0.14%	-0.53%	-0.75%	0.06%	0.12%
Consumer staples	0.57%	-0.23%	0.13%	0.38%	0.41%
Energy	0.94%	-0.95%	-0.28%	0.51%	1.00%
Financials*	0.07%	0.00%	-0.16%	—	0.07%
Health care	0.56%	0.07%	0.69%	0.16%	0.22%
Industrials	0.47%	0.39%	0.08%	0.36%	0.03%
Information technology	0.18%	-0.12%	-0.16%	0.51%	5.51%
Materials	-0.30%	-0.70%	0.13%	1.21%	-0.07%

Source: FactSet, analysis Voya Investment Management, analysis period Jan 2007 – Mar 2021, rebalanced monthly

* Financial sector analysis period Jan 2013 – Mar 2021. **Past performance is no guarantee of future results.**