

Beyond the Numbers

Value, Cash Flow, and the Capital Cycle

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Executive Summary

Value has reasserted itself into the market's psyche after a long period in which growth leadership felt permanent. Growth's leadership throughout the 2010s and first half of the 2020s was one of the rare periods in which large cap growth materially outperformed value, helped by falling rates, software multiple expansion, and the rise of asset-light platform companies. However, markets are regime-sensitive, and the market regime appears to be shifting. Since late 2025, as U.S. equity markets have broadened out, value has regained momentum as investors have become more sensitive to technology valuations, AI-related capital spending, and the durability of free cash flow. This rotation is the market repricing the relative value of near-term cash generation versus long-duration earnings promises.

Of course, "value" can mean different things. Value style benchmarks, which are how many asset allocation focused investors think about value, typically represent broad index exposure of stocks and sectors that screen cheaper than the market on a few simple valuation metrics. Those familiar with my thinking know my general misgivings about these indexes for anything beyond a broad barometer of market activity. Analyzing value as a factor is more instructive, asking which valuation measure best identifies stocks where the market is paying too little for the economic output of the business, as not all cheapness is created equal. In this month's edition of *Beyond the Numbers*, we contextualize the recent outperformance of the value style, compare value factors based on various fundamental metrics, and connect these learnings to today's dominant investment debate: the AI capital expenditures (capex) cycle.

Key Takeaways

- **Why value is outperforming growth, putting "style" in context.** Higher interest rates, rising capital investment requirements, and increased scrutiny of AI spending have shifted investor preference toward near-term cash generation.
- **Value indexes versus value factors—what's the difference?** Value indexes provide broad exposure to stocks and sectors that screen as inexpensive on common valuation metrics, while value factors help identify which valuation metrics have historically mattered the most in identifying undervalued securities.
- **Where's the value in the AI capex cycle?** Hyperscalers appear reasonably valued on earnings, but substantially less attractive on free cash flow as AI-related capex outpaces operating cash flow.
- **How we think about value investing in the current regime.** We favor cash-generative businesses capable of self-funding growth rather than relying on simple value index definitions such as price-to-earnings or price-to-book ratios. In a higher-cost-of-capital environment, free cash flow provides a more useful valuation lens because low price-to-earnings ratios do not always reflect compelling intrinsic value.

Value Is Back in Style: The Rotation in Context

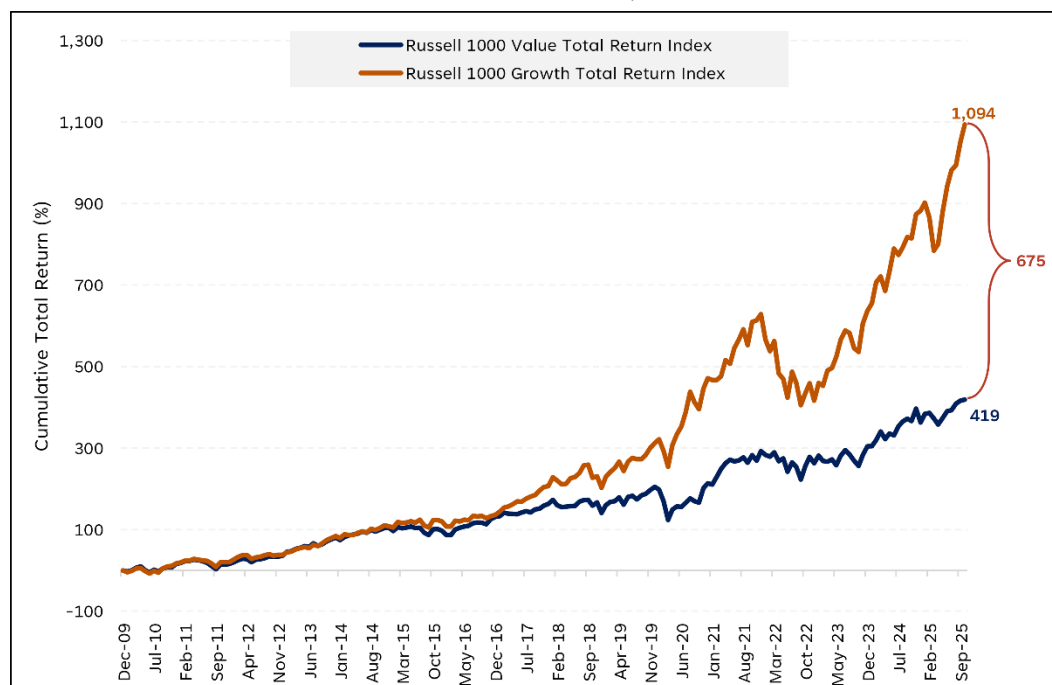
Should the recent value rotation be viewed as a regime shift-driven change in market preference, rather than a simple reversal trade? We think there is a compelling case to be made for the former. In a regime of higher interest rates and stubbornly above target inflation, the market is increasingly focused on capex intensity, free cash flow conversion, and the cost of capital. Therefore, it makes logical sense that companies with visible cash generation

