

The Emergence of Defense as a Key Long-Term Megatrend

Stockholm (HedgeNordic) – Global defense spending has shaped into a defining megatrend, fueled by great power rivalry and escalating geopolitical tensions. This environment has made defense, resilience and homeland security a top priority for many governments, not just for the short term but for the next decade or longer. While few wish for the devastating consequences of war, there is broad recognition that bolstering and modernizing defense capabilities is essential to maintaining effective deterrence.

"Strengthening defense readiness not only ensures the protection of national interests but also serves as a powerful preventive measure," argues Joakim Agerback, portfolio manager of the equity fund Finserve Global Security Fund, which predominantly invests in defense companies. "By presenting a credible deterrent, we reduce the likelihood of conflict and contribute to a stable, peaceful environment with sustainable societies," he adds. This perspective has also contributed to a shift in viewing defense and security companies as responsible investments.

In 2017, a Swedish team from the defence, intelligence and the finance industries were convinced that increasing geopolitical tensions would create long-term demand in the defense industry, creating a compelling long-term investment theme. Joakim Agerback, a partner since its inception in 2019, has managed the equity fund since May 2022. The fund targets structural trends within the growing "defense investing" megatrend, with a particular focus on the aerospace, defense, and cybersecurity sectors.

Finserve Global Security Fund has been classified as an Article 8 fund since the beginning of 2024. "The fund promotes social characteristics within its portfolio companies, where active integration of sustainability aspects and risks is central to the fund's investment decisions," explains Agerback. As geopolitical uncertainties remain heightened and military conflicts intensify, this megatrend shows no sign of slowing down. "In the West, we have realized that we can no longer afford to underinvest in defense; the threats continue to grow and we need a credible deterrent," he argues. With the world becoming increasingly multipolar, defense spending is driven by rising security concerns and long-term government commitments. "Defense and security spending typically spans 10 to 15 years, making it a solid long-term trend."

Unlike sectors impacted by economic cycles or FED policies, defense investments are mainly exposed to strategic, multi-year government planning. As Agerback notes, "Governments aren't likely to shift spending priorities due to short-term economic changes" or even the resolution of specific conflicts. This long-term view creates structural resilience and less sensitivity to economic cycles, as these sectors enjoy a growth trajectory often uncorrelated with broader market dynamics. Additionally, geopolitics is again set to play a central role in global trade, particularly in areas like critical technological development, critical resources, and a renewed push for re-globalization. "Many Western democracies now seek to increase resilience and de-risk from China and Russia and totalitarian regimes," says Agerback.

Thematic Exposure to Structural Long-Term Megatrends

The Finserve Global Security Fund seeks to provide thematic exposure to long-term trends in aerospace, defense and cybersecurity sectors by blending a top-down thematic analysis with a bottom-up fundamental approach. The investment process begins with a top-down thematic assessment to identify regions and sectors where secular growth is anticipated to create more opportunities for attractive investments. "We begin with a systematic, quantitative analysis, drawing on insights from an advisory board with military and industry expertise to pinpoint regions likely to experience high growth in defense spending," explains Agerback. Their process involves assessing regional growth rates and identifying countries expected to see the largest increases in defense investment.

From there, the fund compiles a list of companies exposed to these markets, assessing each by their revenue sources and sector relevance. "We examine companies for their level of exposure to high-growth markets," he explains. The fund then applies bottom-up analysis to assess company fundamentals, such as historical profit margins and projected earnings growth, resulting in a refined portfolio of about 30 companies across the aerospace, defense, and cybersecurity sectors.

Summing up the approach, Agerback explains, "Our top-down approach identifies regions and countries with the strongest projected increases in defense spending, as well as the sectors with the highest growth potential and favorable margins." From there, "we assess which companies are best positioned to benefit from these sizable investments, as that can lead to significant growth potential and earnings growth for those businesses," he continues. "That's essentially how we find growth opportunities stemming from megatrends and sub-trends in these sectors."

With the ongoing war in Ukraine and Europe's historical underinvestment in defense, the fund's allocation reflects current priorities: 55 percent dedicated to European defense, 30 percent to U.S. defense, and 15 percent to cybersecurity. "Cybersecurity also represents a critical long-term trend, driven by the geopolitical environment," Agerback highlights, "due to persistent hybrid threats both on state and company level. Cyber warfare due to its profitability and damaging effect is set to remain an enduring challenge, along with the increasing influence of industrial espionage. It's a long-term theme that won't change overnight," he continues.

Expertise as a Competitive Advantage

Investing in public equities tied to the defense industry requires a deep level of expertise due to the unique complexities within the sector. Defense companies are subject to high levels of government oversight and are deeply embedded in political, regulatory, and ethical considerations that often diverge from other industries. "We need to have in-depth knowledge of how defense investing works with tenders, offers, identifying the best products, and so on," emphasizes Agerback. He notes that "data accessibility, data quality, and transparency" represent the biggest hurdles for investing in the defense and related sectors, stating that "these factors are critical not just for us, but for other investors as well, who often face significant limitations in this area."

The Finserve Global Security Fund leverages not only the extensive expertise of its investment team and its systematic approach to identifying growth areas but also the insights of an advisory board comprising four experts with substantial experience in the defense and related sectors. This combination enables the fund to pinpoint the most promising investment opportunities benefiting from the "defense investing" megatrend. "Achieving a global perspective and understanding all the relevant companies is challenging without a systematic method for measuring growth and areas of opportunity," Agerback notes.

Ultimately, the ongoing and escalating military conflicts around the globe, coupled with increasing geopolitical tensions, are expected to drive defense and security spending for many years to come. Consequently, these sectors are positioned for structural and secular growth that surpasses the broader market. Such investments not only contribute positively to society but also offer investors valuable diversification within their portfolios. This diversification comes with reduced sensitivity to economic fluctuations and a lower correlation to business cycles, attributable to the long-term nature of defense expenditures. "We believe that value can be generated through exposure to megatrends that significantly impact the global economy and the world we live in. These megatrends can enable companies to achieve exceptional growth and increased profitability, ultimately creating value for investors."