

How innovation is changing where investors look for defensive quality

From the Field
Q1 2026



Key Insights

- Traditional defensive sectors and highly profitable, stable businesses historically have held up better during market downturns. We expect that to continue.
- However, technological innovation and structural market changes are making some of these historical risk profiles less reliable at the sector or factor level.
- Integrating sector and factor frameworks with stock-level analysis and an awareness of positioning can help with defense in stormy markets.

The first quarter was marked by the U.S. war with Iran, which started on February 28. At a high level, the overall quarter reflected continued strength in momentum, a rotation from growth to value, and, somewhat unusually, the underperformance of both risk and quality (Figure 1). Beneath the surface, there were two key themes.



Tedd Alexander
Head of Integrated Equity



David Corris, CFA®
Portfolio Manager



Brian Dausch, CFA®
Portfolio Specialist

Quarterly factor returns

(Fig. 1) January 1, 2026–March 31, 2026

Index	Total Return	Valuation	Growth	Momentum	Quality	Profitability	Risk	Size
MSCI Pacific ex-Japan	2.99%	22.14%	-24.09%	21.41%	-16.25%	-14.53%	-18.11%	-3.46%
Russell 1000 Value	2.10	2.25	-7.00	7.59	-2.25	-2.17	-7.89	3.68
Russell 2500	2.04	8.12	-3.37	7.22	1.77	3.06	-11.37	1.59
MSCI Japan	1.51	8.10	-6.86	13.76	-10.75	-1.82	0.71	5.01
MSCI Emerging Markets	-0.10	8.50	-8.60	9.85	0.58	0.92	0.53	-0.38
MSCI Europe	-2.68	2.49	-8.92	9.56	-4.18	-7.42	-13.09	2.03
Russell 1000	-4.18	7.28	-13.56	7.64	-3.03	-0.06	-8.66	1.66
Russell 1000 Growth	-9.78	5.43	-13.10	10.88	5.54	11.26	-8.08	-1.07

Past performance is not a guarantee or a reliable indicator of future results.

Sources: Refinitiv/IDC data, Compustat, Worldscope, Russell, and MSCI. Analysis by T. Rowe Price. See Additional Disclosures for more detail on the sources used throughout this material. Total return data are in U.S. dollars. Factor returns are calculated as equal-weighted quintile spreads. Quintiles are rebalanced daily.

Factors or factor analysis involves targeting quantifiable firm characteristics, or “factors,” that can explain differences in stock returns. Over the last 50 years, academic research has identified hundreds of factors that impact stock returns. **See Appendix for calculation methodology, definitions of financial terms, and more details on the factors referenced throughout the article.** The data presented in this material are for illustrative purposes only and do not represent an actual investment nor any T. Rowe Price product.

Theme No. 1: Market broadening

There was a significant shift in leadership from U.S. large-cap growth to U.S. value, small- and mid-cap U.S. stocks, and international equities (Figure 2), in line with our thinking from last quarter's newsletter.¹ The market had become increasingly concerned about the mega-cap tech companies' spending on infrastructure underpinning advanced artificial intelligence (AI), as these outlays reduce their free cash flow and capacity to buy back shares. Meanwhile, the market rewarded signs of improving relative earnings in other areas.

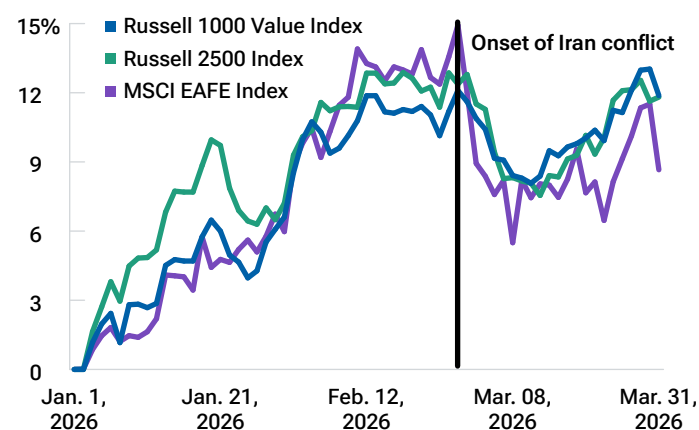
Notably, the broadening trade reversed sharply at the onset of the war but quickly recovered. To us, this highlights a key unresolved tension in the market: Are large-cap growth companies still defensive? The market's immediate reaction suggests that these stocks can still offer some resilience during market corrections, but the speed of the reversal calls that into question.

