A Value Investor and a Growth Investor Walk into a Tech Company...

When a familiar growth metric for tech companies called the "Rule of 40" meets our enhanced value framework, the result sets a new bar for cracking the code on value tech.

James Dorment, CFA
Co-Head of Fundamental Research and Portfolio Manager

David Zujkowski, CFA
Head of Fundamental Analytics

William Marble, PhD
Equity Research Analyst

Conventional thinking falls short

In the fast-paced tech sector, traditional value metrics often struggle to find attractive stocks. Three characteristics of tech companies stand out for their tendency to blur the lens of conventional value screens:

- Technology companies tend to invest heavily in intangible assets, such as research and development, software and intellectual property.
- Tech companies are more likely to reinvest profits into growth opportunities rather than distributing them as dividends, which makes dividend yield a less relevant metric.
- A tech company's book value is often misleading, because the rapid pace of innovation can quickly render physical and technological assets obsolete.

As a result, value strategies tend to underweight the technology sector or, worse, rely on these traditional metrics and then stumble into the dreaded "value trap." Is there a better way?

[1] Excess capital yield (ECY) is cash on the balance sheet plus free cash flow minus dividends, adjusted for balance sheet optimization (the competitive advantage afforded to companies with respect to their leverage relative to peers) to determine a company's excess capital, then divided by market capitalization to determine the yield. ECY is then analyzed on a sector-by-sector basis.

Reassessing value with excess capital yield

Our value strategy uses an investment framework that emphasizes a proprietary Voya measure called excess capital yield. (See methodology below[1]). We apply ECY to evaluate how effectively a company uses and deploys its "dry powder," typically in the form of dividend growth, share repurchases, accretive M&A and organic investment.

Exhibit 1. Where other value metrics struggled with tech, ECY was a successful stock-selection tool

Excess returns by value metric & quartile (software sector)

	Earnings yield NTM	Dividend yield	Book yield	Excess capital yield
Top quartile	-1.4%	-0.8%	-0.6%	+1.0%
2nd quartile	+2.4%	-2.2%	-2.1%	+0.5%
3rd quartile	-1.0%	-1.3%	-0.1%	-0.5%
Bottom quartile	-1.5%	+0.4%	+1.8%	-2.0%

For the period 01/01/08 to 12/31/23. Source: Voya IM, Russell, S&P, MSCI. Represents factor performance within the U.S. large cap software universe, comprising stocks in the GICS software and services industry group from the Russell 1000, S&P 500, S&P 400 and MSCI USA Large/Mid Cap indexes. The universe is partitioned into quartiles by each value metric, and performance is then calculated as the equal-weighted 12-month return. **Past performance is not indicative of future results.**

We have found that this approach provides deeper insights into a company's strategic financial health and its potential to sustain growth and generate returns. This makes it a more relevant and insightful tool for assessing true value in the fast-paced world of technology.

Historically, ECY has proven to be more effective than traditional value screens. Looking at the period January 2008 through December 2022, an analysis of the U.S. large cap software universe showed that stocks screened in the top quartile based on ECY generated higher excess returns, compared with stocks identified through book yield, dividend yield and earnings yield factors (Exhibit 1). Moreover, ECY's quartile rankings offered successful indications of future returns, whereas other metrics were highly inconsistent, often ranking good stocks bad and bad stocks good.

We're off to a good start, but that's not the end of the story. Our equity platform is designed with the goal of generating an information advantage supported by a culture we call "collaborative alpha." Working with the fundamental analytics team, our software sector analyst found an even better way to assess value opportunities in the tech sector.

Collaborative alpha in action: The Rule of 40 enters the chat

The "Rule of 40" is a staple for growth-oriented investors in the tech space. The rule states that a company's combined revenue growth and free cash flow margin should add up to at least 40%. The metric provides a quick litmus test of a company's operational efficiency, profitability and market competitiveness.

