

2017



## Investing in the Defense, Homeland Security, and Space Market

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**SP<sup>♠</sup>DE<sup>®</sup> Defense Index**

Index: 'DXS'

Exchange Traded Fund\*: 'PPA'

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## Inside the Numbers...

- **\$6.7 Trillion** – Amount Spent by the U.S. on defense in the last decade
- **4-5% of U.S. GDP** – Estimated amount spent on defense
- **\$1.74 Trillion** – Amount Spent Globally on Defense Activities \*\*
- **\$578 Billion** – U.S. Defense Budget Authority including OCO – FY17\*

- **\$60+ Billion** – Budget for ‘Classified Military and Intelligence Items’ \*\*\*
- **\$308 Billion** – 114% Growth in U.S. Defense Budget Between FY-97 and FY-17 (since the launch of the SPADE Defense Index)

\* *Defense News* \*\* *SIPRI 2016 est.* \*\*\* *Washington Post 2014 est*

## Before we get started...

## ...Who We Are

The **SPADE Defense Index** was developed by sector executives familiar with index management in cooperation with leading Wall Street firms in order to benchmark the investment performance of companies operating in defense, homeland security, and space. It is the **only** index to focus on all aspects of the defense sector – from the manufacture of aircraft, naval vessels, tanks, and missiles, to current and future modernization efforts related to IT and network centric warfare, armor and armored vehicles, secure communications, UAVs, satellites, border security, and battlespace awareness.

- Ticker NYSE: DXS
- Weighting Modified Market Capitalization
- Constituents/Rules 50 (March 2017) / \$100M+ Market Cap, \$5+ share price, liquidity
- Historical Data Availability 30 December 1997 to present, Index went live on 6 July 2004
- Index Manager Consulting group with expertise in defense, space, security, investing
- Calculation & Distribution NYSE / ICE Data Services
  
- Investable Products: Powershares Aerospace & Defense ETF (NYSE: PPA)
- ETF IPO Date: 26 October 2005
- ETF Liquidity / Assets As of March 2017: +/- 100,000 avg shares/day, \$530 Million AUM

# Why Defense? A Decade Old Quote...

(1Mar04)

"How To Profit from a Stronger America"  
LOUIS RUKEYSER's Wall Street Week

## How Long Will the Military-Spending Boom Last?

A good long while, it appears. Even after the current war on terrorism cools down (which itself could take years or decades), there are plenty of other conflicts to keep the weapons-makers busy. Right now, there are more than 30 insurgencies, uprisings, struggles, guerrilla movements and full-fledged wars being waged worldwide.

***Sadly, the business of war is a growth business and has been so for a while.***

... the money spigot flowing from the Pentagon to defense contractors won't be turned off anytime soon. After all, if you're going to be the world's policeman, you'd better have a powerful pistol.

One last thought: ***While it would be wonderful if the demand for weapons dried up tomorrow, thousands of years of human history argue against it...*** Wall Street is engaged in the realpolitik of investing, not wishful thinking. No one ever improved the world—or their financial lot in it—by ignoring the way the world really works.

# Defense Is...

## Manufacturing

- **Planes / Aircraft**
- **Ships / Naval Vessels**
- **Vehicles / Tanks**
- **Missiles & Rockets**
- **Space / Satellites**

## Services

- **Communications**
- **Intelligence Gathering**
- **Data Analysis**
- **Border Security**
- **C4ISR**
- **Information Tech**

*The SPADE Defense Index is the only defense index that reflects all activities that are systematically important to the DoD...not just manufacturing.*

## A Quick History Lesson ...

Like many other industries, the defense industry goes through cycles.

*However...* In addition to the investment / replacement cycle associated with capital goods, the rise and fall of the defense sector also must respond to outside factors:

- Aggressors
- New Technologies

*During the 20<sup>th</sup> century, there has been a major U.S. military action within every 20-year period.*

### U.S. Military Actions

- 1914 - 1918                      WWI
- 1939 - 1945                      WWII
- 1950 – 1953                      Korean War
- 1945 – 1985/1991              Cold War
- 1959 – 1975                      Vietnam War
- 1991                                  Gulf War
- 2001 – 2011/14                  War on Terror
- Present                              The ISIS Threat

## The Portfolio Managers' View

Investors discover the benefits of investing in companies involved with defense, homeland security, and space

