

Tobin's Q and Net ROI: Value Creation and the Concentration of Returns

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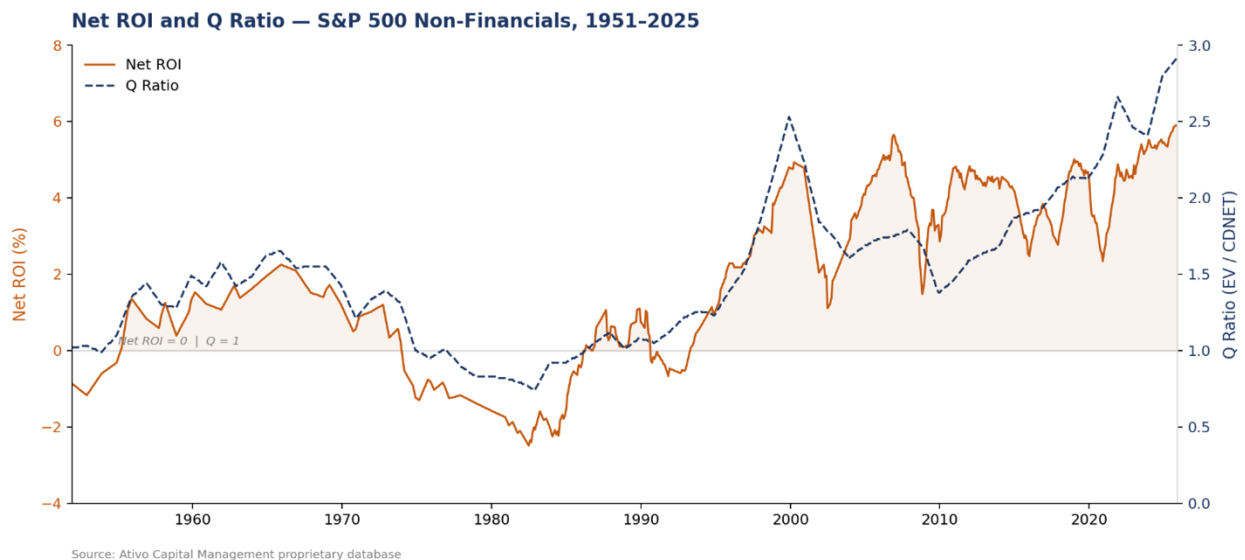
Background

In our earlier paper, *Tobin's Q and Net ROI: Why Record Valuations Still Reflect Real Value Creation*, we showed that elevated Q ratios were aligned with a historically wide Net ROI spread. Extending that framework through 2025 does not overturn the conclusion. It sharpens it: a disproportionate share of that value creation now resides in the Magnificent Seven.

We use the same DCFROI-based definitions and aggregate methodology set out in the earlier paper. The only changes are that the series is extended through 2025 and decomposed between the Magnificent Seven - Apple, Microsoft, Nvidia, Amazon, Alphabet, Meta, and Tesla - and the rest of the S&P 500 operating companies. Financial firms and utilities are excluded throughout. Financial firms deploy capital through balance sheet intermediation rather than productive investment, while utility returns are administratively set rather than competitively earned. In both cases, replacement-cost analysis becomes inapplicable or distorted. The earlier paper presents the full 1951-2024 aggregate series and detailed methodology.

The aggregate picture still supports the original conclusion

Extending the series through 2025 does not overturn the original conclusion. It strengthens it.



Aggregate Q for S&P 500 operating companies rose to 2.92x in 2025, while aggregate Net ROI increased to 5.85% from 5.42% in 2024. The spread between returns on capital and the cost of capital therefore remains near postwar highs.

That continuity matters. The market still looks expensive by historical standards, but the premium continues to coincide with unusually strong realized returns on capital. That was the central message of the earlier paper. The 2025 data confirm it.

The new result is concentration

What has changed is not the broad relationship between Q and Net ROI, but where it now comes from.

The aggregate index has become materially less representative. When the S&P 500 operating company universe is split between the Magnificent Seven and the rest of the index, the shift is hard to miss. In 2010, the group then comprising five members represented approximately 5.0% of gross cash receipts and 7.3% of total enterprise value. By 2025, those shares had risen to 32.4% and 37.0% respectively. About one-third of the cash generated by S&P 500 operating companies now flows through seven firms, which also account for more than one-third of total enterprise value.

More important, the group's share of value is not merely large. It is supported by a very different level of economic performance.

A two-speed market

The 2025 split makes the divergence explicit. The Magnificent Seven generated a Net ROI of 15.2% in 2025, versus 4.0% for the rest of the S&P 500 operating companies. Their Q ratio was 5.24x, compared with 2.32x for the remainder of the index.

