



The New Security Dividend

How Defense Is Emerging as a Long-Term Investment Theme

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The conversation around defense is changing. For much of the post-Cold War period, defense spending was often viewed as cyclical, politically sensitive, and largely confined to specialist investors. Today, that framework appears increasingly outdated.

A combination of geopolitical fragmentation, evolving security threats, supply-chain vulnerabilities, technological disruption, and renewed alliance commitments has transformed defense from a periodic spending category into a long-term strategic priority. Many governments are no longer debating whether they need to invest in defense capabilities—they are determining how quickly they can rebuild them.

The implications extend far beyond traditional aerospace and defense contractors. The emerging investment opportunity encompasses advanced manufacturing, cybersecurity, artificial intelligence

(AI), drones, satellite infrastructure, semiconductors, software, logistics, and critical industrial capacity. In many respects, defense is becoming less about military hardware and more about societal and economic resilience.

For investors, the key question is no longer whether defense spending will increase. Increasingly, the relevant question is where sustainable growth, competitive advantages, and durable cash flows are likely to emerge within the defense ecosystem.

A structural shift, not a cyclical rebound

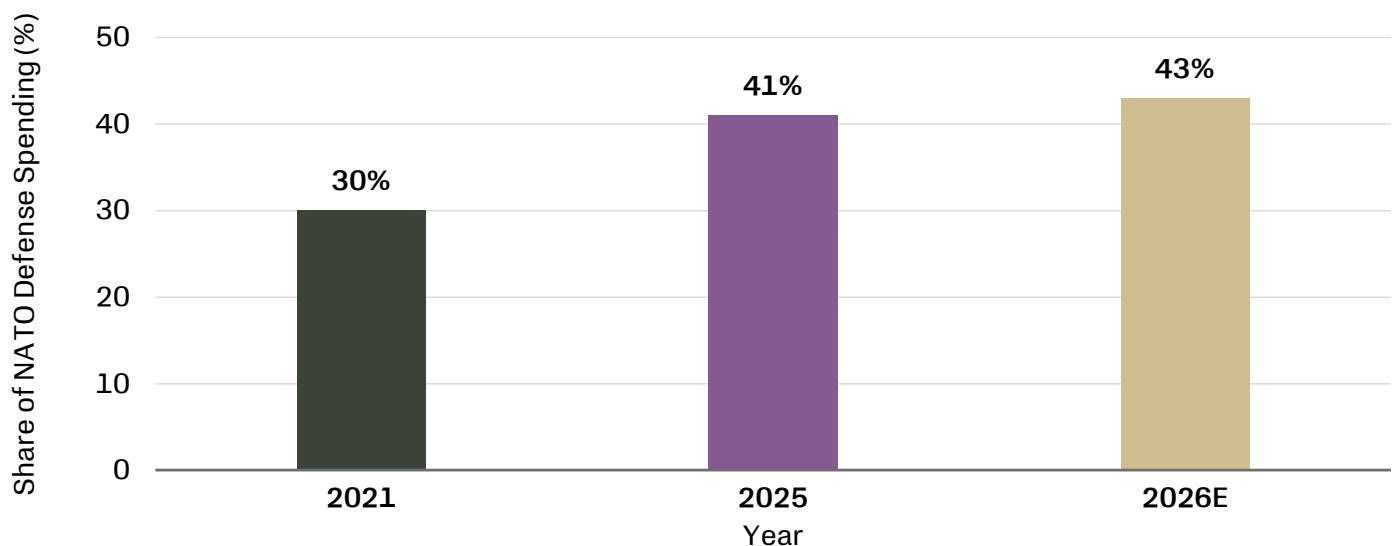
The most important distinction for investors is that current defense spending trends appear structural rather than cyclical. At the June 2025 NATO Summit, alliance members agreed to a significantly higher defense and security spending ambition, targeting 5% of GDP by 2035. The framework includes a 3.5% target for core defense expenditures and an additional 1.5% for broader security-related investments such as cyber resilience, critical infrastructure, and defense-supporting capabilities.¹

This represents a meaningful departure from the previous 2% spending benchmark that dominated alliance planning for more than a decade. The significance of this change lies not simply in the headline spending number, but in what it implies

for capital allocation. Defense budgets increasingly represent long-duration commitments requiring governments to expand domestic industrial capacity, replenish depleted inventories, modernize aging platforms, develop next-generation technologies, and strengthen national resilience.