- **Growth** - Solid Returns that have outperformed the S&P500 consistently since 2000
- **A Hedge Against Portfolio Risk** - Associated with world events such as war/terrorist action.
- **A Hedge Against Economic Downturns** - Sales & earnings of defense companies are not directly tied to changes in the economy. Escalation clauses in many contracts allow price increases due to inflation.
- **Diversification** - Most investment portfolios have historically provided limited sector exposure

### ➤ **A Stable and Long-Term Customer and Business Base**

Notably a key client whose mission is fundamentally more important than the cost to implement

- **Dividends** – Offered by many defense companies
- **Significant Barriers to Entry**– Security, contracting, relationships, etc.

# How Defense Companies Grow

1. Rising Budgets for the Department of Defense
2. Supplemental Budgets to fund the Global War on Terror & ISIS
3. Outsourcing – Increased Hiring of Private Companies to Do Tasks Previously Performed by Military Personnel
4. Increasing International Sales as Foreign Militaries Ramp-up Their Capabilities
5. Acquisitions – A steady supply of emerging small companies
6. An Investment Cycle Associated with the Military Transformation from One Designed to Defend/Fight the Soviet Union to One Leaner and More Mobile That Puts People and Equipment Further Out of Harms' way
7. 'Internal' Diversification – Defense companies maintain a range of skills and technologies that in some cases are of use to other customers – diversifying to some degree their revenue stream.

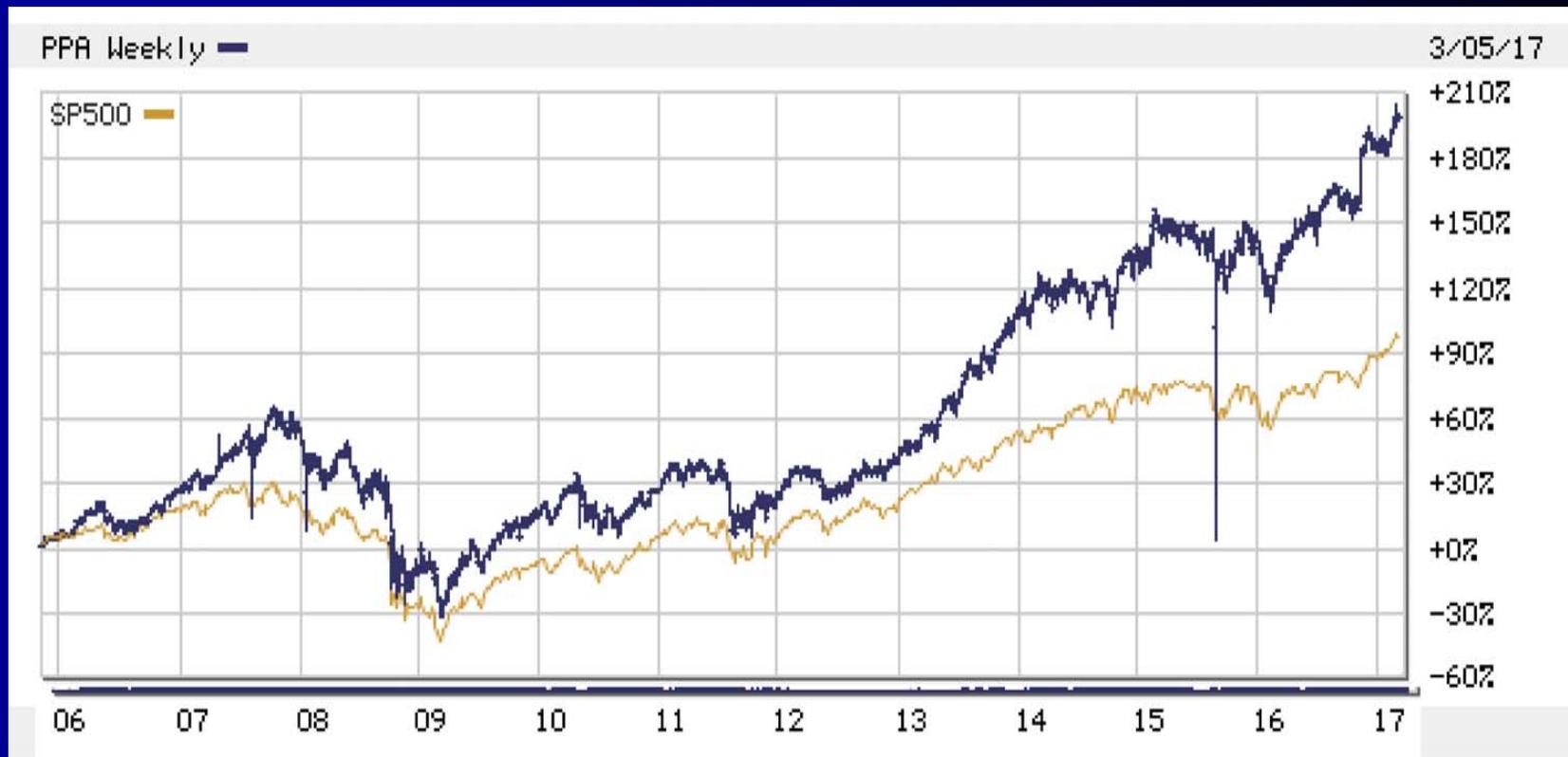
# Representative Firms: Annual Global Defense Revenues >\$500M