have broadly regained relative appeal. This does not mean “growth” stocks cannot work. After all, growth is a core component of determining intrinsic value for a diligent stock operator. It simply means investors are less willing to pay premium multiples for earnings streams that require rising amounts of reinvestment to sustain in a “higher for longer” interest rate environment.

Let’s take a trip down memory lane. Starting from the beginning of the 2010’s to late last year (October 31, 2025), the Russell 1000 Growth Index, which we will use as our growth style proxy, outperformed the Russell 1000 Value Index (our value style proxy) by ~675%, as shown in “Value Has Lagged Growth Over the Last Decade and a Half.” The market regime during the majority of this nearly 16-year period was one of low economic growth, low interest rates, and subdued inflation, while the U.S. equity market was fixated on software platforms that delivered consistent earnings growth with minimal re-investment requirements that allowed for generous share repurchases. More recently, since roughly the end of 2022, a novel technology known as artificial intelligence (AI) captured the investment community’s attention, further supporting growth (and the technology sector broadly) outperformance, despite the burgeoning shift in the macro regime as inflation and interest rates began to rise. Over the last three years or so, the new regime solidified as inflation remained sticky and the Federal Reserve maintained higher interest rates. Simultaneously, the capex required for the AI buildout continued to grow larger and larger. Hyperscale cloud businesses (“hyperscalers”) continued to invest to meet the compute demanded by AI labs, and these formerly “cash-cow” companies burned through operating cash flows, forcing them to turn to capital markets to fund their investments. New AI focused cloud businesses (“neoclouds”) without existing cash-generative business lines sprung up to meet the AI compute demand, going straight to the capital markets to fund their own datacenter buildouts.

Exhibit 1: Value Has Lagged Growth Over the Last Decade and a Half

Russell 1000 Value Index & Russell 1000 Growth Index; cumulative total return %



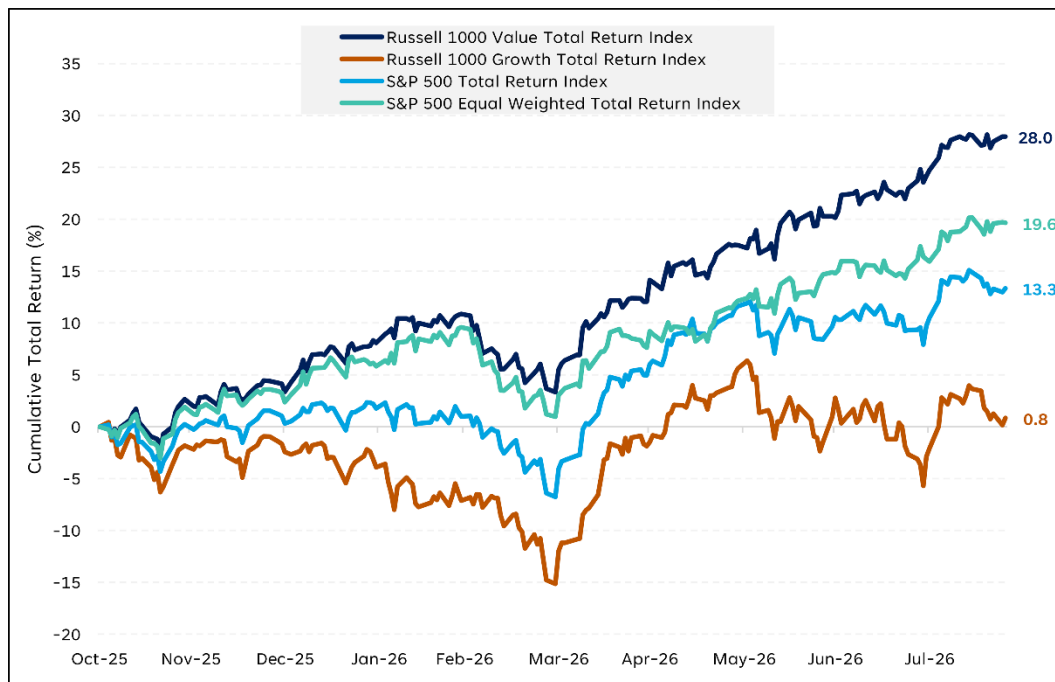
Source: LPL Research, Bloomberg 08/25/26; Monthly Total Returns, Cumulative, 12/31/09–10/31/25