Theme No. 2: Mixed performance of "quality" factors during the March drawdown

The March sell-off was notable for the lack of clear defensive leadership. For example, higher-quality companies and those with better profitability did not meaningfully outperform, while higher-risk stocks did not meaningfully underperform.

Market broadening briefly interrupted at onset of U.S. war with Iran

(Fig. 2) Excess returns of select indexes relative to Russell 1000 Growth Index



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January 1, 2026, to March 31, 2026

Sources: FTSE/Russell, MSCI. Analysis by T. Rowe Price. Total return data are in U.S. dollars.

In addition, stocks with valuation support underperformed those with higher valuations, which is not what we would have expected in a richly priced equity market. (See Figure 3.) The mixed performance of "quality" extended beyond factors, with gold and U.S. Treasuries also underperforming, for example.

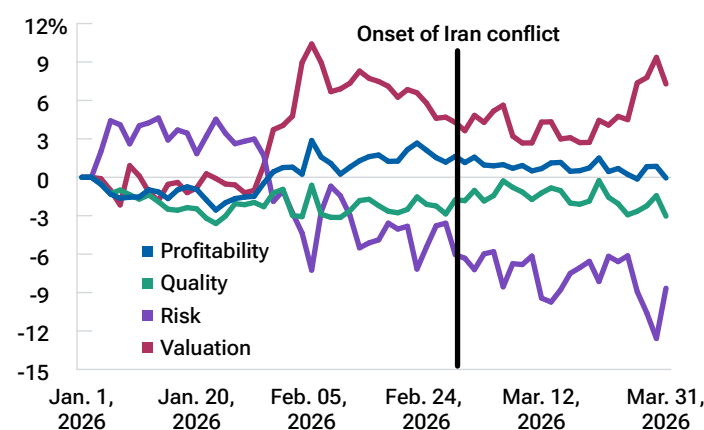
Why didn't quality hold up better during the drawdown? We highlight a few reasons:

- **Pre-war trading:** Factor performance shows that the risk-off, valuation-sensitive trade occurred earlier in the quarter. Whether the market was anticipating the war or not, some of the effect may have happened earlier in the quarter.
- **Hedge fund deleveraging:** Funds appeared to sell crowded long positions—often in higher-quality companies—while covering their short positions in lower-quality stocks.
- **Yield competition:** Rising U.S. 10-year Treasury yields led to weakness in bond proxies, or stocks where dividends² typically have accounted for a sizable portion of their prospective return.

Overall, we think that the first quarter reinforced the case for equity market broadening and highlighted how traditional defensive relationships can break down in the short term.

March sell-off marked by lack of clear defensive leadership

(Fig. 3) Selected factor returns within Russell 1000 Index, before and after the onset of the war



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January 1, 2026, to March 31, 2026

Sources: Refinitiv/IDC data, Compustat, Worldscope, Russell, and MSCI. Analysis by T. Rowe Price. Total return data are in U.S. dollars. Factor returns are calculated as equal-weighted quintile spreads. Quintiles are rebalanced daily.

¹ See the T. Rowe Price Integrated Equity team's Q4 2025 paper, "Why the Stock Market Could Broaden Sustainably Beyond U.S. Large-Cap Growth."

² Dividends are not guaranteed and are subject to change.

The mixed performance of quality factors in March spurred us to address a more general question: How are technological innovation and structural changes in industry fundamentals and market behavior affecting the types of stocks that can offer defense?

- Based on our analysis of historical market data, the **outside view** suggests that bond proxies and other traditional defensive groups, such as utilities, consumer staples, and health care, should still behave defensively in most environments. Leading technology and communication services companies with strong profitability, growth, and competitive moats have also evolved to behave more defensively.
- However, the **inside view** adds a wrinkle. Disruptive innovation may change the risk profile of some stocks that the market has historically viewed as defensive. Key examples of these new forces include GLP-1 weight-loss drugs, advanced AI, and rising participation of retail investors in the stock market.

Combining these inside and outside views leads us to believe that traditional sources of defense should remain effective in many environments but are becoming less reliable when applied purely at the sector or factor level.

Playing defense increasingly requires an approach that integrates an awareness of factor exposures with fundamental, stock-level analysis.