Lockheed Martin	Textron	Vectrus
Boeing	Leidos	Oshkosh Defense
Raytheon	SAIC	Engility
General Dynamics	Orbital ATK	Cubic
Northrop Grumman	Booz Allen	Moog
L-3 Communications	CACI	Curtiss-Wright
Huntington Ingalls	Rockwell Collins	ViaSat
United Technologies	Aerojet Rocketdyne	AAR Corp
Honeywell	CSRA	Ball Aerospace
Harris	ManTech	

Credit: Defense News, 2015 data

# A Two-Decade Long Rally

Since Inception, PPA has more than doubled the return of the S&P500



# A Two-Decade Long Rally

## Since 2000

- SPADE Defense Index has outperformed the S&P 500 for 5 consecutive years, gaining 134.7%
- Outperformed the S&P500 in this timeframe by 56.7%
- Since 2000, the SPADE Defense Index has outperformed the broader market in 14 of 17 years
- In the three years it underperformed, the index gained 21.71%, 9.62%, and [-2.75%]
- Since 2000, the SPADE Defense Index has gained a whopping 393.02%!

Period	SPADE (DXS)	S&P 500
2000	4.98%	[10.14%]
2001	0.94%	[13.04%]
2002	[2.87%]	[23.37%]
2003	37.27%	26.38%
2004	20.47%	8.99%
2005	5.30%	3.00%
2006	19.33%	13.62%
2007	22.17%	3.53%

Period	SPADE (DXS)	S&P 500
2008	[38.03%]	[38.49%]
2009	21.71%	23.45%
2010	9.62%	12.78%
2011	[2.75%]	0.00%
2012	16.30%	13.41%
2013	48.27%	29.60%
2014	11.77%	11.39%
2015	3.23%	[0.73%]
2016	17.95%	9.53%

*Calculated by SPADE Indexes using publicly available end-of-year pricing data for both indexes*

## Driver #1    **An Unstable Global Situation**

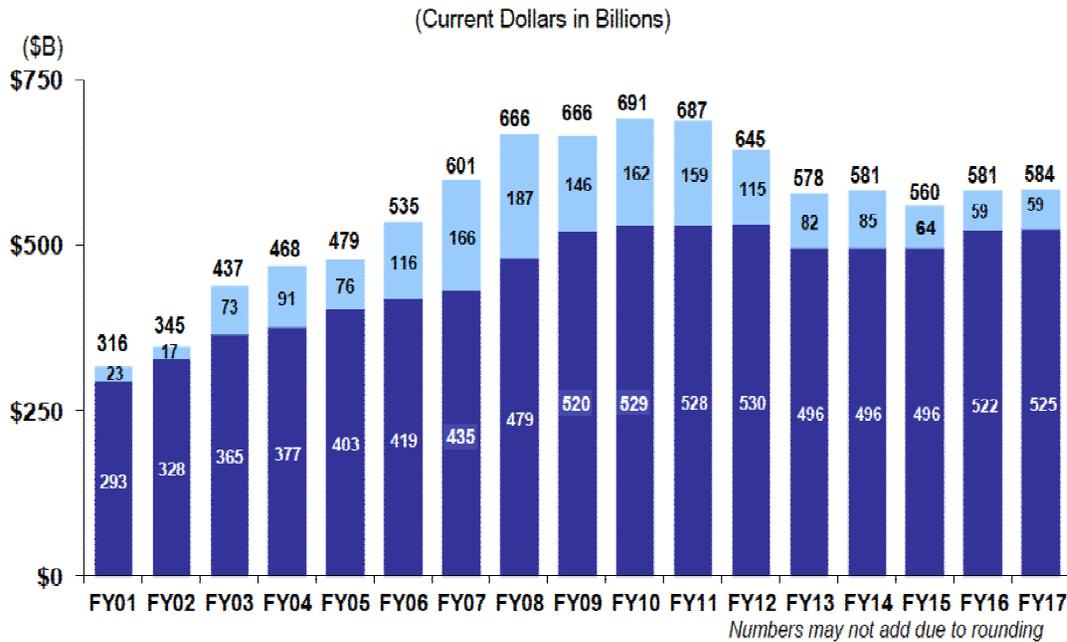
*Defense spending is in part insurance against global risk and change. Below are just some of the current global political situations monitored by U.S. defense authorities.*