Disclosures: All indexes are unmanaged and cannot be invested in directly. Past performance is no guarantee of future results.

This brings us to 2025, when slowly but surely investors started to question just how much capital this new technology would require, what kind of returns should be expected of this invested capital, and how long will it take to show up? We covered this topic in last month's note, "[What Does Hyperscaler Capex Have to Earn?](#)" This increased level of scrutiny presented itself in equity index performance starting late last year; you may have heard the financial talking heads speak of this phenomenon as a "broadening out," as the equal-weight S&P 500 began outperforming the more widely quoted market-cap-weighted version of the S&P 500. However, the value vs. growth performance reversal was even more stark. From October 31, 2025 to August 25, 2026, the growth index has generated total returns of just 0.8%, while the value index has generated total returns of 28%. The "Value Has Taken Over Leadership in Current Regime" charts the cumulative return of each aforementioned index.

Exhibit 2: Value Has Taken Over Leadership in Current Regime

Russell 1000 Value, Russell 1000 Growth, S&P 500, S&P 500 Equal Weight Indexes; cumulative total return %



Source: LPL Research, Bloomberg 08/25/26; Daily Total Returns, Cumulative, 10/31/25–08/25/26

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There are several explanations we can choose from for this relatively short period of value outperformance. There is index concentration: the value index is much less concentrated than the growth index, which as of October 31, 2025 had >50% weighting to just six companies. There's also sector composition: Information Technology's weighting averaged over 50% in the growth index relative to value's 14% average weight, while energy & materials (the top-performing sectors over the period) combined for an average weight of 0.7% relative to value's 10.3%. Don't forget idiosyncratic security "selection": cyclical memory chip and storage companies that put up 3x–7x returns during the period, such as Micron Technology Inc. (MU), Sandisk Corp. (SNDK), and Western Digital Corp. (WDC), were solely constituents of the value index up until the late June 2026 Russell FTSE Index reconstitution. It's easy to accept any or all of these facts, but they are simply narratives describing bits and pieces of the broader story, which is that the market is in the early innings of a new regime that is unlikely to reward the same stock underwriting as the prior regime.

So, we know the value style can outperform when the corners of the market that the value index rules typically favor (banks, energy and materials companies, industrials, defensive cash generators) outperform. What we don't learn from studying value style indexes is what valuation metrics are telling us about intrinsic value, and what metrics investors should focus their efforts. For example, a stock can be cheap on earnings and expensive on free cash flow. Or it can be cheap on book value because the business is structurally impaired. It can be expensive on trailing earnings but attractive on normalized cash flow. In other words, what we want to understand is which definition of value is doing the heavy lifting. This is where quantitative factor analysis shines.