Outside view: What parts of the equity market have been defensive?

To analyze what kinds of stocks the market has viewed as defensive, we first consider the evolving composition of a U.S. equity index that is designed to limit volatility.

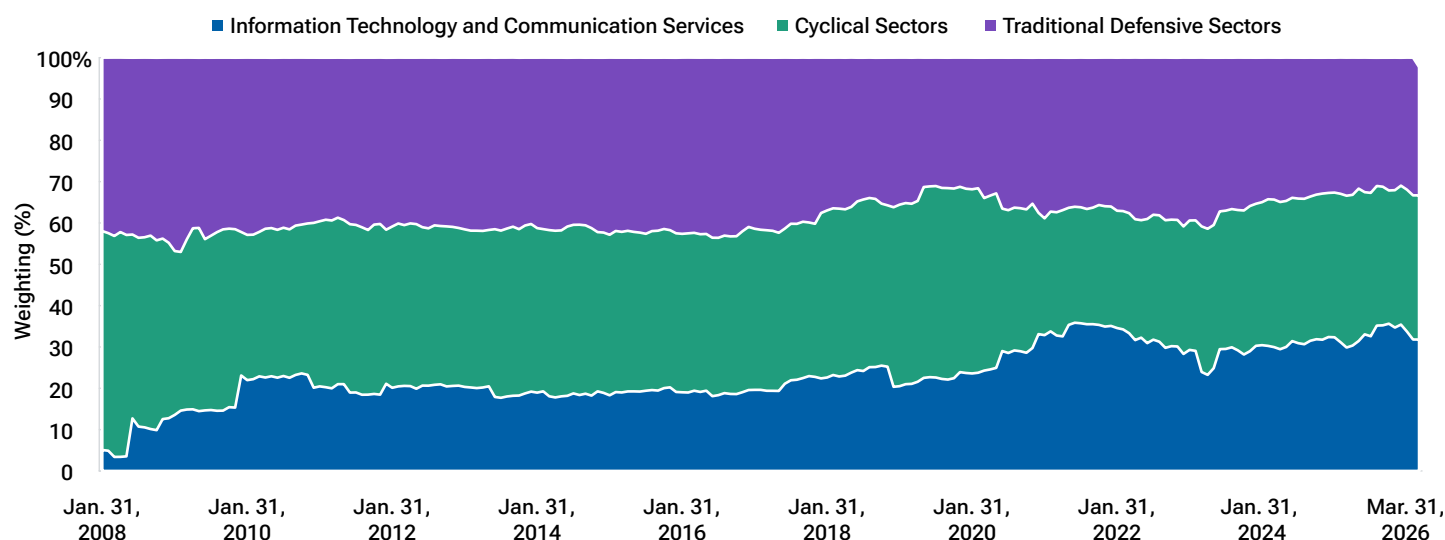
Since 2008, the weighting of traditional defensive sectors in the MSCI USA Minimum Volatility Index has declined, while its exposure to the information technology and communication services sectors has increased (Figure 4).

This shift stems, in part, from strong relative performance. But it also reflects the changing volatility profile of these sectors as the profitability of these tech-related business models and their competitive advantages made the market view these companies' cash flows and growth prospects as more resilient.

For further insight, we look at sector and factor performance during eight meaningful market drawdowns from the past 30 years (Figure 5).

Market perception of defensive stocks has shifted

(Fig. 4.) MSCI USA Minimum Volatility Index's tech weighting has increased



January 31, 2008, to March 31, 2026

Sources: MSCI. Analysis by T. Rowe Price.

The MSCI USA Minimum Volatility Index seeks to reflect the performance characteristics of applying a minimum variance strategy to the large- and mid-cap U.S. equity universe. Cyclical sectors comprise the following sectors: consumer discretionary, energy, financials, industrials, materials, and real estate. Traditional defensive sectors comprise consumer staples, health care, and utilities.

What has worked and what hasn't during past market drawdowns?

