

# Behind the metrics: the science of finding good value



**Value investing is often synonymous with finding ‘cheap’ stocks. But cheap doesn’t always mean a bargain. We go beyond traditional valuation measures using a more expansive framework to target attractively valued companies through both a value-creation and quality lens.**

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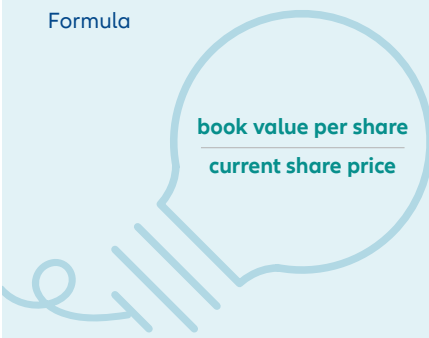
While some investors think value investing is just about finding attractively priced stocks, many companies that seem cheap may have weak financial positions or lack the ability to generate value. Additionally, a high dividend yield, which can be appealing to investors, might actually signal financial trouble. Neither of these situations is usually a good fit for value-seeking investors.

Traditional metrics can be misleading because they assess value through a limited perspective, often overlooking other crucial aspects of the business and its financial health. Here, we present our view of the four most common metrics and what we consider to be their pitfalls.



## Book value yield

Formula


$$\frac{\text{book value per share}}{\text{current share price}}$$

### Why it’s commonly used

Think of book value as the net worth of a company if it were to go out of business. It is defined as total assets minus total liabilities, making it a straightforward metric that is commonly used to compare companies within the same industry.

### Pitfalls

- **Write-downs:** Book value can be distorted due to management discretion. For example, after overpaying for an acquisition, management can choose to write down the value when it fails to meet expectations.
- **Hidden assets/liabilities:** This metric fails to capture off-balance-sheet items such as operating leases, deferred compensation, or expensed investments.
- **Liquidation focus:** It also focuses on the value available to investors in the event of a liquidation, rather than the intrinsic value of a company.

## Earnings yield

Formula



### Why it's commonly used

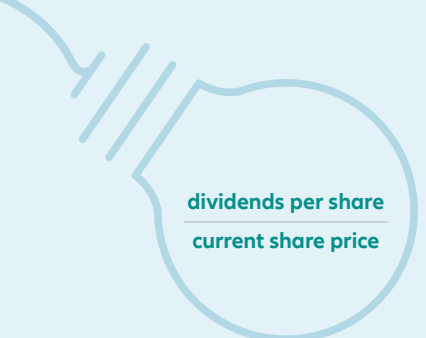
If book value is the net worth of a company based on its balance sheet, earnings represent how much a company makes after paying all its expenses, based on its income statement. Earnings yield is the reciprocal of the price-to-earnings ratio. Unless a company has negative earnings, earnings yield is one of the most commonly used ratios.

### Pitfalls

- **Creative accounting:** Earnings is the bottom line on the income statement, so it is the most affected by revenue recognition, capitalizing (rather than expensing) expenses, and one-time items.
- **Leverage:** This metric does not consider the amount of debt that a company carries; thus it is a poor comparison for companies with different levels of leverage.

## Dividend yield

Formula



### Why it's commonly used

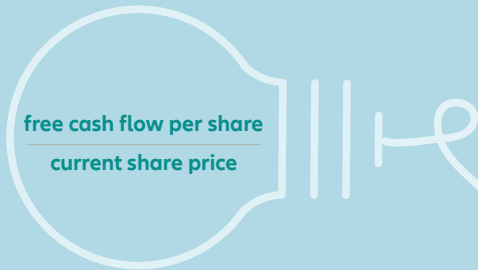
Many value investors follow a philosophy of generating income, so they look for companies with high dividend payouts. Investors expect dividends to be nearly "guaranteed," and cutting them is highly undesirable, as it often signals financial stress. Dividend yield is a useful metric for screening these companies.

### Pitfalls

- **Incomplete measure of shareholder return:** Dividend yield only captures capital returned to shareholders through dividends paid. However, companies can also return capital via share buybacks and/or debt repurchases.
- **Excludes growth investments:** This metric ignores a company's reinvestment in its own business or investment through mergers and acquisitions. We believe that attractive value opportunities deliver more than a dividend. Some of the most profitable opportunities are turnarounds of mature businesses, which are not captured by dividend yield.

