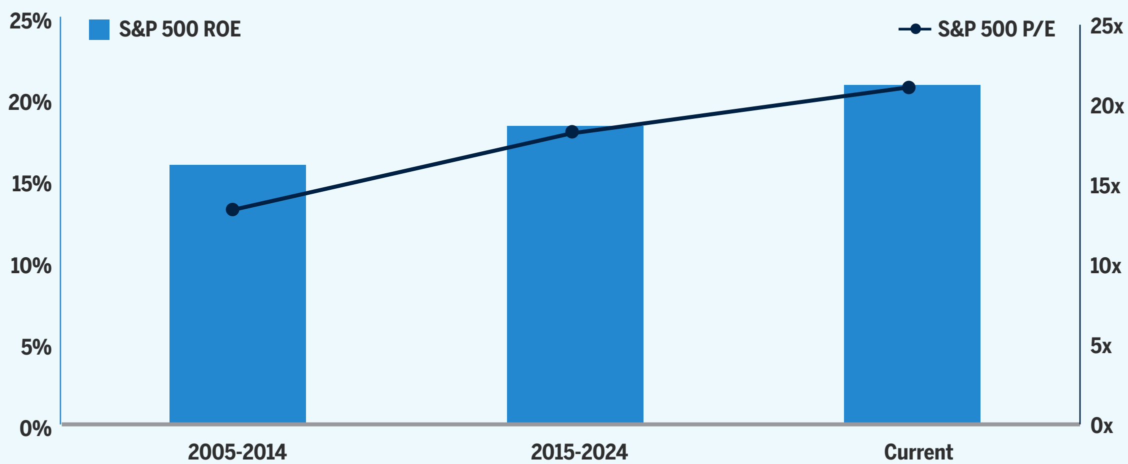
A Paradigm Shift?

Over the past two decades, the price that investors have been willing to pay for each dollar of S&P 500 earnings has increased, reflected by the price-to-earnings ratio (P/E). Do today's elevated valuations signal investor exuberance, or are they justified by strong corporate fundamentals?

Rising Return on Equity May Justify Higher S&P 500 Index Valuations



Source: FactSet and Standard & Poor's, based on monthly values from 1/1/2005–6/30/2025. Price-to-earnings (P/E) data calculated by dividing the S&P 500 Index price by its next twelve month consensus estimates.

- A company's return on equity (ROE) is its net income divided by average shareholder equity, which measures how effectively a company generates profit using the capital provided by shareholders both through stock issuance and accumulated retained earnings. In the chart above, the ROE of the S&P 500 has trended higher on average over the past two decades.
- One reason for the increase in ROE, in our view, is the index's growing share of asset-light, high margin businesses. These companies often post higher ROE because net income (the numerator) scales quickly, while shareholder equity (the denominator) rises more slowly thanks to low tangible asset needs (e.g., property, inventory, equipment). Examples of asset-light businesses include social media platforms and enterprise software firms, which generate significantly more revenue from fewer physical assets compared to asset-intensive industries like automotive or telecommunications that require substantial investment in factories or equipment to achieve comparable revenue growth (see also Rational Exuberance). As a result, the S&P 500 Growth Index has a significantly higher ROE than the S&P 500 Value Index, as growth companies typically operate more asset-light business models.[1]
- Additionally, this shift toward asset-light business models has increased free cash flow conversion—the ratio of free cash flow to net income. Companies today increasingly allocate investments to intangible assets, such as research and development, which are expensed immediately, lowering reported earnings more significantly than similar investments in tangible assets. Yet over time, these intangible investments tend to significantly enhance profitability, supporting sustainably higher ROE. For this reason, we believe this trend toward higher ROE and stronger free cash flow conversion supports elevated P/E ratios in the equity market, carrying important implications for asset allocation.

[1] As of 6/30/25, the ROE of the S&P 500 Growth Index was 28.8%, while the S&P 500 Value Index was 15.1%.

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Price-to-earnings is the ratio for valuing a company that measures its current share price relative to its earnings per share.

Earnings per share (EPS) is the portion of a company's earnings or profit allocated to each share of common stock.

Free cash flow is the cash a company generates after taking into consideration cash outflows that support its operations and maintain its capital assets.

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