Sustainability
in Action

Third Quarter 2025

Defense as Resilience

In Brief

- Rising geopolitical tensions and a renewed focus on national security have redirected capital toward tangible defense capabilities, particularly those powered by emerging technologies like drones and advanced propulsion systems.
- Defense stocks have historically been resilient, underpinned by long-term contracts and stable, government-backed cash flows. Increasingly, the sector is also being shaped by broader themes such as climate policy and industrial innovation. While many investors have traditionally excluded defense, a more nuanced approach is gaining traction—one that balances ethical considerations with the sector's evolving strategic role and governments' increased defense spending. Engagement, rather than exclusion, may offer a more constructive path forward.
- As with any capital cycle, this shift will create both opportunities and risks. We explore these dynamics in the pages that follow.

A Shifting Defense Paradigm in Europe

Europe is undergoing a structural shift in its defense posture. The evolving transatlantic relationship and rising geopolitical uncertainty have prompted a reassessment of strategic priorities. What was once a region characterized by restrained military spending is now entering a new phase — one defined by urgency, investment and rearmament.

For decades, European defense budgets declined as a share of GDP, with many countries falling short of NATO's 2% target [Appendix 1]. That baseline has now shifted significantly. Member states have agreed to a new framework that includes 3.5% of GDP in core defense spending, supplemented by up to 1.5% in broader security-related investments. This is not a temporary adjustment, but a structural recalibration of what sovereignty requires in an increasingly fragmented global order. This trajectory was further solidified at the June 2025 NATO summit in The Hague, where leaders committed to raising total defense spending to 5% of GDP by 2035. Described as a historic agreement, the decision reflects a shared recognition of the enduring threat landscape and the need for sustained investment in both military capabilities and supporting infrastructure. This shift is not just about spending more, it's about spending differently. Capital is being redirected toward tangible capabilities, particularly in the land domain, where underinvestment has been most pronounced. Non-personnel expenditures, including equipment and modernization, are expected to rise materially, with Eastern European nations likely to lead the acceleration[1]. These developments mark the early stages of a new capital cycle in European defense — one that may reshape both the industrial and investment landscape for years to come.

Defense as Resilience

Aerospace and defense companies have historically provided a measure of resilience in portfolios, particularly during periods of heightened volatility and geopolitical uncertainty. This resilience is underpinned by long-term government contracts and stable, sovereign-backed cash flows, which help smooth earnings and reduce cyclicality. As a result, many institutional managers have traditionally included the sector as a strategic allocation within diversified portfolios.

Performance data supports this view. Over the past 14 years, the MSCI Europe Aerospace & Defense Index has outperformed the broader MSCI Europe Index in 11 of those years [Appendix 2]. The global picture is similar: the MSCI World Aerospace & Defense Index outperformed the MSCI World Index in 10 of the last 14 years.[2] On a longer horizon, the MSCI Europe Aerospace & Defense Index has delivered an annualized return of 8.61% over the past 30 years, nearly double the 4.41% return of the MSCI Europe Index over the same period.[3]

Despite this track record, investor interest in the sector has been surprisingly limited in recent years. One [Morgan Stanley] poll found that 68% of global long-only funds and 62% of European funds had zero exposure to European defense equities.[4] This is partly explained by the sector's modest growth profile in Europe prior to the Russian invasion of Ukraine in 2022, especially when compared to the US defense sector's expansion over the past two decades.

Another key factor has been regulatory and ESG-related exclusions. Many institutional investors have historically applied blanket restrictions to defense exposure, ranging from outright bans on companies involved in controversial weapons to revenue-based thresholds that exclude firms with significant defense operations. This has led to a paradox wherein one of the sectors most directly tied to national sovereignty and global stability has been sidelined by some of the world's largest asset owners.