The scale of the opportunity is substantial. According to NATO estimates, the share of alliance spending contributed by European allies and Canada is expected to rise from approximately 30% in 2021 to nearly 43% by 2026.² Meanwhile, McKinsey estimates that European defense expenditures could approach €800 billion (\$1,285 billion Canadian Dollars) annually by the end of the decade under expanded spending scenarios.³

European and Canadian Defense Spending Is Taking on a Larger Share of NATO Burden-Sharing



Source: NATO Defence Investment Update and ICDS Defence Spending. Data as of July 31, 2026. E = estimate

Such figures suggest that the current cycle is not a temporary response to a single geopolitical event. Rather, governments are repositioning defense as a core component of economic and national security

policy. As a result, investors may need to evaluate defense using a framework more commonly applied to secular themes such as energy transition, artificial intelligence, or digital infrastructure.

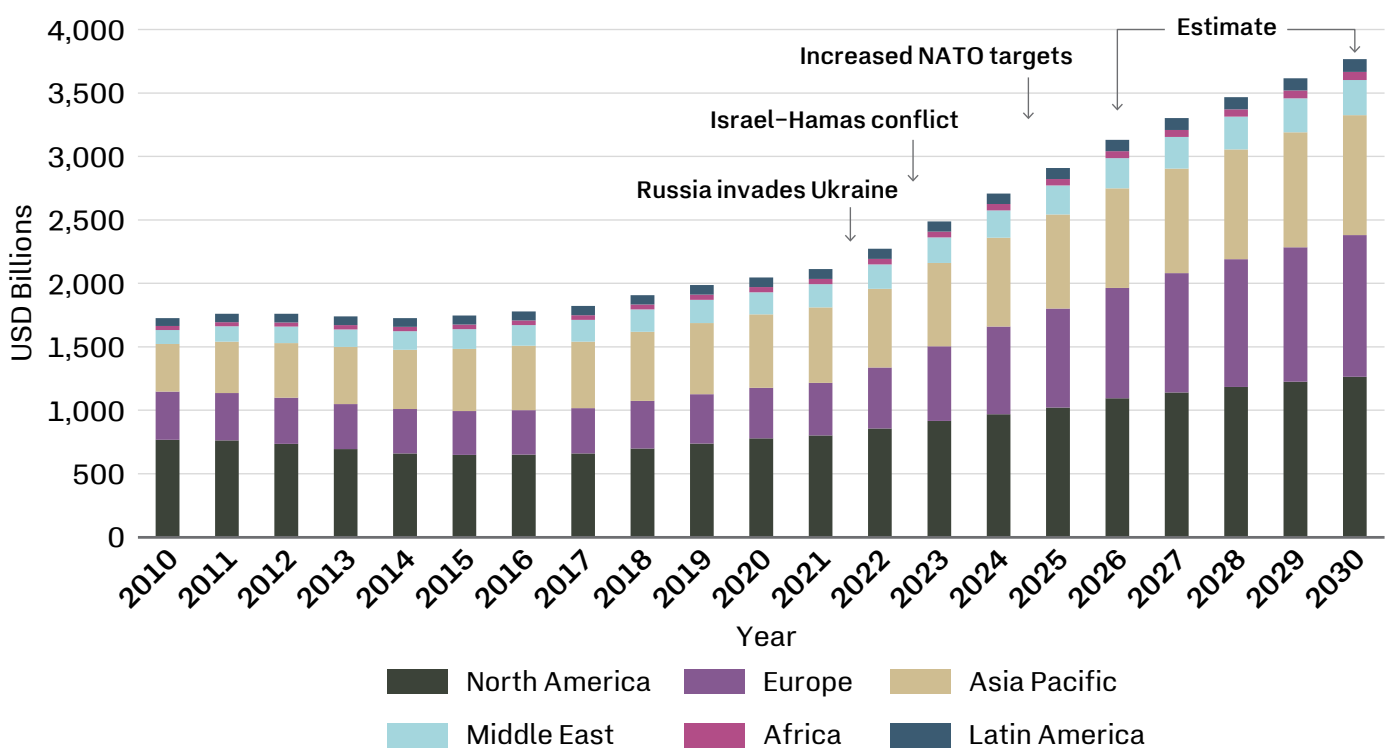
From peace dividend to preparedness premium

