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Quality | Theme Update

Q3 2026

In a Nutshell

Resilient to yields, compounded by AI

Summary

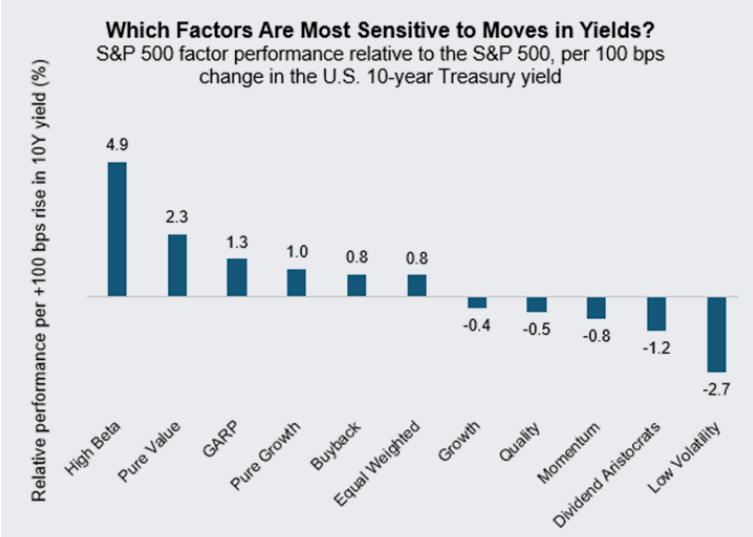
The third quarter (Q3) of 2026 provided an immediate test for our systematic Quality allocation. Global bond yields broke out to multi-year highs, with the 10-year US Treasury yield crossing 5% for the first time since 2023. Rising yields are typically a headwind for the quality factor, as higher discount rates compress the valuation multiples of long-duration cash flows. Despite this pressure, the iShares Edge MSCI World Quality Factor ETF (Quality ETF) returned +1.2% (dollar terms), versus a +1.7% rise in the FTSE All-World index.

This resilience was achieved during an extraordinary Q3 for technology equities. While speculative momentum suffered a historic sell-off – with Jefferies recording a record drawdown in its tech momentum index while mainstream media adopted a pervasively bleak tone – artificial intelligence (AI) progress accelerated dramatically. Major breakthroughs in September, notably Google DeepMind open-sourcing its frontier DNA model and OpenAI solving the Millennium Prize Navier-Stokes problem, confirmed that AI is advancing at an exponential pace that continues to surpass even industry insiders' expectations.

Beneath the surface, the Quality ETF's diversification and sector neutrality proved their worth, helping the portfolio avoid the negative quarterly returns posted by most regional equity benchmarks outside the US. Robust cash generation and earnings led by large-cap US tech platforms fully absorbed double-digit sell-offs across semiconductor equipment holdings. By anchoring our allocation to a rules-based quality-factor process, the portfolio captured structural tech advances while filtering out balance-sheet leverage and businesses vulnerable to AI disruption.

Market Developments

The narrow momentum rally that characterised Q2 paused in Q3, replaced by a rate-driven market and pronounced factor dispersion. With oil rising by over 50% in Q3 and inflation remaining persistent, global bond yields surged.



Source: S&P Dow Jones. Data from 7 Jul-95 to 23 Sep-26

When yields have risen, the High Beta factor has outperformed the S&P 500 most (+4.9%), with Low Volatility the biggest laggard (-2.7%). While the Quality factor faces a modest multiple drag (-0.5%), it proves relatively resilient

The yield spike created a valuation hurdle for Quality in Q3. As discount rates climbed, capital favoured short-duration, cyclical areas of the market. However, because the Quality ETF selects constituents on a sector-neutral basis (matching the MSCI World index), it avoided unwanted macro sector bets during the quarter.

The AI Paradox: Breakthrough Boom vs Pervasive Doom

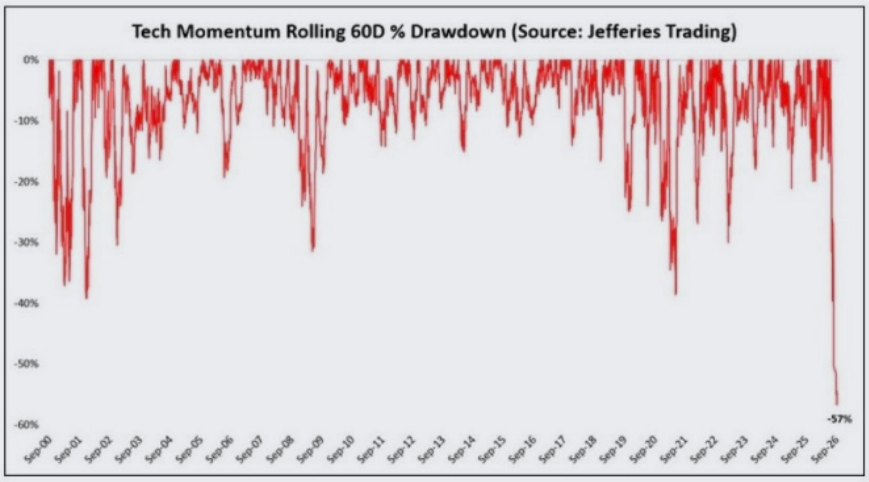
With Technology and Communication Services comprising 40.5% of the Quality ETF, developments in AI are central to the theme's long-term compounding power. In September, mainstream commentary turned pervasively bleak, epitomised by The Economist's cover depicting a binary mushroom cloud under the heading "Can the AI arms race be stopped?"



