

➤ On the Minds of Investors

## Investors seeking resilience should consider a quality bias

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**It is intuitive that quality characteristics would be attractive for investors, given the way in which they can make companies more resilient while also ensuring that company performance is translated into shareholder value.**

At first glance, 2025 appeared to be another strong year for global equity markets. However, a closer inspection reveals some unusual dynamics beneath the index level, as higher-quality companies were shunned by investors, while a preference for lower-quality companies overwhelmed fundamental analysis. In this note, we provide context on last year's "dash for trash" and explain why we believe it is a mistake to ignore the higher-quality characteristics that have traditionally outperformed over longer periods.

There are various ways that quality characteristics can be defined, but three key principles are generally consistent. First, strong balance sheets—often captured by low leverage ratios—typically enable companies to be more resilient during periods of economic stress. Second, the ability to generate stable earnings growth in different macro environments offers investors strong visibility about the future path of profits. And third, skillful management teams ensure that companies can translate investments into healthy profits, as reflected by metrics such as higher levels of return on equity (ROE).

### Portfolio construction matters

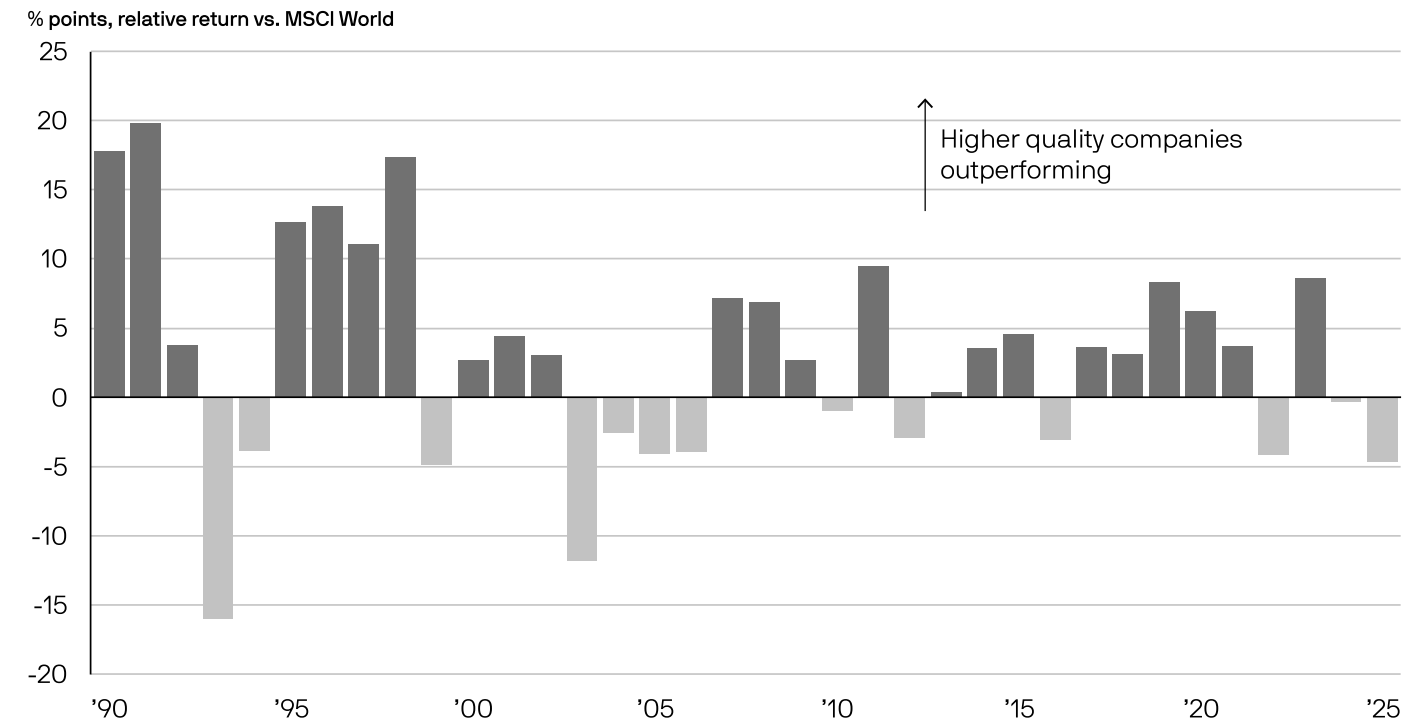
*Quality portfolios can be constructed in a variety of ways. Passive allocations may track benchmarks that select a subset of stocks with higher-quality characteristics, tilt the weights of all index constituents towards higher-quality names, or tilt towards higher-quality companies in each sector while keeping sector weights consistent with the parent index.*