Value Factors: Why FCF Yield Deserves the Spotlight

Quantitative investors ("quants") typically focus on factors, which are simply quantifiable characteristics of a given stock that explain what likely drove the stock's returns. There are countless factors quants have come up with, but most studied are typically fundamental factors, such as value and quality (profitability, leverage, etc.) and market factors, such as momentum (trailing price-based returns) and volatility. Some factors, such as value and size, typically combine fundamental metrics with market-based metrics. Our focus is on the value factor, which was one of the first factors academically studied in the seminal work by Eugene Fama and Kenneth French in 1992s, "The Cross-Section of Expected Stock Returns."

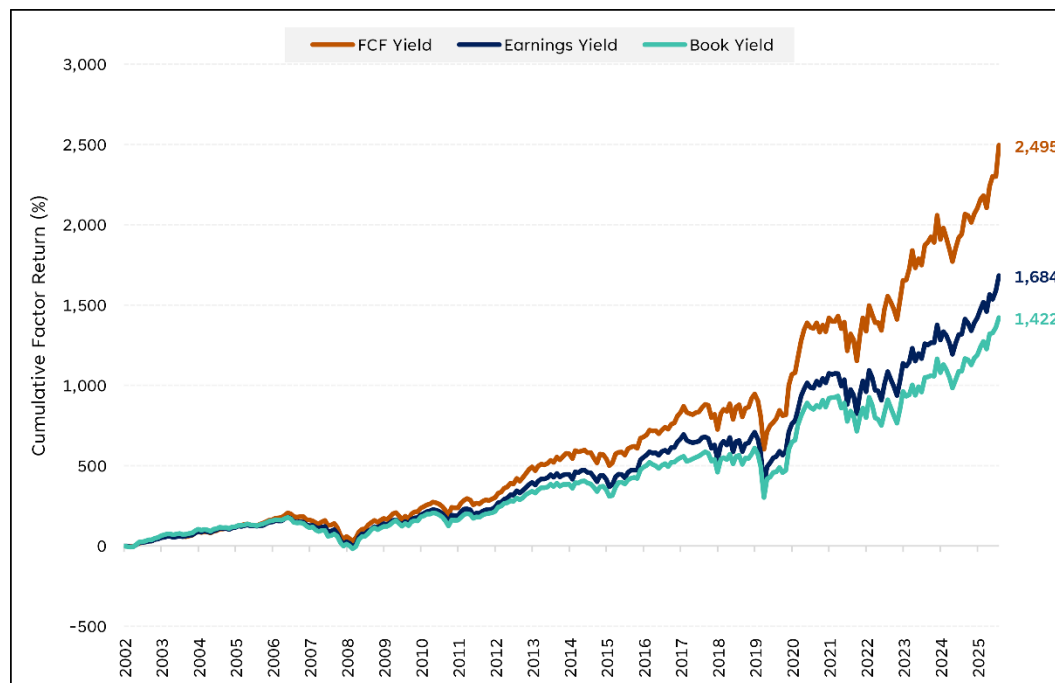
To set the stage for our brief analysis of value factors, we will focus on fundamental metrics relative to price or enterprise value (EV), sourced from each of the three financial statements, including:

- Income statement: earnings yield (EPS/price, the inverse of the oft-cited price-to-earnings (P/E) ratio)
- Balance sheet: book yield (book value per share/price)
- Cash flow statement: FCF yield (free cash flow (FCF)/EV)

Earnings yield asks how much accounting profit a company generates relative to price. Book yield asks what is the net asset value (that is, assets less liabilities on the balance sheet) of the business relative to the value the market is pricing. Note that traditionally book value measures primarily tangible assets, which has led the factor to fall out of favor as a greater percentage of economic value is now created from intangible assets (like software code, pharmaceutical research, etc.) relative to tangible assets. Finally, FCF yield asks how much cash remains after the business funds the capex required to operate and grow. Among value factors, free cash flow (FCF) yield has historically been one of the cleaner ways, in our view, to measure what investors are actually buying. Focusing on the differences between earnings and FCF yields, these two metrics can be very similar in stable, low-capex businesses, but they can diverge significantly in capital-intensive or acquisition-heavy businesses, as well as companies where working capital, stock-based compensation, leases, and depreciation schedules create a wide gap between reported earnings and economic cash generation.