- **North Korea**
- **China Naval Incursions in the Pacific**
- **Tension Between China and Taiwan**
- **Turkey / Erdogan**
- **Syrian Civil War**
- **Iran / Nuclear Tensions**
- **Instability in Iraq**
- **Nigeria / Boko Haram**
- **ISIS / ISIL Around the Globe**
- **Disintegration of the EU Model**
- **Yemini / Saudi Arabia Crisis**
- **Central American Drug / Gang Wars**
- *Unforeseen/Unpublicized Events*

# Driver #2 The Department of Defense Budget

*In FY2017, the DoD budget was \$577.9 Billion.<sup>1</sup>*

## DoD Topline: From 9/11 Through BBA15

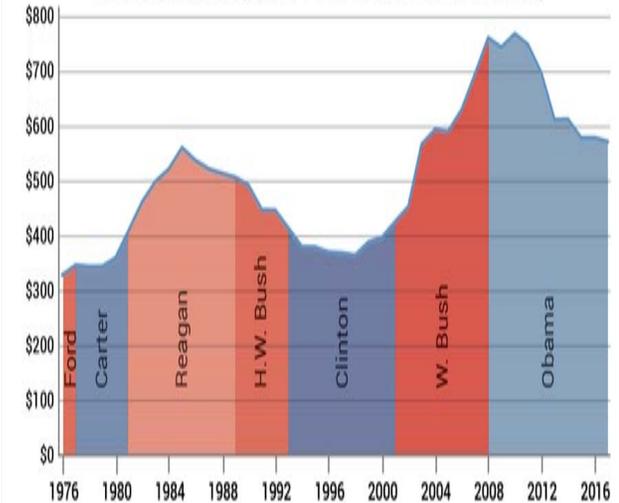


### DoD Topline, FY 2001 – FY 2017

(Current Dollars in Billions)

■ Base Budget ■ OCO

## DoD Budget Authority (Base + OCO in Constant 2016 Billion \$)



*Although down from its 2010 peak, U.S. spending has been remained stable.*

<sup>1</sup> Current estimate per *Defense News* article

## Driver #3 International Defense Sales

*US Defense Suppliers are less reliant on the U.S. DoD budget than ever before. Global sales are more than compensating for changes in the U.S. defense budget*

- The United States spends **36%** of the total spent worldwide on defense<sup>2</sup>
- Combined, in 2015 the world spent \$1.68 Trillion on defense<sup>2</sup>
- Through 23Dec16, the State Department OK'd 21 foreign sales worth \$45.2B. For all of 2016, \$33.6B in sales was cleared.<sup>1</sup>
- 2017 is on pace to beat the \$68.6 Billion in total foreign weapons sales set in 2012.<sup>1</sup>
- Lockheed Martin expects foreign sales in 2017 to hit 30%, up from 21% in 2015. Raytheon generates nearly 1/3 of its sales from international clients.<sup>1</sup>

### Total Global Defense Spending<sup>2</sup>

- USA 36%
- China 13%
- Saudi Arabia 5.2%
- Russia 4.0%
- UK 3.3%'
- India 3.1%
- France 3.0%