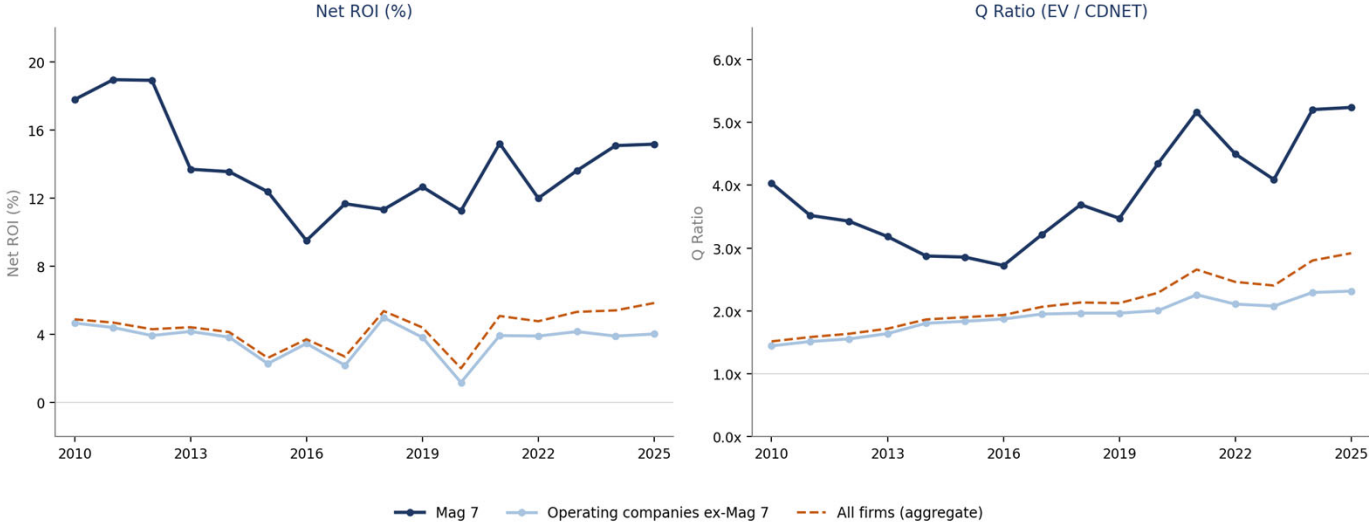
Key metrics, 2025

	Mag 7	Operating companies ex-Mag 7	All firms
Net ROI	15.2%	4.0%	5.85%
DCFROI	20.4%	9.2%	11.1%
Q ratio (EV / CDNET)	5.24x	2.32x	2.92x
Share of gross cash receipts	32.4%	67.6%	100%
Share of enterprise value	37.0%	63.0%	100%
Share of capital deployed	20.3%	79.7%	100%
Number of firms	7	338	345

Net ROI = DCFROI minus average annual cost of capital (5.20% for 2025). Q ratio = enterprise value / current-cost net assets (CDNET).

The aggregate figures - 5.85% Net ROI and 2.92x Q - do not describe a uniform market. They describe one in which an extraordinary subgroup pulls the aggregate above what the rest of the index would imply.