Exhibit 3: FCF Yield Has Outperformed Earnings Yield and Book Over 20+ Years

Factor returns for FCF/EV (FCF yield), E/P (earnings yield), and B/P (book yield)



Source: LPL Research, Bloomberg 08/25/26; Monthly Factor Returns, Cumulative, 12/31/02–07/31/26

Disclosures: Past performance is no guarantee of future results.

As demonstrated in “FCF Yield Has Outperformed Earnings Yield and Book Over 20+ Years,” leveraging Bloomberg’s “*Factors That Work*” function and the Russell 1000 Index constituents as our universe, FCF yield has outperformed earnings yield and book yield over 20+ years of history. A brief aside: What is this analysis doing, exactly? It sorts the universe on each respective factor and takes the top quintile (i.e., top 20%) of yields and averages the monthly performance of each stock; rinse and repeat (i.e., re-sort the universe) monthly and chain those returns together over the study period. Needless to say, these kinds of studies are purely hypothetical and should not be considered an investable strategy or a recommendation. What this study shows is simply how stocks demonstrating high levels of these value characteristics (relative to peers) historically have performed.

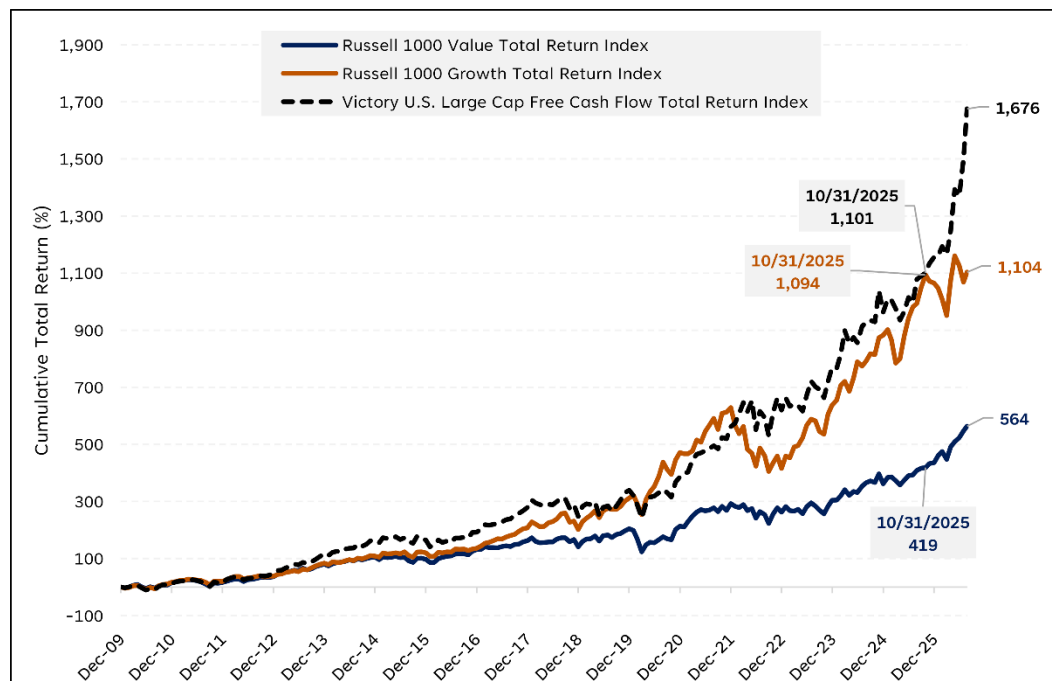
The reason FCF yield has outperformed other value factors, in our view, is not a mystery. Intrinsic value is ultimately the present value of future free cash flows. GAAP earnings can be a useful approximation when accruals are clean, depreciation roughly matches maintenance capital spending, working capital is stable, and stock-based compensation is modest. It is when those assumptions break down that earnings yields become less reliable as a value signal. FCF yield gets closer to the economic question investors should focus on, namely, how much cash can this business produce for owners after reinvestment? That said, FCF is not perfect. FCF can be distorted by working capital timing, underinvestment, and financing choices. However, and the historical factor study effectively shows us this via FCF’s outperformance, it is harder to sustain illusions in cash flows than in accounting-based earnings.