Source: The Economist, 19 Sep-26

Mainstream media headlines have succumbed to 'if it bleeds, it leads' sensationalism, contrasting sharply with contemporaneous AI breakthroughs in mathematics and science

This editorial alarmism coincided almost exactly with Jefferies' Tech Momentum Index hitting the nadir of a -57% rolling 60-day drawdown, the sharpest such momentum unwind in market history.



Source: Jefferies Trading, Sep-26

Pure tech momentum suffered a historic -57% sell-off over the 60 days to Sep-26, punishing speculative names while relatively rewarding cash-generative quality compounders

This pervasive 'AI will kill us all' narrative fits a classic media reflex ('if it bleeds, it leads') and mistakes market volatility for tech deceleration. In fact, peak 'doomer' coverage coincided with two landmark scientific leaps – Google in genomic mapping and OpenAI in mathematics – signalling that AI is far more likely to extend human life than extinguish it.



Google DeepMind maps human DNA in quest to cure 'all disease'

The AI system can predict the effects of nine billion tiny changes to human DNA, allowing scientists to pinpoint the mutations that cause disease

AI Has Solved One of Math's $1 Million Millennium Prize Problems

Source: The Times, Quanta Magazine

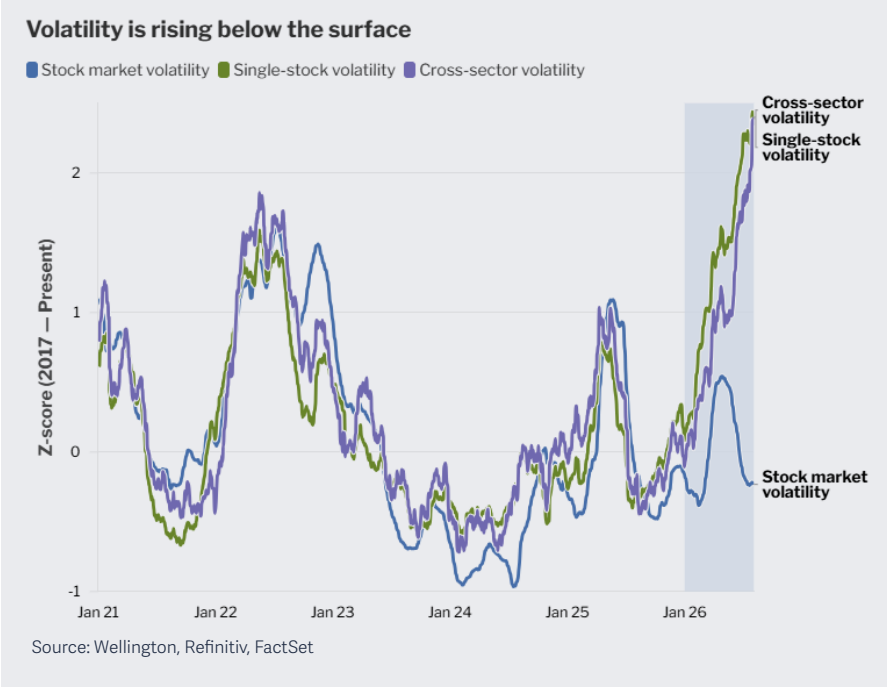
Google's DNA model will compress drug discovery timelines across 9 billion potential mutations, while OpenAI's Navier-Stokes solution unlocks major advances in aerodynamics and climate modelling

Brian Armstrong, CEO of Coinbase, observed the irony: *"165,000+ people already die every day. Cancer, heart disease, illnesses, car crashes. AI is helping us solve these".*

The Quality ETF sidesteps the unprofitable momentum names caught in Jefferies' index drawdown, owning the cash-generative businesses positioned to commercialise advances in AI and survive its disruptive effects.

Turbulence Beneath the Surface

While headline market indices remained relatively calm, with the VIX Index subdued, volatility beneath the surface reached multi-year highs in Q3.