*Active managers have more flexibility in how quality characteristics are incorporated, but these decisions may also result in sector or style biases. Investors should think carefully about the impact these decisions can have on performance in different market environments.*

It is intuitive that quality characteristics would be attractive for investors, given the way in which they can make companies more resilient while also ensuring that company performance is translated into shareholder value. Since the turn of the millennium, higher-quality companies have outperformed broad developed markets by an impressive 5 percentage points, annualized, based on the MSCI World Quality Index<sup>1</sup>.

However, such outperformance does not come in a straight line. Higher-quality companies in developed markets have underperformed in 13 out of the last 35 years, with last year being a particularly acute example. In 2025, higher-quality companies underperformed broad developed markets by 5 percentage points, marking their worst year on a relative basis since 2003.

## Calendar year relative performance of MSCI World Quality



Source: LSEG Datastream, MSCI, J.P. Morgan Asset Management. Relative returns are shown in USD total return terms. Past performance is not a reliable indicator of current and future results. Data as of December 31, 2025.

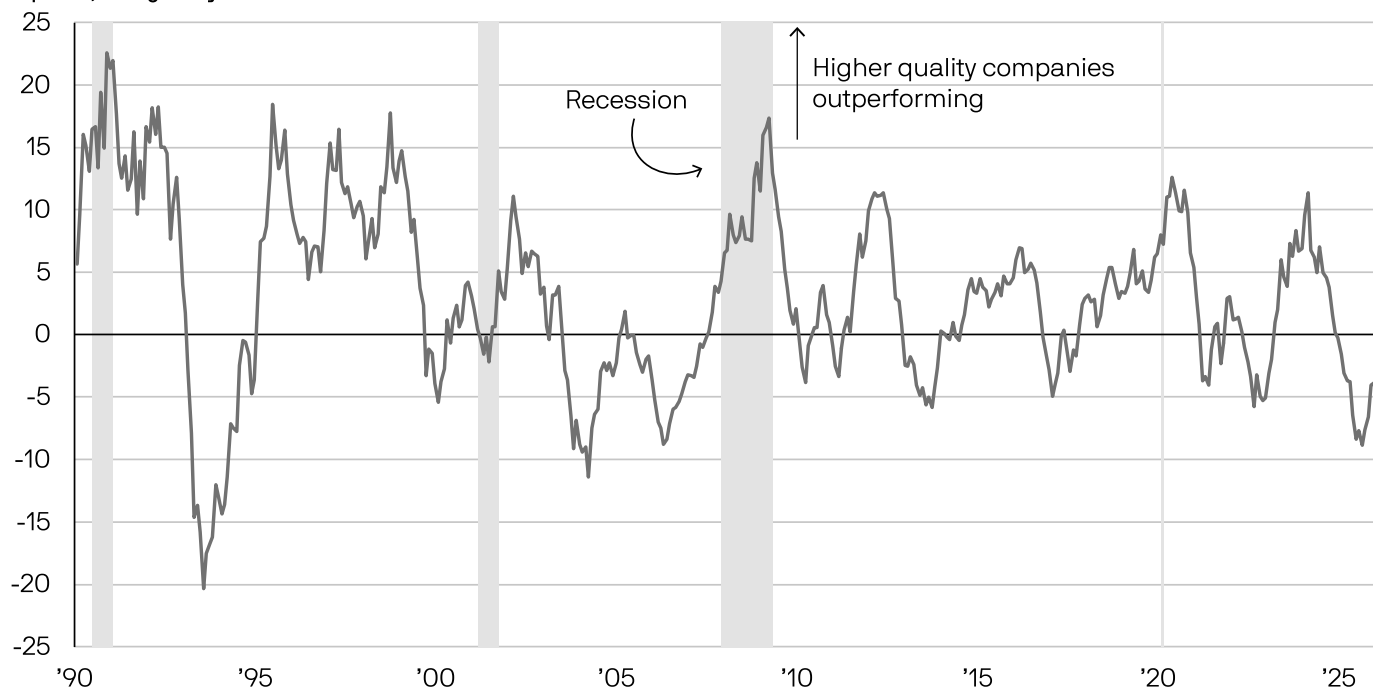
## Lessons from history

There are several things that we can learn from previous periods where higher-quality companies have underperformed. First, such underperformance is typically associated more with rising equity markets than falling markets. Since 1990, for example, developed market equities have registered 10 calendar years with negative total returns. In these years, higher-quality companies underperformed only once.