Bringing FCF-focused strategies into our comparison of style indexes, we highlight the Victory U.S. Large Cap Free Cash Flow Total Return Index in “FCF Yield With a Growth Overlay Works Well in the Current Market Regime” over the full period reviewed previously. What is interesting about this index is that it focuses not only on stocks with high FCF yields but then selects a subset of those high FCF yield stocks with the highest historical and expected growth prospects. Therefore, this approach is not directly representative of a single-factor strategy like in the prior study. This approach of FCF-based value, with a growth overlay, appears to play well in the current market regime we find

ourselves in, as the strategy kept pace with the growth style in the long-term horizon analyzed (2010 through October 2025) and has broken out from both value and growth style indexes in the shorter time horizon (October 2025 to current).

Exhibit 4: FCF Yield With a Growth Overlay Works Well in the Current Market Regime

Russell 1000 Value Index, Russell 1000 Growth Index, and Victory U.S. Large Cap Free Cash Flow Index; cumulative total returns



Source: LPL Research, Bloomberg 08/25/26; Monthly Total Returns, Cumulative, 12/31/09–08/25/26

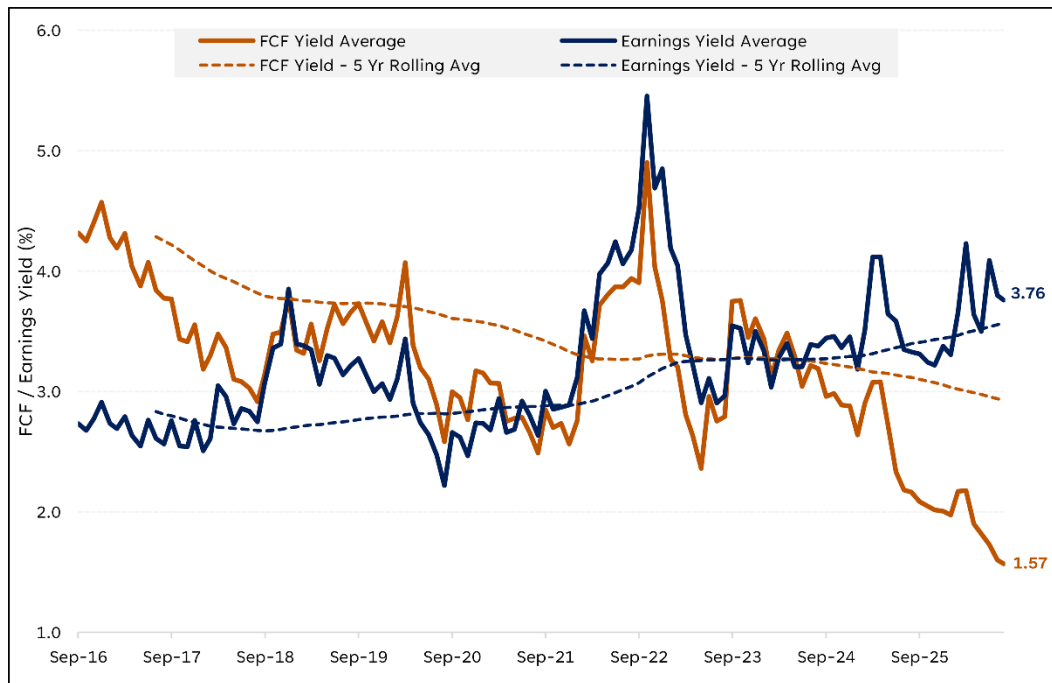
Disclosures: All indexes are unmanaged and cannot be invested in directly. Past performance is no guarantee of future results.