## Free cash flow yield

Formula



### Why it's commonly used

Of all the traditional metrics, free cash flow (FCF) yield has the fewest pitfalls. FCF is the cash left after a company supports its ongoing operations and maintains its capital assets (buildings, land, and equipment). Since it "follows" cash, it

excludes non-cash expenses like depreciation but includes investment spending and the difference between current assets and liabilities on the balance sheet (changes to working capital). Compared with the other ratios, it is the most immune to manipulation.

### Pitfalls

- **Does not deduct recurring expenses:** Since investors expect to receive dividends each period, we believe a more complete metric should also deduct dividends.

**Excess capital yield: Assessing a stock from all angles**

Excess capital yield (ECY) is a more complete metric. It starts with the strongest traditional metric, FCF, along with cash on hand, then

adjusts for recurring dividend expense. We then employ a balance sheet optimization to capture the competitive advantage afforded to companies with respect to their leverage (relative to that of their

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.

**Excess capital yield**

Formula

$$\frac{\text{cash} + \text{free cash flow} - \text{dividends} \pm \text{balance sheet optimization}}{\text{market capitalization}}$$

**Why we use it**

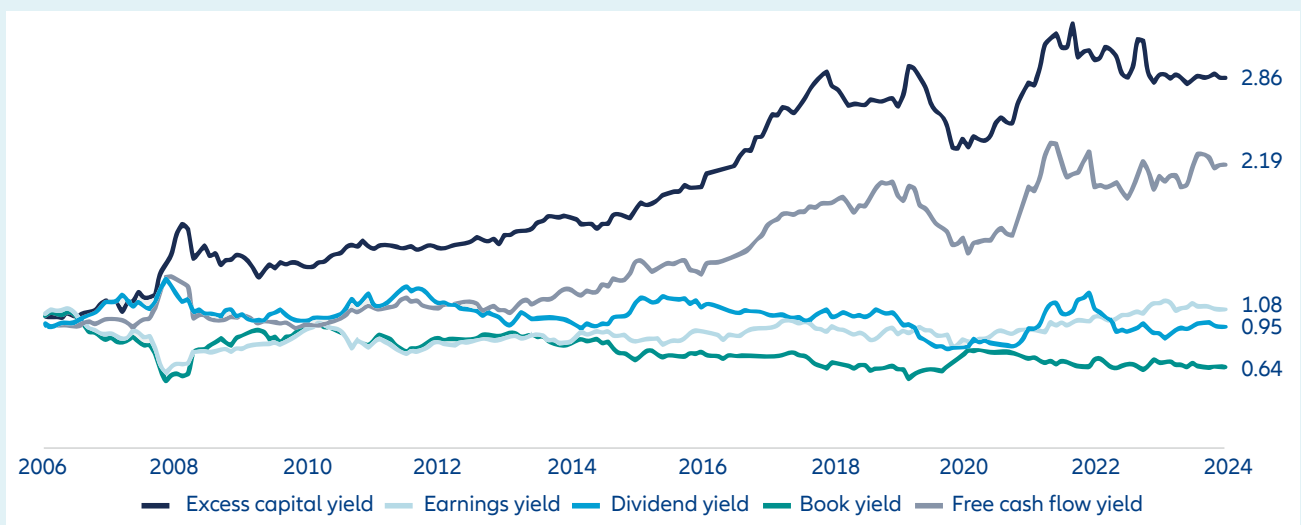
ECY quantifies the “dry powder” available to a company to supplement value creation through dividend growth, share repurchases, accretive M&A, and organic investment. Portfolios constructed based on ECY may display more consistent, less volatile performance than those built using traditional valuation measures. Our research shows that ECY identifies high-quality companies that tend to grow and outperform over the long term.

**Pitfall mitigation**

- **Removes potential earnings manipulation:** Focuses on ongoing operations, captures leverage differences, and reflects off-balance-sheet activities.
- **A more comprehensive analysis:** Combines data from all three financial statements.

**ECY has outperformed traditional metrics over time**

Quintile spread returns, R1000V ex-financials, REITs, and utilities



As of 12/31/24. Source: FactSet. Returns reflect the spread between the lowest quintile and the highest quintile of the respective factor of the Russell 1000 Value Index (ex-financials, REITs, and utilities) from 01/07 through 12/24. **Past performance is no guarantee of future results.**

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