(Fig. 5) Relative returns for select sectors and long-short returns for select factors

Select Sectors and Barra Factors	Long Term Capital Management (7/31/1998–8/31/1998)	Bursting of Internet Bubble (9/30/2000–9/30/2002)	Global Financial Crisis (11/30/2007–02/28/2009)	European Debt Crisis (4/30/2011–9/30/2011)	U.S.-China Trade War Concerns (10/31/2018–12/31/2018)	Covid-19 Pandemic (2/29/2020–3/31/2020)	Federal Reserve Raising Rates (1/31/2022–9/30/2022)	U.S. Trade Tariffs (2/28/25–4/30/2025)
■ Consumer Staples	0.4%	57.0%	24.0%	15.6%	8.5%	6.9%	12.6%	12.0%
■ Health Care	4.3	21.0	17.1	9.9	4.3	10.1	10.1	3.5
■ Utilities	11.8	1.8	12.7	20.1	14.9	1.0	17.8	10.3
■ Communication Services	6.1	-17.9	1.1	1.9	7.1	1.9	-12.1	11.9
■ Energy	0.6	28.9	6.9	-10.3	-11.0	-24.7	60.4	1.1
■ Financials	-7.0	23.6	-23.4	-14.0	0.5	-10.3	3.6	2.0
■ Consumer Discretionary	-1.8	28.2	-0.3	7.3	-2.8	0.3	-5.9	-9.6
■ Information Technology	1.6	-35.2	-0.3	2.1	-4.0	5.3	-9.7	-3.4
■ Industrials	-1.5	14.2	-5.6	-3.5	-3.2	-5.0	-0.7	0.8
▲ Earnings Quality	6.2	60.6	30.7	13.7	1.4	5.0	3.8	3.8
▲ Dividend Yield	17.0	35.4	0.5	8.7	3.0	-14.1	12.3	-2.9
▲ Momentum	-0.2	26.1	14.3	2.7	-3.1	3.9	22.1	0.1
▲ Size	8.4	-19.9	8.4	7.4	-0.6	5.0	6.5	6.0
▲ Beta	-11.9	-87.8	-26.2	-18.4	0.2	-13.8	-30.4	0.9
▲ Leverage	-2.9	31.2	-23.0	-4.6	1.4	-7.7	-0.8	-4.1
▲ Residual Volatility	-2.7	-51.7	-18.6	-2.5	-2.9	18.4	-6.1	-0.3
▲ Liquidity	-4.3	-69.1	-16.4	-6.9	-1.8	-1.3	-10.6	-2.5

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Sources: Refinitiv/IDC data, Russell, and MSCI Barra. Analysis by T. Rowe Price. Total return data are in U.S. dollars and cumulative for each period. Returns for Russell 1000 sector indexes are relative to the Russell 1000 Index. Factor returns are calculated monthly as equal-weighted quintile spreads. Factors are defined according to the Barra US Risk Model. See Appendix for details.

■ = Sector. ▲ = Barra Factor.

Much of what outperformed and underperformed during past market corrections shouldn't come as a surprise.

- **Sectors:** Traditional sources of defense—consumer staples, health care, and utilities—outperformed the market in each instance. Cyclical, on the other hand, tended to underperform.
- **Factors:** Earnings quality, dividend yield, momentum, and size generally outperformed. Beta, leverage, residual volatility, and liquidity tended to underperform.

However, the historical data and sector performance during the March 2026 pullback also reveal two notable takeaways. First, technology stocks historically have tended to underperform during periods of market stress, which contrasts with their perceived defensiveness and increasing representation in the MSCI USA

Minimum Volatility Index. Second, the relative underperformance of consumer staples and health care in March 2026 stands out as unusual versus their historical resilience.

Next, we turn our attention to the inside view and how some of these historical relationships may be evolving.

Inside view No. 1: Technological disruption could affect which stocks behave defensively

Many defensive stocks are market leaders, which should make them more resistant to disruption because they tend to have strong business moats, established brands, customer relationships, barriers to entry, and economies of scale.

However, disruptive innovation, almost by definition, can disproportionately impact even high-quality incumbents. Consider the health care and AI innovation waves and their potential effects on business fundamentals and competitive dynamics across a variety of industries.

- **Consumer staples:** Growing adoption of GLP-1 weight-loss drugs, which help to suppress appetite, has raised concerns about consumption of packaged food and beverages, making parts of the consumer staples sector less defensive.
- **Health care:** The potential health benefits of GLP-1s have also led to worries about longer-term demand trends for other health care products and services.
- **Software:** The risk of AI disruption has led to many software stocks, formerly prized for the resilience of their subscription-based cash flows, behaving less defensively.
- **Utilities:** Their defensiveness, especially in capitalization-weighted strategies offering exposure to the sector, could change as power companies linked to the buildout of AI infrastructure become a larger part of the market.