Hyperscalers and the AI Capex Cycle: Cheap on Earnings, Expensive on FCF

Now, let's bring everything covered on valuation factors and the current market regime into one of the biggest debates in markets today — the hyperscalers' investment bonanza. Our goal isn't analyzing what kind of returns the current investments can be expected to generate (as noted in our [July Beyond the Numbers](#)), but to evaluate where the group is trading today in terms of value. On earnings, the largest AI infrastructure spenders (we're defining the hyperscalers as Google (GOOGL), Amazon (AMZN), Microsoft (MSFT), and Meta (META)) can still look reasonably valued relative to their growth rates and historical averages, trading at an earnings yield of 3.76% (P/E equivalent of 26.6x), which is 5% above the group's trailing five-year average of 3.57% (P/E equivalent of 28.0x). In other words, the group is trading roughly in line (or at a slight discount) to historical levels. FCF yields, on the other hand, paint a different picture altogether. The cohort is producing strong reported earnings growth, but free cash flow has come under immense pressure as AI-related capex has accelerated. This produces a current group average FCF yield of 1.57%, which is 46% below their trailing five-year average of 2.92%. The average historical yields on a monthly cadence and trailing five-year averages for the hyperscaler cohort is presented in "Hyperscaler FCF and Earnings Yields Diverge Amid AI Capex Splurge."

Exhibit 5: Hyperscaler FCF and Earnings Yields Diverge Amid AI Capex Splurge

Average FCF and earnings yields for hyperscaler* cohort



Source: LPL Research, Bloomberg 08/25/26; Average LTM FCF and earnings yields, Monthly, 09/30/16–08/25/26

Disclosures: Past performance is no guarantee of future results.

*Hyperscaler cohort includes GOOGL, AMZN, MSFT, META.

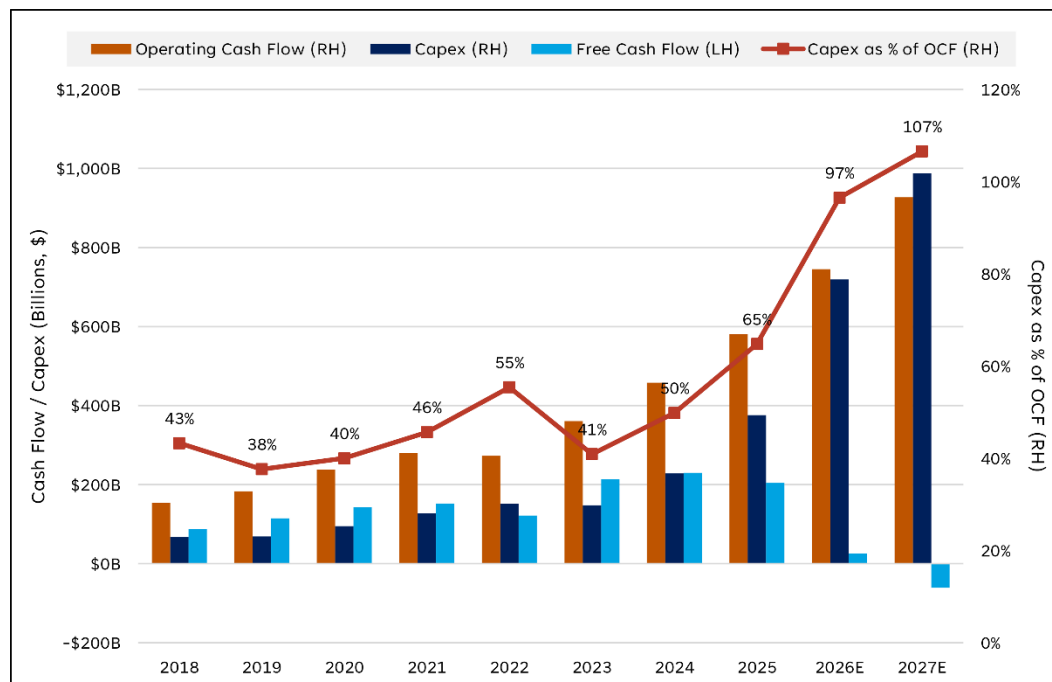
Furthermore, when looking over the last 10 years, FCF and earnings yields largely tracked one another. The divergence we are now seeing shows us what we already know, that the AI buildout has significantly changed the cash flow profile of these businesses. And as that divergence has expanded year to date, the stocks have collectively underperformed the S&P 500, with just one of the four (AMZN) slightly outpacing the broader market. The current regime's preference for cash flow expresses itself yet again, among some of the largest and most widely followed stocks in the market, no less.