Looking at the same universe of software companies and time period used in Exhibit 1, stocks that screened well with both ECY and the Rule of 40 produced even higher excess returns than those screened with the ECY metric alone (Exhibit 2).

The combination of Voya's ECY with the Rule of 40 provides a powerful lens to not only avoid the pitfalls of outdated value strategies but also uncover compelling investment opportunities that other value investors might overlook.

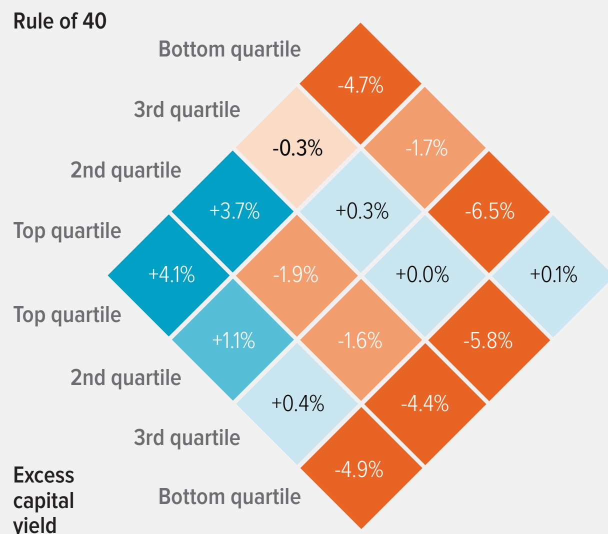
This combined framework is a prime example of Voya's "collaborative alpha," an organizational mindset that encourages the sharing of information across teams while preserving the unique strengths of each.

Exhibit 2. Combining ECY and Rule of 40 screens produced better results

Excess returns by value metric quartile (software sector)

	Earnings yield NTM	Dividend yield	Book yield	Excess capital yield
Top quartile	-1.4%	-0.8%	-0.6%	+1.0%
2nd quartile	+2.4%	-2.2%	-2.1%	+0.5%
3rd quartile	-1.0%	-1.3%	-0.1%	-0.5%
Bottom quartile	-1.5%	+0.4%	+1.8%	-2.0%

Excess return for double sorts of ECY and Rule of 40



For the period 01/01/08 to 12/31/23. Source: Voya IM, Russell, S&P, MSCI. For illustrative purposes. Represents factor performance within the U.S. large cap software universe, comprising stocks in the GICS software and services industry group from the Russell 1000, S&P 500, S&P 400 and MSCI USA Large/Mid Cap indexes. The universe is partitioned into quartiles on both Rule of 40 and excess capital yield metrics, and performance is then calculated for each quadrant as the equal-weighted 12-month return. **Past performance is not indicative of future results.**

A note about risk

The principal risks are generally those attributable to investing in stocks and related derivative instruments. Holdings are subject to market, issuer and other risks, and their values may fluctuate. Market risk is the risk that securities or other instruments may decline in value due to factors affecting the securities markets or particular industries. Issuer risk is the risk that the value of a security or instrument may decline for reasons specific to the issuer, such as changes in its financial condition.

Past performance does not guarantee future results. This market insight has been prepared by Voya Investment Management for informational purposes. Nothing contained herein should be construed as (i) an offer to sell or solicitation of an offer to buy any security or (ii) a recommendation as to the advisability of investing in, purchasing or selling any security. Any opinions expressed herein reflect our judgment and are subject to change. Certain of the statements contained herein are statements of future expectations and other forward-looking statements that are based on management's current views and assumptions and involve known and unknown risks and uncertainties that could cause actual results, performance or events to differ materially from those expressed or implied in such statements.

©2024 Voya Investments Distributor, LLC • 230 Park Ave, New York, NY 10169
All rights reserved.

Not FDIC Insured | May Lose Value | No Bank Guarantee
IM3520916 • 222973 • 052824 • 2024-05-3349546