68%
Global long only funds
WITH ZERO EXPOSURE TO EUROPEAN DEFENSE SECTOR

62%
European funds
WITH ZERO EXPOSURE TO EUROPEAN DEFENSE SECTOR

43%
International funds
WITH ZERO EXPOSURE TO EUROPEAN DEFENSE SECTOR

Morgan Stanley. (2025, March 28). European Defense Investor Survey Results [Research report]. Morgan Stanley Research. Data is based on Morgan Stanley Research estimates using fund holdings sourced from MSCI, Datastream, and FactSet. The analysis reflects the percentage of Global and European long-only funds with zero exposure to the European Defence sector as of December 2024. The sample group of funds varies month-to-month, though there is approximately 90% overlap across periods. December data for European funds is preliminary

However, this dynamic is beginning to shift. As Europe prioritizes territorial integrity and strategic autonomy, the investment case for defense is being re-evaluated, not just on performance grounds, but as a matter of policy alignment and long-term, real-world resilience.

Engagement Over Exclusion: A Strategic Reframing

We recognize the importance many investors place on ensuring their portfolios do no significant harm, avoid reputational risk, and align with their personal or institutional values. Where clients have provided clear guidelines—such as exclusions related to controversial weapons or specific revenue thresholds—we are fully committed to honoring those preferences.

At the same time, MFS' preferred approach is grounded in engagement rather than blanket exclusions. We believe the defense sector, given its dual strategic importance to national sovereignty and global stability, warrants a more nuanced lens. As active owners, we aim to develop a deep understanding of each issuer: its business model, governance practices, and broader societal impact. Through ongoing dialogue and engagement, we believe we can help shape the practices and direction of companies operating in this space. In today's environment of heightened geopolitical uncertainty, this approach allows us to support our clients' long-term investment goals while aligning with their values as responsible stewards of capital.

Navigating the Next Phase of the Defense Capital Cycle

As capital flows back into defense, particularly across Europe, the sector's projected growth trajectory is not without its complexities. While the renewed investment underscores the strategic importance of aerospace and defense (A&D) firms, it also brings to the fore a set of structural and operational risks that investors must navigate with care.

A&D companies tend to be labor-intensive, employing a relatively high proportion of skilled workers. This, combined with the presence of strong unions, introduces a layer of rigidity in cost structures and operations. Moreover, product segments with elevated safety risks—such as advanced propulsion systems or unmanned aerial vehicles—carry the potential for costly recalls and warranty liabilities, which can materially impact earnings.

Another dimension of risk stems from the sector's strategic significance. High levels of state ownership—31% of A&D firms compared to 18% in the broader MSCI ACWI Index[5] —can lead to government intervention, particularly in times of geopolitical stress. Control-enhancing structures, often embedded in these ownership models, may dilute the influence of minority shareholders and raise governance concerns, including susceptibility to corruption or political interference.

At the same time, the sector is under increasing pressure to align with broader industrial decarbonization goals. Clean technology innovation, particularly in propulsion systems, is emerging as a strategic imperative. As of mid-2024, 42% of A&D firms had identified clean-tech development as a core strategic objective.[6] The financial implications of this shift, ranging from increased capital expenditure to long-duration R&D cycles, will be a critical area of focus in the coming quarters.

In short, the defense sector is entering a new capital cycle—one shaped not only by geopolitical necessity but also by environmental accountability and evolving ownership dynamics. For investors, this means moving beyond binary exclusion frameworks and toward a more engaged, risk-aware approach. Investors who can identify firms that balance innovation with operational discipline, and who engage constructively on governance and sustainability, may be best positioned to capture the potential upside of this evolving capital cycle.

Case Study: Howmet Aerospace – Strategic Resilience, Governance Depth, and Climate Transition in Action

Howmet Aerospace is a global leader in advanced components for the aerospace and transportation industries. Its mission-critical products, ranging from engine parts to fasteners and structural systems, are essential to both commercial and defense platforms, placing the company at the intersection of national security and industrial innovation.

