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Leaning into the Quality Factor

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February 18, 2026

Several weeks ago, I posted my 2026 Market Outlook, which was bullish for several reasons including strong corporate earnings and net profit margins, lagged effects of Fed rate cuts, OBBA benefits, deregulation initiatives, and expected AI productivity gains. I also mentioned that I expected heightened volatility in 2026 due to elevated equity valuations, geopolitical tensions, the Supreme Court's ruling on tariffs and federal debt levels. Well, I'm still bullish and the volatility is certainly alive and kicking so far in 2026.

The market rotation has been violent as Value has assumed leadership over Growth, and Small Cap stocks have outperformed Large Caps. The market is on a manhunt for any company and/or sector that may potentially be exposed to the AI revolution. Industries such as real estate office space, tax preparation, and travel platforms are experiencing sell-offs in the short-term. Software companies are currently under the most distress as software stocks have dropped nearly 24% over the past three months, wiping out more than $2 trillion in market cap. Interestingly enough, during that time, the 2-year forward earnings estimates for software stocks have risen by 5%. It reminds us that momentum can be so powerful at times that fundamentals can be temporarily ignored.

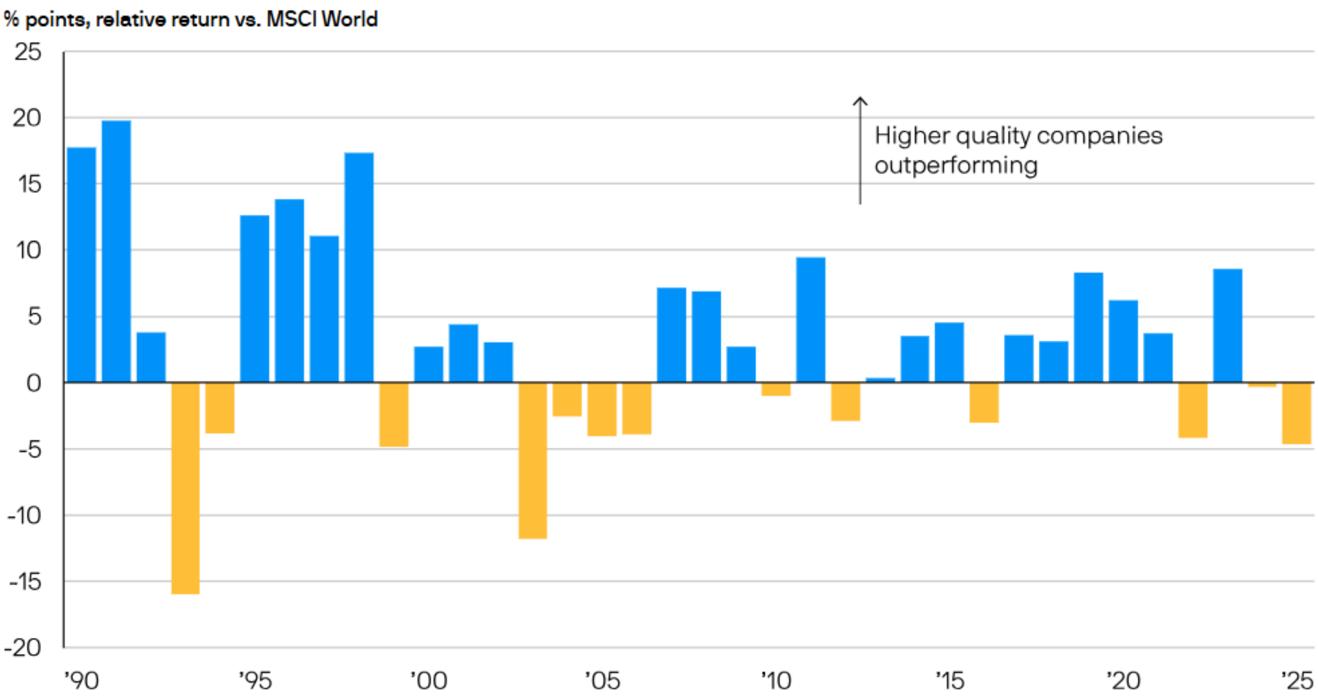
Leaning into the Quality Factor

As you also may recall from my previous commentaries, we have been tilting our portfolios towards the Quality factor for several months now due to the expected heightened volatility and risks in the markets. Quality factor investing focuses on companies with strong balance sheets and cash flows as well as a strong track record of earnings. It sounds like a no-brainer that an investor should focus on such companies, but there are time periods that the Quality factor can underperform the market including last year. The Quality factor can sometimes underperform when the Fed is cutting rates as it provides improving investor sentiment, which, in turn, can create tailwinds to equities as we saw in the fourth quarter. As investors' sentiment and risk appetites grow, so too can the rallies of lower quality companies. An example can be found within Small Cap stocks. There are two major small cap stock benchmarks with the Russell 2000 and the S&P 600. The Russell 2000 represents approximately 2000 of the smallest publicly traded US companies. Nearly 40% of the companies in the Russell 2000 are unprofitable. The S&P 600, on the other hand, represents nearly 600 smaller companies and it applies a profitability screen for inclusion. Companies in this index must have positive earnings in the most recent quarter and the sum of the last four consecutive quarters. Therefore, one could say the S&P 600 is more quality focused than the Russell 2000.

Last year, the market was building up froth as many investors were in complete risk-on mode with rates dropping and the markets rising. Evidence of this excessive risk-taking could be seen through the returns of these two benchmarks as the Russell 2000 outperformed the S&P 600, 12.81% and 6.02% respectively, in 2025.