Net ROI and Q Ratio by Group — S&P 500 Operating Companies, 2010-2025



Source: Ativo Capital Management proprietary database

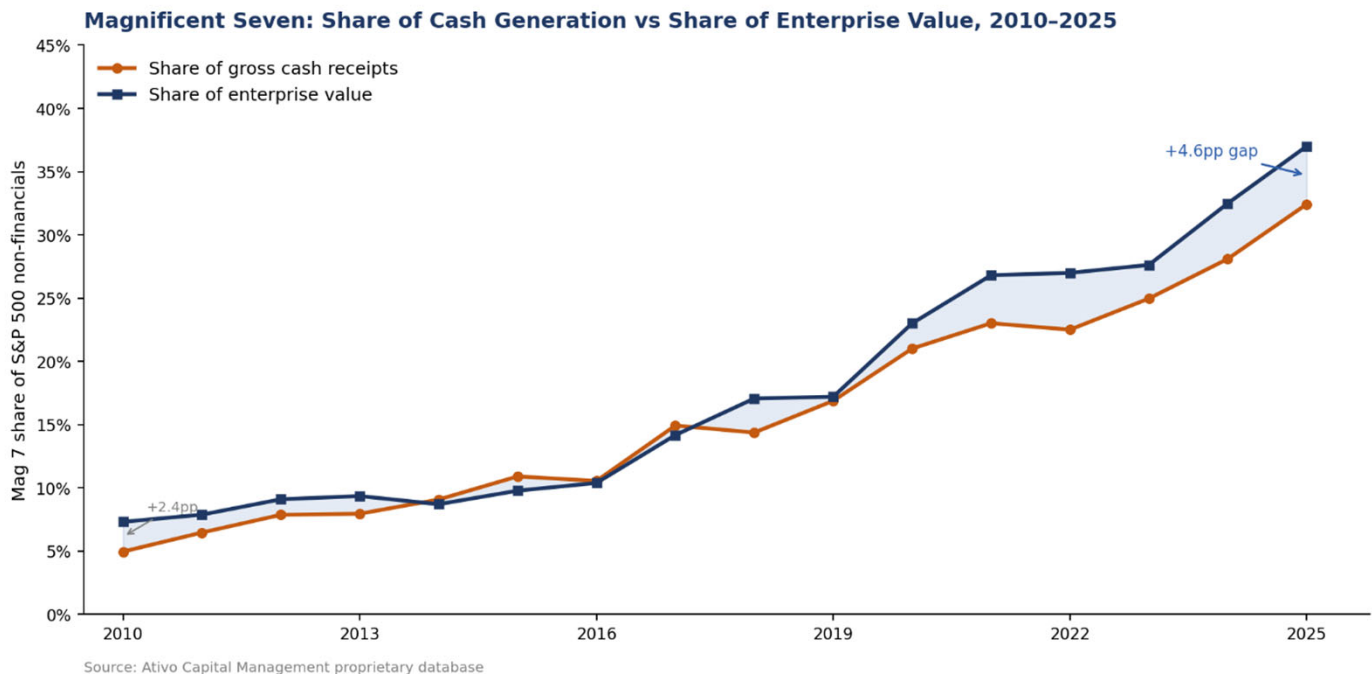
This distinction matters because aggregate data can be accurate and still conceal structure. At the index level, elevated valuations remain tied to elevated returns. At the constituent level, the market is better described as two-speed: one segment with unusually high returns on capital, unusually high valuation multiples, and an outsized share of cash generation; and another with positive but much more ordinary rates of value creation.

It is also important not to overstate the opposite case. A Net ROI of 4.0% and a Q ratio of 2.32x for the rest of the index still indicate positive value creation. The operating companies ex-Mag 7 portion of the market remains profitable and, viewed on its own, sits within the historically normal range for the aggregate. It is simply much closer to ordinary conditions than the headline numbers suggest.

What the market appears to be pricing

In 2025, the Magnificent Seven accounted for 32.4% of gross cash receipts but 37.0% of total enterprise value. The market is therefore assigning them a share of value that exceeds their already exceptional share of current cash generation. That gap - 4.6 percentage points in 2025, up from 2.4 percentage points in 2010 - is consistent with an expectation of continued outperformance, not merely recognition of what has already been achieved.

That expectation may or may not prove correct. But the valuation premium above current cash-generation share has been widening. The market is not merely capitalizing current returns; it is also assigning a longer duration to this group's superiority than to the typical firm's.



Methodology note

Net ROI is defined as DCFROI minus cost of capital (COC). DCFROI is the internal rate of return equating a firm's current-cost investment base with its future cash flows available to all securityholders, computed from four components: current-cost gross assets (PV), non-depreciating assets (FV), asset life (n), and gross cash receipts (PMT). COC figures are averaged across all monthly observations within each calendar year. The aggregate COC for 2025 is 5.20%. Aggregation is performed at the index level by combining firm-level inputs and computing a single IRR on the pooled cash flows, then subtracting the pooled COC. Q is defined as enterprise value divided by current-cost net assets (CDNET = current-cost gross assets minus accumulated depreciation at current cost). Financial firms and utilities are excluded from all figures. Financial firms (banks, insurers, asset managers) deploy capital through balance sheet intermediation, making total assets a poor proxy for productive capital deployment. Utilities operate under regulated capital structures where returns are administratively set rather than competitively earned, distorting the relationship between capital deployed and cash generated. Different methodologies or assumptions may produce materially different results.