For over three decades, many developed economies benefited from what economists often referred to as the "peace dividend"—the ability to reduce military expenditures and redirect resources toward other priorities. That period appears to be ending.

Threats posed by Russia, together with renewed concerns about defense preparedness and NATO burden-sharing, have contributed to changing threat

perceptions among policymakers.⁴ The cost of insufficient preparedness has become increasingly visible. Consequently, governments are pursuing policies designed not only to strengthen military capability but also to ensure operational readiness, industrial resilience, and domestic production capacity.

Global Military Spending by Region, 2010–2030 (USD Billions)



Source: Bloomberg Finance L.P. Data as of August 30, 2026.

This evolution has important investment implications. Historically, defense spending often flowed toward a relatively small group of prime contractors responsible for major platforms such as aircraft, ships, and armoured vehicles. Today's requirements are significantly broader and increasingly integrated with commercial technologies. Military effectiveness now depends on data, connectivity, software, autonomy, cloud infrastructure, artificial intelligence, electronic warfare, and cybersecurity capabilities.⁵

Consequently, the investable universe is expanding well beyond traditional defense manufacturers and the Global Industry Classification Standard (GICS) Aerospace and Defense industry. The next phase of defense investment may therefore look less like a conventional military buildout and more like a large-scale modernization of industrial and technological infrastructure.

Self-reliance creates new winners

Another defining feature of the current cycle is the pursuit of strategic autonomy. Governments increasingly recognize that military expenditure alone does not guarantee security. The ability to manufacture, sustain, and replenish critical systems domestically has become equally important.

Capability Area	Strategic Priority
Munitions & Missiles	Inventory replenishment and surge production
Air & Missile Defense	Sensors, interceptors and integrated defense networks
Drones & Counter-Drone	Autonomous systems and electronic warfare
Space, Cyber & C4ISR	Intelligence, surveillance and AI-enabled operations
Industrial Infrastructure	Manufacturing capacity and supply-chain resilience

Source: Bloomberg, July 2026; NATO Innovation Fund, Jan. 2025; McKinsey, Feb. 2026; TD Asset Management Inc. (TDAM).

Russia's invasion of Ukraine accelerated European efforts to expand defense industrial capacity, replenish munitions and missile inventories, strengthen supply chains, and address critical capability gaps across defense systems.⁶ As a result, many NATO members are pursuing policies aimed at increasing domestic production and reducing dependence on external suppliers. This creates opportunities throughout the value chain.

- **Munitions and missile systems** – Depleted inventories and increased readiness requirements have created significant demand for expanded ammunition and missile production. Industry backlogs remain elevated, while governments continue placing replenishment orders to rebuild stockpiles over multiple years.⁷
- **Air and missile defense** – Growing concerns around missile threats and drone attacks have accelerated investment in radar systems, interceptors, sensors, and command-and-control capabilities. These areas are increasingly viewed as foundational components of national defense.⁸
- **Drones and autonomous systems** – The proliferation of low-cost autonomous systems is reshaping modern warfare. Recent conflicts have demonstrated that relatively inexpensive drones can achieve operational effects previously requiring significantly more costly military platforms. As a result, spending on drones, counter-drone technologies, electronic warfare, and autonomous systems is expanding rapidly.⁹
- **Cybersecurity and digital warfare** – Cyberattacks now represent a persistent national security threat. Governments are therefore allocating greater resources toward cyber defense, secure communications, data protection, and AI-enabled intelligence systems.¹⁰
- **Industrial infrastructure** – Perhaps the least discussed but potentially most important opportunity lies in industrial capacity itself. Factories, engineering talent, manufacturing equipment, logistics networks, testing facilities, and critical supply chains represent essential enablers of defense readiness. Governments increasingly recognize that production capacity can be as strategically important as the technologies being produced.¹¹