Source: Wellington, Refinitiv, FactSet

Muted index-level volatility conceals significant internal dispersion: single-stock and cross-sector volatility have surged above +2 standard deviations, making balance-sheet resilience essential

Research from Wellington Management highlights that single-stock and cross-sector volatility climbed above +2 standard deviations from their historical average – the highest level of internal equity churn since 2021. In an environment of elevated single-stock dispersion, holding companies with conservative debt profiles and steady cash flows offers vital protection against unexpected earnings misses or funding strains.

Performance

The Quality ETF rose +1.2% in Q3, trailing the FTSE All-World (+1.7%) by 0.5%. The largest positive contributors in Q3 were US big tech platforms: Microsoft, Meta, and Apple. Meta (+28.8%) benefited from stronger digital ad pricing and AI-driven targeting efficiency, while Apple (+15.2%) was supported by resilient hardware upgrade demand and double-digit services growth.

STOCK	Q3-26 PERFORMANCE (%)	Q3-26 CONTRIBUTION (%)
MICROSOFT	37.8	1.8
META	28.8	1.0
APPLE	15.2	0.8
NVIDIA	14.3	0.7
RECRUIT	53.4	0.2

Source: Bloomberg, Bentley Reid

Microsoft (+37.8%) was the leading contributor in Q3 (+1.8%). Cloud revenue accelerated and software margins expanded, as enterprise AI adoption translated directly into rising free cash flow

The largest detractors were a trio of semiconductor equipment manufacturers: Applied Materials, Lam Research, and KLA. Lam Research (-24.1%) and KLA (-35.3%) suffered as memory and logic chipmakers digested prior capacity additions and deferred discretionary tooling orders.

STOCK	Q3-26 PERFORMANCE (%)	Q3-26 CONTRIBUTION (%)
APPLIED MATERIALS	-29.2	-0.7
LAM RESEARCH	-24.1	-0.7
KLA	-35.3	-0.6
CATERPILLAR	-23.7	-0.4
ASML	-7.7	-0.3

Source: Bloomberg, Bentley Reid

Applied Materials (-29.2%) was the largest detractor (-0.7%) as wafer-fab equipment orders softened, memory makers paused expansions, and trade restrictions weighed on exports to China

Structural Case & Valuation

Investors often ask whether the valuation premium for Quality is justified, particularly when bond yields have risen to multi-year highs. A comparison between the Quality and FTSE All-World ETFs highlights that this premium reflects far superior underlying economics rather than speculative multiple expansion (as has occurred in loss-making, high-beta names).

Name	Wgt	BEst P/E	P/CF	P/B	Net Debt/E...	P/S	ROE	Div Yld	FCF Yld	ROC
iShares Edge MSCI World Quality Factor UC...	100.00	20.179	18.84	6.84	33.41	4.25	29.31	1.43	3.72	18.38
VANGUARD FTSE ALL WORLD UCITS ETF (VW...	100.00	15.138	15.45	3.60	44.62	2.56	16.38	1.73	3.66	8.18

Source: Bloomberg, Bentley Reid, fundamental characteristics as at Oct-26

While the Quality ETF trades at a 33% headline forward P/E premium (20.2x vs 15.1x), its valuation spread sits near the low end of its multi-year range. Its operational metrics justify the multiple:

- **Superior Capital Efficiency:** A return on capital (ROC) of 18.4% is more than double the All-World's 8.2%, alongside a return on equity (ROE) of 29.3% vs 16.4%.
- **Cash-Backed Valuation:** A free cash flow yield (FCFY) of 3.72% exceeds the All-World's (3.66%) despite the higher P/E multiple; earnings are backed by hard cash conversion.
- **De-Risked Balance Sheets:** Net debt to equity is 25% lower (33.4% vs 44.6%), leaving constituent companies less exposed to refinancing stress in a higher-for-longer rate regime.

Positioning

We access the Quality theme through the iShares Edge MSCI World Quality Factor ETF. The $6.4bn fund invests in 290 companies across developed North America, Europe and Asia for a fee of 0.25%.

The Quality ETF tracks the MSCI World Sector Neutral Quality Index, targeting companies screened across three fundamental metrics: high ROE, low financial leverage, and stable earnings growth. To ensure its factor exposure is concentrated purely on Quality, the ETF maintains sector weights that match the MSCI World index, selecting the highest-scoring companies within each industry.

Top 10 Holdings

MICROSOFT	6.42%
APPLE	5.81%
NVIDIA	5.41%
META PLATFORMS CLASS A	4.22%
VISA CLASS A	3.44%
ASML HOLDING	3.24%
ELI LILLY	2.51%
LAM RESEARCH	2.12%
MASTERCARD CLASS A	1.97%
TJX	1.89%
Total of Portfolio	**37.03%**

Source: iShares, 30 Sep-2026

The top 10 holdings account for 37.0% of the portfolio, anchored by cash-generative global franchises with dominant market share and fortress balance sheets

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