In fact, you could see similar results through other asset classes such as the MSCI World Index vs the MSCI World Quality index.

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.

As evidenced in this graphic, Quality underperformed the market last year. However, higher quality stocks have a better long-term track record as they have outperformed 23 out of the last 35 years. In fact, since 2000, higher quality companies have outperformed broad developed markets by approximately 5%, annualized, based on the MSCI World Quality Index.

Quality Factor During Periods of Volatility

As mentioned earlier, we expect heightened volatility this year for several reasons. One of those reasons is the fact that 2026 is a midterm election year. Market volatility is typically higher in midterm years, especially in the months leading up to the elections. Since 1970, midterm years have a median standard deviation of returns of nearly 16%, compared with 13% in all other years. During these periods, leaning into the Quality factor can help investor portfolios better weather these market storms. According to research from BlackRock, in months when the VIX (volatility index) rose by 20% or more between 1990 and 2019, quality stocks beat the S&P 500 roughly 75% of the time, by an average of about 60 basis points.

Quality focused portfolios have also typically performed better than the broad market during market downturns. Over the past 30 years, developed market stocks have seen nine drawdowns of 10% of more. During these market corrections, Quality stocks have outperformed the broader market 78% of the time with a median excess return of 3.4%.

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Summary

We are living through exciting times with the AI revolution, but it can also produce anxiety as some investors will sell first and ask questions later. Software stocks may be in oversold territory now. While some software companies may truly face displacement risk from AI, other software providers may be more resilient and AI may even strengthen their business models.

While the market swings so far this year have been sharp and violent, there is plenty of good news. As of 2/13/26, the S&P 500 is flat for the year, and the Russell 1000 Growth index (Large Cap Growth stocks) is down 5.45%. However, the Russell 1000 Value index (Large Cap Value stocks) is up 6.42%, the MSCI EAFE index (International Developed Markets) is up 7.81% and the MSCI Emerging Markets index is up 10.81%. Diversification is an investor's best defense to market volatility.

The Quality factor is also helping investors through these market swings. While the higher quality S&P 600 trailed the lower quality Russell 2000 last year, those roles have reversed in 2026 with the S&P 600 up 8.94% YTD as of 2/13/26 while the Russell 2000 is up 6.73%. As always, stay disciplined to your investment plan and I would advise clients that 2026 may not be the year of a complete risk on investing environment. Stay Quality-focused!