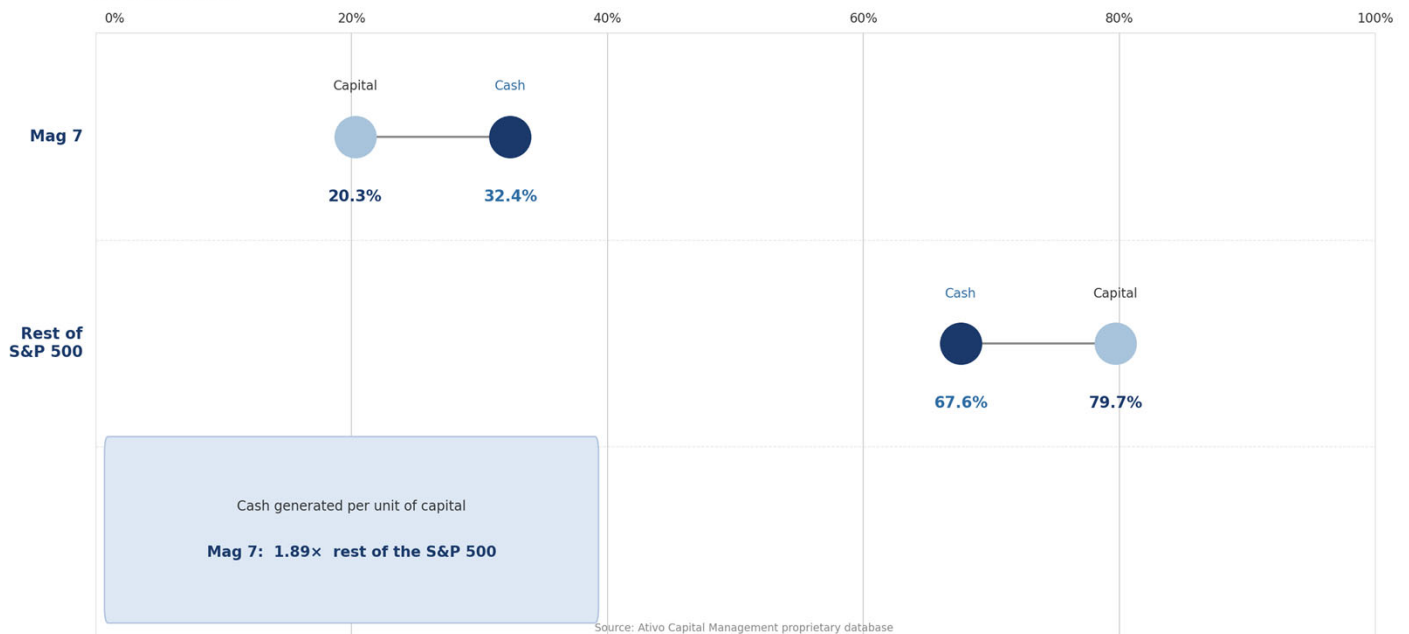
Capital efficiency: what the seven firms actually do differently

The Magnificent Seven's share of enterprise value exceeds their share of cash generation and far exceeds their share of capital deployed. In 2025, they accounted for 20.3% of current-cost gross assets across the index, but 32.4% of gross cash receipts. Put differently, they generate about 1.89 times as much cash per unit of capital as the rest of the index. That ratio has been broadly stable since 2010, ranging between 1.7x and 2.1x.

That stability is informative. The cash generation advantage is not a recent phenomenon or a product of any single year's results. It has persisted across multiple interest rate cycles, two recessions, and significant changes in the composition of the group itself. The persistence is consistent with structural advantages in capital efficiency, though the data here show the output rather than the mechanism.

Cash share exceeds capital share for the Mag 7

Share of total capital deployed vs. share of gross cash generated, 2025
S&P 500 non-financials



Data coverage note

2025 figures are preliminary and reflect 338 firms representing approximately 96.6% of the index by market capitalization. Oracle is the most notable omission; its fiscal year ends in May and its results will be incorporated once available. We do not believe the remaining firms would materially alter the conclusions presented here.

Positioning and interpretation

The practical conclusion is narrower than the headlines around market concentration usually imply.

This is not evidence that aggregate valuations are detached from fundamentals. Nor is it evidence that most of the market is in a speculative condition. It is evidence that the aggregate premium is increasingly being earned by a concentrated set of firms with exceptionally strong economics.

That creates both clarity and a well-defined risk.

The clarity is that the market's high Q ratio remains intelligible through the same framework as the earlier paper. High Q continues to align with a wide Net ROI spread. That relationship has not broken down.

The risk is more precise than it was when the earlier paper was written. The aggregate equilibrium described there - high Q supported by wide Net ROI - has not changed in its basic character. But it has become more dependent on a smaller number of firms. A material deterioration in Mag 7 profitability, or a sustained rise in financing costs, would now compress the aggregate Q ratio faster than the headline level implies, because a larger share of the aggregate premium sits in one subgroup. The earlier paper already noted that rising financing costs or falling profitability would narrow the spread. The additional point here is that concentration has made that sensitivity more asymmetric than before.

Takeaway

The 2025 update preserves the core conclusion of the earlier paper. Elevated Q ratios still reflect genuine value creation rather than speculative excess. Aggregate Net ROI of 5.85% and Q of 2.92x are consistent with each other, and consistent with the long-run relationship between the two measures.

But the composition of that value creation has become far more concentrated. The Magnificent Seven now account for roughly one-third of gross cash receipts and more than one-third of enterprise value within S&P 500 operating companies, while generating Net ROI of 15.2% versus 4.0% for the rest of the index. Their share of enterprise value exceeds their share of cash generation. That gap has widened over fifteen years, consistent with the market assigning a longer duration to their superiority.

The right way to read today's aggregate market valuation is therefore not simply that the market is expensive for good reason. It is that a growing share of that reason now resides in seven firms - and that the aggregate's sensitivity to their continued performance has grown accordingly.

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