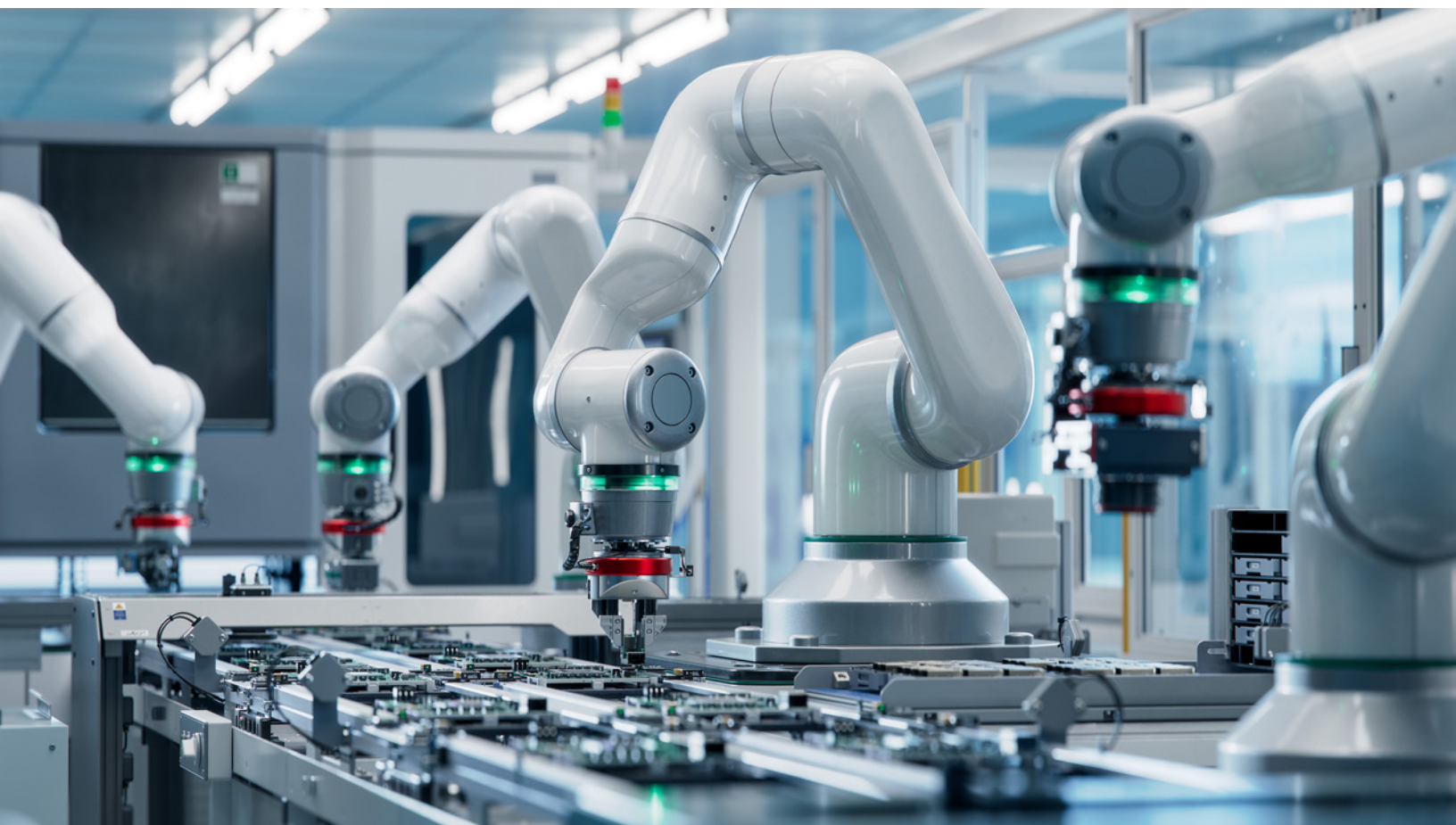
Defense is increasingly a technology story

Modern warfare is becoming increasingly software defined. The distinction between defense technology and commercial technology continues to blur as artificial intelligence, cloud computing, advanced sensors, autonomous systems, and space-based platforms become integral to military operations. This is creating an entirely new class of defense companies.