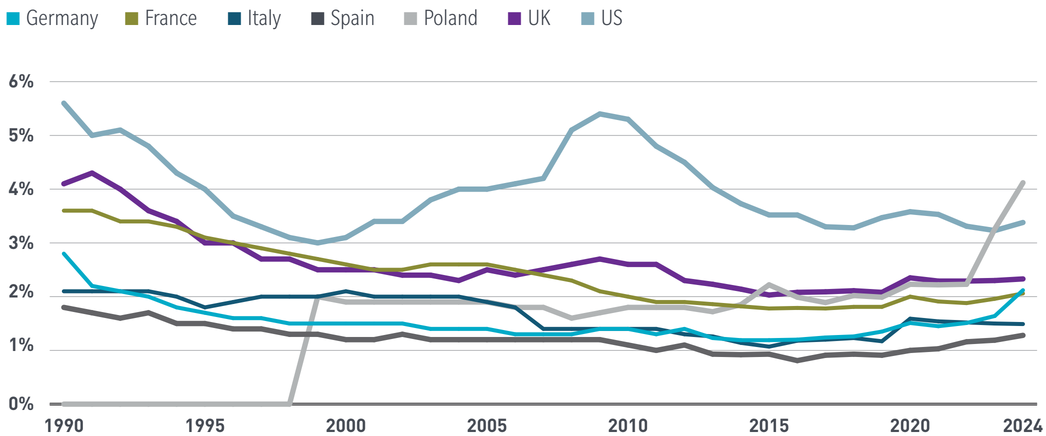
Howmet has demonstrated accelerating earnings growth, disciplined capital allocation, and exposure to structurally advantaged aerospace platforms. It exemplifies the type of defense-aligned industrial business that benefits from both long-term tailwinds and active stewardship. The company continues to deliver strong financial performance, with EBITDA margins expanding from 21.4% in 2019 to a projected 28% in 2025, and buybacks expected to contribute 2%-3% to EPS growth over 2025 – 2026.[7] As commercial aerospace recovers and next-generation engine programs scale, we believe Howmet is well-positioned to benefit from both volume leverage and pricing power.

Beyond financials, our engagement with the company has spanned multiple dimensions, including board and executive succession, climate strategy, and product quality. Succession planning is a board-wide responsibility, with internal candidates undergoing rotations across business units, a structure that reflects the company's commitment to developing leaders from within.

On climate, Howmet has committed to a 33.6% reduction in Scope 1 and 2 emissions by 2027, backed by over $30 million of investments in energy efficiency and renewable procurement.[8] While Scope 3 emissions remain a challenge, primarily from purchased metals, the company is engaging suppliers and scaling recycling initiatives. Though it does not yet label its products as "transition-enabling," many, such as lightweight aluminum wheels and advanced engine components, clearly support downstream emissions reduction. The company is also exploring low carbon manufacturing technologies, including heat pumps and hydrogen furnaces, though its three-year capex cycle limits medium-term target setting.

This combination of financial strength, governance maturity, and climate responsiveness reinforces Howmet's role as a strategically relevant and actively engaged holding in the evolving defense capital cycle.

Appendix 1: Defense Expenditures as a % of Gross Domestic Product



Source: NATO - Financial and economic data relating to defence 1990 -2024.

Appendix 2: Annual Performance (%)

Year	MSCI Europe Aerospace and Defense	MSCI Europe
2024	26.4	-0.87
2023	41.69	16.68
2022	3.46	-17.28
2021	2.26	13.75
2020	-20.07	3.14
2019	30.4	20.03
2018	-3.18	-17.27
2017	30.41	22.13
2016	0.04	-3.39
2015	1.46	-5.32
2014	-20.78	-8.59
2013	56.82	21.68
2012	24.13	15.15
2011	-1.61	-13.82

Past performance is no guarantee of future results. It is not possible to invest in an index.

Endnotes

[1] MFS Sector Analyst Notes.

[2] MSCI World Aerospace and Defense Index Data (2025).

[3] The MSCI Europe Aerospace and Defense Index is composed of large and mid cap stocks across 15 Developed Markets (DM) countries in Europe*. All securities in the index are classified in the Aerospace and Defense industry group (within the Industrials sector) according to the Global Industry Classification Standard (GICS®).

[4] Morgan Stanley. (2025, March 28). European Defense Investor Survey Results [Research report]. Morgan Stanley Research. Data is based on Morgan Stanley Research estimates using fund holdings sourced from MSCI, Datastream, and FactSet. The analysis reflects the percentage of Global and European long-only funds with zero exposure to the European Defence sector as of December 2024. The sample group of funds varies month-to-month, though there is approximately 90% overlap across periods. December data for European funds is preliminary

[5] MSCI Industry Report Aerospace & Defense 2024 June.

[6] MFS Sector Analyst Notes.

[7] Howmet ESG report 2024, MFS Investment Research Notes.

[8] MFS Sector Analyst Notes

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