These are leading examples, but the broad applicability of AI could change the competitive dynamics in many other business

models that are perceived as lower risk, such as insurance and professional services.

Finally, we emphasize that the risk to these companies doesn't need to be existential. Rather, our point is that the uncertainty around these companies' terminal values can reduce their effectiveness as defensive exposures—particularly if investors penalize that uncertainty during risk-off periods.

Inside view No. 2: Changes in stock market structure could affect how the quality factor performs

Hedge funds and retail investors have accounted for a greater proportion of trading volume since the COVID-19 pandemic, which has changed the nature of highly shorted stocks.

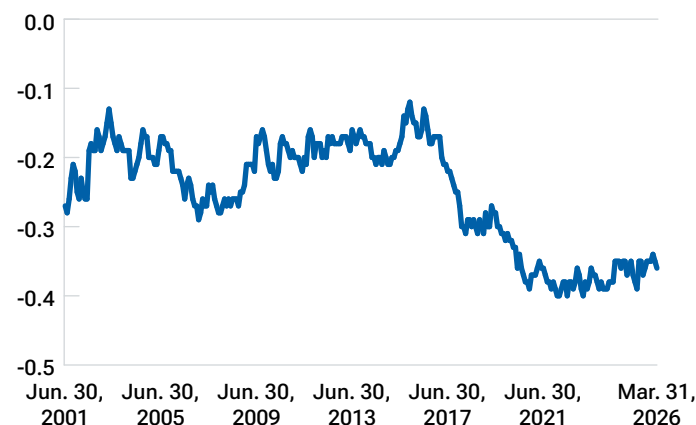
Investors have always bet against lower-quality stocks. However, there has been a paradigm shift: Market participants are shorting lower-quality stocks much more than in the past (Figure 6).

Meanwhile, the increase in retail trading has led highly shorted stocks to become much more volatile (Figure 7). Some retail investors now employ sophisticated strategies to target highly shorted stocks with low liquidity and self-organize using social media. We have come to view retail investing as a sophisticated “risk factor” that we need to respect.¹

¹ The T. Rowe Price Integrated Equity team explored this phenomenon at length in the Q3 2025 paper, “Why Quality Looks Expensive in U.S. Large Caps and Attractive in U.S. Small Caps.”

Market participants are increasingly shorting lower-quality stocks

(Fig. 6) Correlation between short interest and quality, Russell 1000 Index



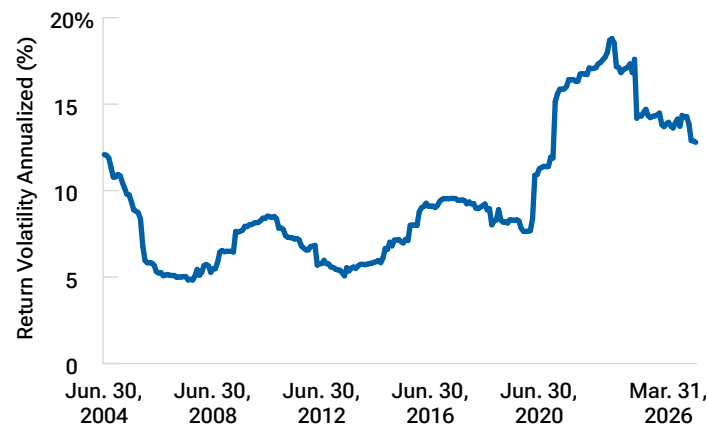
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June 30, 2001, to March 31, 2026

Sources: Refinitiv/IDC, Russell data. Analysis by T. Rowe Price. Chart depicts the correlation, calculated monthly, between short interest and our proprietary quality score for the universe of stocks in the Russell 1000 Index. Short interest is defined as the percentage of shares sold short relative to a company's float. See Appendix for more details on how we define the quality factor.

Structural factors have made heavily shorted stocks more volatile

(Fig. 7) Rolling three-year return volatility for stocks with the highest short interest, Russell 3000 Index



Past performance is not a guarantee or a reliable indicator of future results.

June 30, 2004, to March 31, 2026

Sources: Refinitiv/IDC, Russell data. Analysis by T. Rowe Price. Total return data are in U.S. dollars.