The second lesson is that periods of quality underperformance can be followed by sharp reversals. The period from 2003 to 2008 provides a prime example. Higher-quality companies lagged broader developed markets for four consecutive years from 2003 to 2006, in the run-up to the global financial crisis. But as the cycle matured and the global economy eventually entered recession, higher-quality fundamentals returned to the fore, with quality stocks outperforming by 7 percentage points in both 2007 and 2008.

## MSCI World Quality relative performance

% points, rolling one-year relative return vs. MSCI World



Source: LSEG Datastream, MSCI, J.P. Morgan Asset Management. Relative returns are shown in USD total return terms. Periods of recession are defined using US National Bureau of Economic Research (NBER) business cycle dates. Past performance is not a reliable indicator of current and future results. Data as of December 31, 2025.

More broadly, quality stocks have repeatedly demonstrated their ability to add ballast to portfolios during equity market drawdowns, not just those that have occurred during recessions. Developed market stocks have seen nine drawdowns of 10% or more over the last 30 years. During these periods, quality stocks have outperformed 78% of the time, with a median excess return of 3.4 percentage points. The two times when they failed to boost resilience were during a brief drawdown in 2007, with markets hitting new all-time highs two months later, and in 2022, when a sharp inflation spike saw commodity sectors outperform. During the 2025 drawdown, quality stocks did outperform but only very marginally, with export-oriented companies, particularly in the tech sector, hit hard by the shift in US policy.

Given the current overweight to companies related to the artificial intelligence (AI) theme in some higher-quality passive strategies (linked to the balance sheet strength of tech megacaps), investors should carefully consider which strategies would act as the most defensive exposure in future drawdowns. For example, if the next downturn is triggered by a shift in AI sentiment, investors seeking ballast may benefit from accessing an up-in-quality approach via strategies that avoid a heavy skew towards the tech sector.

## Relative quality performance during equity market drawdowns of 10% or more

%, maximum drawdown from previous all-time highs

Period	MSCI World Quality (%)	Max drawdown	
		MSCI World (%)	Quality relative (% pts)
Jul to Oct '98	-17.1	-20.5	3.4
Mar '00 to Oct '02	-44.2	-51.4	7.3
Jul to Aug '07	-11.3	-11.0	-0.4
Oct '07 to Mar '09	-49.9	-59.1	9.1
May '15 to Feb '16	-12.2	-18.9	6.7
Jan to Dec '18	-18.7	-20.2	1.5
Feb to Mar '20	-30.5	-34.2	3.7
Jan to Oct '22	-31.0	-27.1	-3.9
Feb to Apr '25	-16.7	-16.8	0.1

Source: LSEG Datastream, MSCI, J.P. Morgan Asset Management. Maximum drawdowns are based on daily price returns in US dollars. Past performance is not a reliable indicator of current and future results. Data as of December 31, 2025.

## Building resilience

In our 2026 Investment Outlook, our base case for the global economy sees economic growth regaining momentum and broadening by sector and region in 2026. Given this positive view, there may not appear to be an immediate need for equity investors to shift toward a higher-quality stance.

Yet with equity markets around the world having already moved a long way to reflect a positive outlook, and with geopolitical uncertainty remaining elevated, it's understandable that many investors are seeking ways to build resilience in portfolios. We believe that a quality-centric approach is an attractive way to do just that. Given the valuation premium of higher-quality stocks relative to broader developed markets has more than halved since July 2024, recent underperformance may represent a good opportunity for equity allocations to shift up the quality spectrum.

<sup>1</sup> For the purposes of this piece, statistics for higher-quality companies are based on the MSCI Quality indices, but we believe that the conclusions are broadly indicative of a "higher-quality" bias in equity portfolios.

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