Rather than solely relying on decades-long procurement cycles associated with traditional weapons systems, newer defense technology firms often operate with fast innovation cycles similar to those found in the broader technology sector. The NATO Innovation Fund, established to support dual-use technologies across alliance countries, reflects this growing emphasis on technological innovation.¹² Venture capital investment in defense-related

technologies has similarly accelerated as investors recognize opportunities arising from national security priorities.¹³

For investors, this means that some of the most attractive opportunities may emerge at the intersection of public-sector demand and private-sector innovation. Companies focused on artificial intelligence, satellite networks, cybersecurity, advanced sensors, autonomy, simulation platforms, and defense software could play increasingly important roles in future defense ecosystems. The challenge, however, is distinguishing durable business models from speculative enthusiasm. Not every emerging technology will become mission critical. Investors must assess whether companies can translate innovation into long-term contracts, recurring revenues, and sustainable cash flows.



Following the money: where opportunities may emerge

While defense spending growth is attracting investor attention, opportunities are not evenly distributed. Investors should focus less on broad sector exposure and more on identifying areas where spending growth intersects with sustainable competitive advantages.

Capability Area	Strategic Priority	Key Metrics
Prime Contractors	Program awards and scale advantages	Backlog, margins, export exposure
Tier Suppliers	Critical components and technologies	Pricing power, capex, customer concentration
Defense Software & Data	Cyber, AI, C4ISR and analytics	Total addressable market growth, procurement access
Infrastructure & Services	Training, logistics and maintenance	Contract duration, labour availability
Private Defense Tech	Autonomy, space and drones	Adoption, runway, regulation

Source: McKinsey, Feb. 2026; A&O Shearman, 2026; NATO Innovation Fund, Jan. 2025.

- **Prime contractors**

– Large defense primes benefit from established relationships, regulatory expertise, certifications, and scale advantages. Their order backlogs provide visibility into future revenues and cash flows.¹⁴ However, many investors have already recognized these strengths, and valuations may increasingly reflect favourable spending expectations.
- **Critical suppliers**

– Tier-one and tier-two suppliers often provide differentiated technologies and components that are difficult to replace. Sensors, propulsion systems, specialized materials, semiconductors, energetics, and advanced electronics may represent bottlenecks within defense production chains. In some cases, suppliers possess greater pricing power and more favorable competitive dynamics than larger contractors.¹⁵
- **Defense software and data companies**

– The growing importance of cybersecurity, C4ISR (command, control, communications, computers, intelligence, surveillance, and reconnaissance), AI-enabled decision support, and simulation technologies are creating attractive growth opportunities for software-focused businesses.¹⁶
- **Infrastructure and services**

– Maintenance, logistics, training, and industrial capacity expansion are becoming indispensable elements of modernization efforts. These businesses can benefit from long-duration contracts and recurring demand profiles.¹⁷ For investors, the most compelling opportunities may ultimately reside in enabling capabilities rather than the most visible platforms.

The responsible investment debate is evolving

Responsible investment considerations remain an important part of discussions around defense-related investments. Historically, some sustainable investment approaches limited or excluded exposure to defense companies. More recently, evolving geopolitical and security considerations have contributed to broader discussions among policymakers, asset owners, and investors regarding the role of defense within sustainable and responsible investment frameworks.

Analysis from Morgan Stanley Capital International (MSCI) found that many European sustainable funds now maintain some exposure to conventional defense companies despite continuing exclusions on controversial weapons.¹⁸ Approximately 90% of Article 8 and Article 9 funds still exclude controversial weapons, underscoring the distinction between conventional defense activities and prohibited weapons systems.¹⁹ This transition does not imply a relaxation of standards.