1 26 Dec 16- Defense News

2 SIPRI

- 15 -

## Driver #4

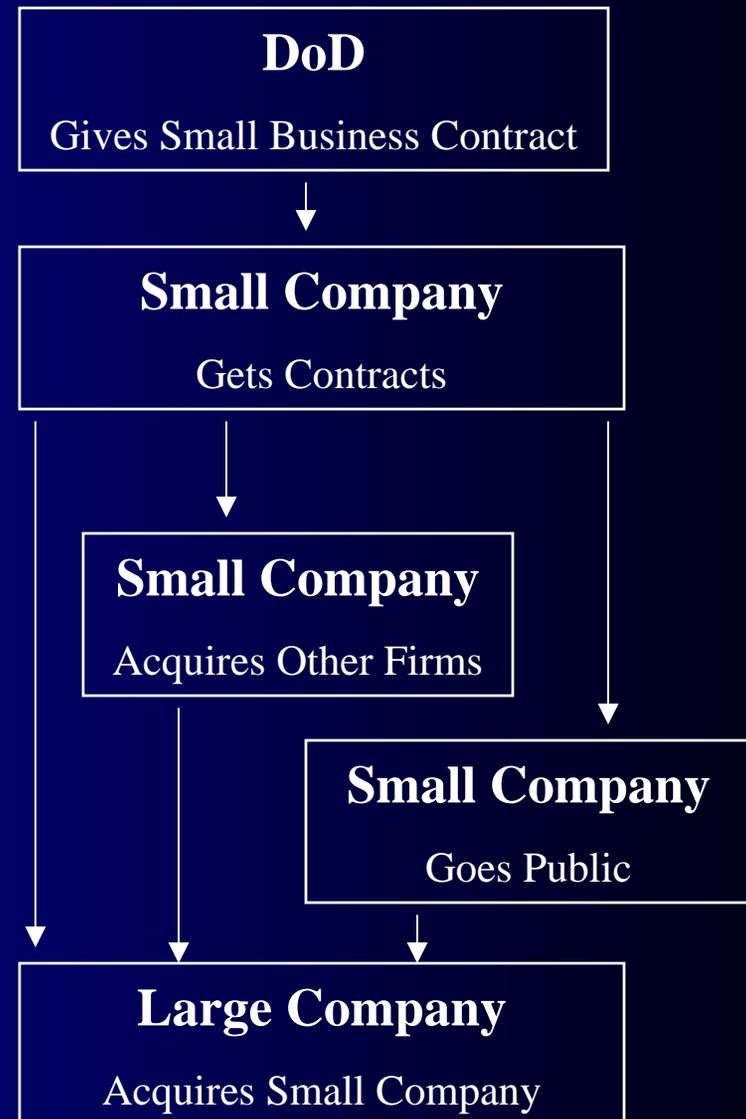
### Acquisitions

*On average, the defense sector sees several hundred deals annually*

- *mostly small, <\$100 million*
- *mostly private*

*The acquisitions provide...*

- *exposure to long-term contracts*
- *key personnel (& clearances)*
- *access to classified programs and personnel*
- *technology & capabilities*



# Driver #5

## Technology

DoD's mission is to maintain capabilities that allow our military to have an advantage over an enemy or possible enemy. **The RDT&E budget is +/- \$70 billion annually – making it the largest investor in advanced technology in the world.**

Many new systems are developed over 10-15-20 year timeframes.

*Areas of interest include:*

- IT/Network Centric Warfare, Battlefield Visualization, Data Visualization
- Armor and Protection against IED/mines
- UAVs / GPS and other technologies that put the soldier and equipment further out of harm's way

- **1916 – 1918 WWI**
  - Aircraft, the tank, machine guns
- **1939 - 1945 WWII**
  - Introduction of the jet, missiles
- **1946-1960+**
  - Nuclear weapons age
- **1957- today**
  - Satellite systems
- **1980s**
  - Stealth technology
- **2000s**
  - Network-centric warfare
- **2010s**
  - Drones, Autonomous Vehicles, Big Data

# Driver #6

## Diversification

- *The larger defense firms tend to work on multiple contracts for different agencies and programs.*
- *Employ their skillset toward contracts from non-military agencies such as NASA, Dep't of Energy, HHS, etc.*
- *Maintain a number of commercial and non-defense related enterprises*
- *Commercial Aerospace: International carrier orders for aircraft is in a multi-year manufacturing cycle expected to run to the early 2020s.*