Short interest volatility is calculated as the trailing three-year standard deviation, rolled monthly, of the return spread between the equal-weighted top decile of Russell 3000 companies ranked by short interest and an equal-weighted Russell 3000 Index. The 10% of the Russell 3000 Index with the highest short interest is reconstituted monthly.

Putting these trends together, we expect potentially greater volatility in the quality factor's performance, particularly during periods of hedge fund deleveraging. In these environments, positioning can override fundamentals, as hedge funds are forced to cover short positions in higher-risk names that are popular among retail investors while simultaneously reducing their long positions in high-quality stocks. As a result, quality may behave less defensively during acute drawdowns, even if these companies' long-term business fundamentals remain intact. This dynamic was evident during the market correction in March 2026.

Conclusion

The mixed performance of quality-related factors during the March 2026 market drawdown has led to questions about if and how investors should evolve their game plans for playing defense.

The outside view suggests that traditional defensive sectors and highly profitable, stable businesses historically have held up better during downturns. We expect that to continue. However, structural changes—both in technological innovation and the makeup of the market itself—are making some of these relationships less reliable.

In our view, identifying longer-term defensive business models and potential havens during stormy markets now requires a more selective approach that integrates sector and factor frameworks with fundamental, stock-level analysis and an awareness of positioning.

Appendix

Factors are our internally constructed metrics, defined as follows:

Valuation: Proprietary composite of valuation metrics based on earnings, sales, book value, and dividends. Specific value factor weighting may vary by region and sector.

Growth: Proprietary composite of growth metrics based on historical and forward-looking earnings and sales growth. Factor selection and weighting vary by region and industry.

Momentum: Proprietary measure of medium-term price momentum.

Quality: Proprietary measure of quality based on fundamental and stock price stability; balance sheet strength; and measures of profitability, capital usage, and earnings quality.

Profitability: Return on equity.

Risk: In this paper, risk is the standard deviation of trailing 12-month returns. High-risk stocks exhibit higher standard deviations, indicating a wider degree of variation or dispersion in their historical return.

Size: Market capitalization (positive return means larger stocks outperform smaller stocks).

Quintile spread: Also referred to as long-short returns, a quintile spread is calculated by sorting securities based on a specific characteristic or factor criterion, dividing them into five groups (or quintiles), equal-weighting the securities within each quintile, and then subtracting the bottom-quintile returns (lowest 20%) from the top-quintile returns (highest 20%).

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Risks: Growth stocks are subject to the volatility inherent in common stock investing, and their share price may fluctuate more than that of income-oriented stocks. The **value approach** to investing carries the risk that the market will not recognize a security's intrinsic value for a long time or that a stock judged to be undervalued may actually be appropriately priced.

Small-cap stocks have generally been more volatile in price than large-cap stocks. **Mid-caps** generally have been more volatile than stocks of large, well-established companies. Investing in **technology stocks** entails specific risks, including the potential for wide variations in performance and usually wide price swings, up and down. **Technology companies** can be affected by, among other things, intense competition, government regulation, earnings disappointments, dependency on patent protection, and rapid obsolescence of products and services due to technological innovations or changing consumer preferences. **International investments** can be riskier than U.S. investments due to the adverse effects of currency exchange rates, differences in market structure and liquidity, as well as specific country, regional, and economic developments. **Financial services companies** may be hurt when interest rates rise sharply and may be vulnerable to rapidly rising inflation. There is no assurance that **profitable** and/or **quality companies** will maintain profitability or quality in the future.

Other definitions:

Barra earnings quality explains stock return differences due to variability around company operating fundamentals (sales, earnings, cash flows) and the accrual components of their earnings.

Barra dividend yield captures differences in stock returns attributable to stock's historical and implied dividend-to-price ratios.

Barra momentum explains common variation in stock returns related to relative strength as reflected in recent (12 months) stock price behavior.

Barra size captures differences in stock returns and risk due to differences in the market capitalization of companies.

Barra beta measures a stock's potential sensitivity to broad market movements. It is calculated using excess returns regression coefficient to capitalization-weighted universe returns over the trailing 252 trading days.

Barra leverage captures common variation in stock returns due to differences in the level of company leverage, based on metrics such as debt-to-assets ratio and market and book leverage.

Barra residual value captures relative volatility in stock returns that is not explained by differences in stock sensitivities to market returns.

Barra liquidity captures common variations in stock returns due to the amount of relative trading and differences in the impact of trading on stock returns.

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