In TDAM's view, investors are increasingly adopting a more nuanced framework based on accountability, governance, transparency, and end-use considerations. The focus is shifting from blanket sector exclusions toward issuer-specific analysis. For investors, due diligence remains critical. Evaluating defense-related investments requires consideration of a number of factors, including:

- Product exposure
- Export controls
- Customer relationships
- Human rights safeguards
- AI governance frameworks
- Board oversight
- Supply-chain transparency

Resilience

Understanding the risks

Despite powerful tailwinds, defense investing is not without risk. Valuations across portions of the sector have risen substantially as capital has flowed toward perceived beneficiaries of increased defense spending. In some cases, investor enthusiasm may exceed the pace at which companies can convert demand into earnings and free cash flow.²⁰

How Expensive Are Global Defense Stocks? Forward P/E Ratio Since 2010



Source: Bloomberg Finance L.P. Data as of August 30, 2026.

Execution risks also remain significant. Defense procurement is often subject to political influence, budget negotiations, program delays, cost overruns, and changing strategic priorities. Even strong demand forecasts can be disrupted by implementation challenges.²¹ Supply-chain constraints represent another concern. Skilled labour shortages, semiconductor availability, energetics production, and export restrictions could constrain industry growth despite robust orders.²²

Finally, reputational and Environment, Social, Governance (ESG)-related risks remain important considerations. Companies operating in sensitive technologies, autonomous systems, surveillance platforms, or weapons production may attract increased regulatory and public scrutiny.²³ Investing in the sector therefore requires discipline, selectivity, and rigorous due diligence.

Accountability

Defense as resilience

The defense investment case today is fundamentally different from that of prior decades. This is not simply a story about military expenditure. It is a story about national resilience, industrial policy, technological sovereignty, critical infrastructure, and strategic preparedness. The result is a structural investment theme with the potential to extend well beyond traditional defense contractors and into broader ecosystems of technology, manufacturing, cybersecurity, logistics, and industrial capacity.

For investors, the opportunity should not be viewed as a blanket endorsement of the sector. Rather, it represents a call for thoughtful analysis. The most compelling opportunities are likely to be found where government priorities, technological differentiation, industrial bottlenecks, and responsible governance align ■



Footnotes:

¹ NATO, Hague Summit Declaration and NATO Defence Investment Update, 2025–2026. ² NATO Defence Investment Update, July 2026. ³ McKinsey & Company, European Defense Dashboard, February 2026. ⁴ International Centre for Defence and Security (ICDS), Defence Spending: Who Is Doing What?, July 2026. ⁵ McKinsey & Company, European Defense Dashboard, February 2026; NATO Innovation Fund, January 2025. ⁶ McKinsey & Company, European Defense Dashboard, February 2026. ⁷ Bloomberg Intelligence, Aerospace & Defense Industry Research, July 2026. ⁸ NATO Defence Investment Update, July 2026. ⁹ NATO Innovation Fund, January 2025; TD Cowen Defense Sector Primer. ¹⁰ NATO Innovation Fund, January 2025. ¹¹ McKinsey & Company, European Defense Dashboard, February 2026. ¹² NATO Innovation Fund, Annual Review, January 2025. ¹³ NATO Innovation Fund, Annual Review, January 2025; A&O Shearman, Defense Investment Outlook, 2026. ¹⁴ Bloomberg Intelligence, Aerospace & Defense Industry Research, July 2026. ¹⁵ McKinsey & Company, European Defense Dashboard, February 2026. ¹⁶ NATO Innovation Fund, January 2025. ¹⁷ McKinsey & Company, European Defense Dashboard, February 2026. ¹⁸ MSCI, Rethinking Defense Exposure in Sustainable Funds, June 2025. ¹⁹ MSCI, Rethinking Defense Exposure in Sustainable Funds, June 2025. ²⁰ Bloomberg Intelligence, Aerospace & Defense Industry Research, July 2026. ²¹ A&O Shearman, Defense Investment Outlook, 2026. ²² McKinsey & Company, European Defense Dashboard, February 2026. ²³ MSCI, Rethinking Defense Exposure in Sustainable Funds, June 2025; PRI Responsible Investment Resources.

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