The hyperscaler capex and free cash flow story is fully appreciated by investors, so we won't belabor the point too much. We will note that negative free cash flow, a distinction most of the hyperscalers should achieve in calendar 2026 based on consensus estimates, is not a bad thing in and of itself. If the return on invested capital (ROIC) clears the cost of capital and the expected returns from competing capital projects, then the spending is not only fine, but encouraged. That is the unknown variable here, of course, and we have our doubts on the value creation in the pure finance textbook sense. Perhaps an alternative way to frame the debate is through sheer size, rather than percentage returns; given the size of these businesses (both in terms of sales and their balance sheets), there aren't likely many investment opportunities that can move the needle in terms of incremental returns on capital. As we discussed in our note last month, perhaps this business looks more like a highly specialized infrastructure play, or even, heaven forbid, a railroad. Note that railroads consistently generate a lot of free cash flow.

"Hyperscaler Operating Cash Flow, Capex, and Free Cash Flow History" chart displays the annual progression of the four hyperscaler's combined operating cash flow, capex, free cash flow, and capex as % of operating cash flow.

Exhibit 6: Hyperscaler Operating Cash Flow, Capex, and Free Cash Flow History

Aggregated operating cash flow (OCF), capital expenditures (Capex), free cash flow, and capex as % of OCF



Source: LPL Research, Company Filings, Bloomberg (Consensus) 08/25/26

Disclosures: Past performance is no guarantee of future results. Hyperscaler cohort includes GOOGL, AMZN, MSFT, META.

So, we know the hyperscalers can appear undervalued based on earnings yields, but not on FCF yields, as depreciation has not yet caught up with the capex cycle. Another interesting point with this phenomenon is that while the capital spending is only partially reflected in earnings for the hyperscalers given capitalization of the costs (calendar 2026 consensus forecasts for depreciation as a percentage of capex for the group equals 26%), the same dollars are fully recorded as revenue for the “picks and shovels” providers, primarily semiconductor companies. This isn’t anything out of the ordinary, simply how accounting standards work and corporate investment pencils out. What’s out of the ordinary is the size of this investment, as well as the outsized influence both the hyperscalers and the semiconductor companies have on index level earnings growth. Food for thought for the record earnings growth narrative.

Tying this back to what the FCF yield factor has identified in this environment, the capital-cycle risk with the hyperscalers is that spending has been pulled forward faster than monetization, GAAP earnings will lag the deterioration in economic returns, all while FCF provides investors plenty of advance warning. This pattern is familiar across capital cycles. Telecom networks in the late 1990s, semiconductor capacity in the early 2000s, and shale oil in the early 2010s all involved real demand and large capital commitments. But when too much capital chases an opportunity all at once, future returns typically underwhelm for the capital providers. FCF yield is useful in precisely these moments, as it forces investors to ask whether reported growth is translating into owner cash.

Conclusion

Earnings tell us what the accounting system recognizes today, while FCF tells us what remains after the business funds itself. In periods when capital is cheap and growth is scarce, investors may be willing to look far into the future and pay for earnings potential, as we saw with growth index outperformance in the 2010s and the early part of the 2020s. In periods when capital intensity rises and the cost of capital matters again, a period we very much believe we are now in, cash flow discipline tends to regain importance. The lesson is simple. Cheap earnings are not always cheap cash flows.

And we believe the recent value rotation has only just begun. However, we aren't leaning into style-box definitions of value or growth. Instead, we focus on cash generation, self-funded growth investment, and economic value creation. There are plenty of ways for investors to implement value in this manner; via systematic expressions like factor investing, or via individual fundamental business analysis a la the Oracle of Omaha. However you apply value principles to your investment portfolio, we simply suggest keeping this north star in mind — over time, intrinsic value is paid in cash.

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Asset allocation does not ensure a profit or protect against a loss.

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Value investments can perform differently from the market as a whole. They can remain undervalued by the market for long periods of time.

Beta Measures a portfolio's volatility relative to its benchmark. A Beta greater than 1 suggests the portfolio has historically been more volatile than its benchmark. A Beta less than 1 suggest the portfolio has historically been less volatile than its benchmark.

The PE ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

All index data from Bloomberg.

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