*Using recent company investor presentations, 10K filings, and details on the Defense News Top 100:*

- *47.1% of revenues are defined as from defense clients (global vs. US whenever possible)<sup>1</sup>*
- *Excluding non-defense revenues from Boeing, United Technologies, and Honeywell, raises this total to nearly 70%<sup>1</sup>*
- *Commercial aerospace revenues make up nearly a third of the total and reflect a dynamic acquisition market for aircraft.<sup>1</sup>*

<sup>1</sup> SPADE Indexes Research

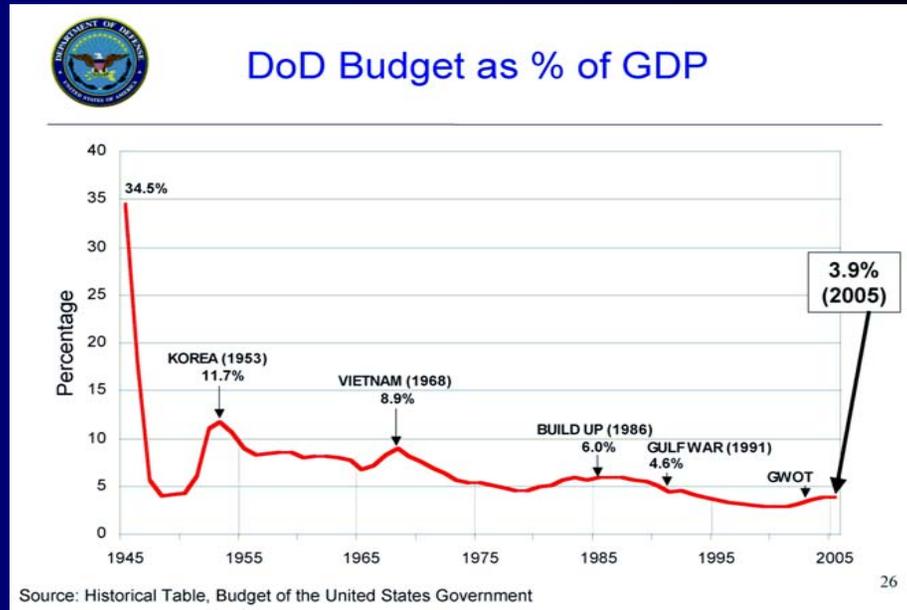
# Misperceptions vs. Reality

## The Belief

We're spending more today than ever on defense and security

## The Reality

In WWII, the U.S. spent 34.5% of GDP on the war effort. We now spend 4-5%



# Misperceptions vs. Reality

## The Belief

**Sector investing  
adds risk**

## The Reality

- Not necessarily and not always. Aerospace and Defense may be the perfect “buy and hold” investment.
- Using historical index data from 1997 to the present and a rough backtest to the Reagan Administration in 1980—at any point in time an investor would recoup their principal within three years after reinvesting dividends. How many sectors can claim that over a 37 year timeframe?
- Most importantly...the world has not changed and remains unstable. A cyclical downturn in defense is not foreseen.

# Misperceptions vs. Reality

## The Belief

**The Trump Administration guarantees a massive increase in defense spending.**

## The Reality

- Possibly, but in the world of politics nothing is guaranteed.
- We'd be remiss if we take this for granted. There are a number of members within Congress and factions of the Republican Party who would be against an increase in the budget for any reason.
- An end to sequestration is anticipated but some in Congress still believe that defense and non-discretionary spending should adjust 1:1.

## Conclusions

**Many money managers believe that defense sector investments should be a *core part* to a portfolio**

1. The reasons behind the defense sector's growth (namely a response to a volatile world) will be with us for some time.
2. The amount the U.S. spends to protect its interests (~ 4-5% GDP) and offer economic and emotional stability to its citizens is reasonable
3. Investor interest in defense sector companies and equity funds is growing

## For More Information ...

Visit [www.spadeindex.com](http://www.spadeindex.com) to learn about:

- Index Rules / Methodology
- Index Constituents and Details
- Links to historical data and performance

To download our complimentary newsletter,

*The SPADE Investor*, visit [www.spadeindex.com](http://www.spadeindex.com)



*Index: DXS*

*Licensed ETF: PPA*

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