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Commentary

A Strong Start to 2014 Follows Nearly 50% Gains in 2013

Aerospace manufacturing remains one of the strongest elements of the global economy. Even as economists question the health of the economy in the United States as well as that in Europe, Asia, Latin America, and elsewhere, industrial activity associated with aviation remains quite strong. Airlines around the globe continue to report solid financials, and their plans to upgrade to more modern, more efficient planes are providing a solid backlog through the end of the decade.

Meanwhile, defense spending in the U.S., under some pressure as wartime spending draws down and the Department of Defense restructures where and how it spends its budget, is being offset by business from international clients. Dozens of countries and regions are experiencing problems whether it is Turkey, Egypt and Syria in the Mid East; Thailand, Indonesia and other nations in Asia; or problems in Venezuela, Argentina, and Brazil; to name just some of the 40-odd areas analysts are watching. Combined with that, a number of orders are coming in for the F-35, a large international program with multi-national support--moving it from the backlog phase to the manufacturing/revenues phase. And not to be ignored, cyber continues to be a hot topic among businesses and nations around the globe. *(Want to see a cyber index/fund launched?...shoot me an email)*

So what does all this mean? In the first quarter, after 2013 returns that saw aerospace and defense outpace the broader U.S. market by NEARLY 20%, the sector continued to ride higher, beating the broader markets by another 300 basis points.

If you doubt the run that the sector is on, read some of our old commentaries. The continuing performance of the sector is not a surprise. The trends we thought we would see are taking place. The massive dropoff and fear spread by the unknowing didn't take into account the parts of the sector that were growing. Instead they focused on what happened to the sector 20-odd years ago when the defense sector was unprepared for the fall of the Soviet Union and the desire of government for what was called the "peace dividend."

Many years ago, when we first pitched the concept of the SPADE Defense Index for use in an investable fund, we highlighted the fact that the sector has a lot of "internal diversification." The commercial and military industrial businesses operate on different cycles and with different influences. Still without a willingness of the Congress to open up our markets to sell defense products internationally, the sector wouldn't be as strong today as the stock performance is indicating. Most of today's defense executives understand the sector and understand the lessons of the late 1980s that nearly bankrupted the sector. And as such, they have been preparing for the current market conditions for nearly half a decade; refining their business operations to succeed in the face of a declining and restructuring defense sector. (ed note: in the collective this is true, of course there are varying degrees of which firms have best prepared their firms).

Looking at the first quarter, **31 of the 49 companies** listed on page 2, **outperformed the broader market**. Last years top performers had mixed results -- large-cap Boeing and small cap Ducommun saw significant declines of 8% and nearly 16% respectively, in Q1, Gencorp which nearly doubled in 2013 was flat; while Alliant Techsystems and Huntington Ingalls continued to run higher with 1Q returns in the double digits.

1Q14 Leaders were:

1. Key W Holdings 39.21%
2. Aerovironment 38.13%
3. Engility 34.88%
4. Mercury Computer 20.64%
5. Orbital Sciences 19.74%

And in case you missed it from our 1Q14 letter, here is what we expect for 2014

1. Solid revenue and earnings by companies with aerospace exposure especially as Boeing increases production rates for the 787 Dreamliner and new 737 products.
2. Continued international growth for defense products

SPADE Defense Index Statistics

12/31/13 Close:	3567.72
3/31/13 Close:	3722.05
All-time Close:	3831.31
Date of all-time close:	7 March 2014

	SPADE Defense	S&P500
2013	48.27%	29.60%
1Q14	4.33%	1.30%

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1Q14 Results

1	Key W	39.21%
2	Aerovironment	38.13%
3	Engility	34.88%
4	Mercury Computer	20.64%
5	Orbital Sciences	19.74%
6	FLIR Systems	19.60%
7	Oshkosh	16.85%
8	Alliant Techsystems	16.82%
9	TASER	15.18%
10	Transdigm	15.02%
11	Booz Allen	14.88%
12	General Dynamics	13.99%
13	Huntington Ingalls	13.61%
14	SAIC	13.06%
15	OSI Systems	12.71%
16	L-3	10.57%
17	Viasat	10.20%
18	Lockheed Martin	9.81%
19	Raytheon	8.92%
20	Computer Sciences	8.84%
21	Rockwell Collins	7.78%
22	Northrop Grumman	7.65%
23	Textron	6.88%
24	Ball Corp	6.10%
25	Teledyne Tech	5.95%
26	Harris Corp	4.80%
27	Esterline	4.49%
28	Heico	3.81%
29	United Technologies	2.67%
30	Honeywell	1.52%
31	Gencorp	1.39%
32	Comtech	1.11%
33	CACI	0.79%
34	Anaren	-0.04%
35	ITT Exelis	-0.26%
36	Mantech	-1.74%
37	Kratos	-1.82%
38	Hexcel	-2.57%
39	Cubic	-3.02%
40	Moog	-3.58%
41	Precision Castparts	-6.14%
42	American Science	-6.59%
43	AAR	-7.35%
44	Boeing	-8.06%
45	URS Corp	-11.19%
46	Triumph Group	-15.10%
47	Ducommun	-15.93%
48	Leidos	-23.92%
49	Digital Globe	-29.50%

as Congress has shown a willingness for approving sales and relaxing export licensing rules. The world remains volatile—especially in the Middle East, Asia, and Africa (which is nothing really new). Additionally, international sales related to homeland and border security—including reconnaissance and surveillance, and IT to make sense of the data and imagery —is anticipated to increase.

3. A budget for 2014 will enable the Department off Defense to make cuts with a scalpel vs. the hatchet of sequestration. Budgets have flattened/declined from the peak of war spending and that is anticipated to continue for a few more years. Efforts relying on the additional funds provided in the supplemental war budget will feel a greater impact than those that do not.

4. It likely goes without saying that small companies will be impacted by defense program restructuring more than their larger brethren, which are more diversified. We believe this will allow the cream to rise to the top and we can anticipate seeing a greater number of small-scale M&A deals along with investments into these firms as the large prime contractors shift from using capital for buybacks to once again positioning their businesses for future growth.

5. Cyber will once again remain a dominant focal area in 2014. Money will flow into cyber security initiatives and we will see (1) a number of mergers as this business sector evolves; and (2) previously military grade products enter the commercial world.

6. After many years where the larger capitalization companies fueled returns in the sector, valuations are seen as closer to the peak than the trough. As such, smaller, non-industrial firms may start to lead instead of lag as they did in the early 2000s.

7. While China and North Korea will continue to garner headlines, the real threat is a conflagration between Israel and Iran's nuclear program.

8. A shift by investors from large cap manufacturers into A&D ETFs such as the Powershares Aerospace & Defense ETF (NYSE: PPA) as they look for diversification and opportunities in small cap and mid-cap firms involved with cyber, border security, C4ISR, surveillance, and communications.

ETF Statistics (NYSEarca: PPA)
Powershares Aerospace & Defense

Exchange / Ticker Symbol:	NYSE / PPA
Assets (3/31/14)	$99 M
Closing Price (3/31/14)	$32.42
Yield (12-Month Yield)	1.2%
1Q2014 Volume	2,810,500
Turnover	4%

source: Marketwatch

Portfolio Price / Earnings*	16.71
Portfolio Price / Book*	1.67
Portfolio Price / Sales*	1.14
Portfolio Price / Cash Flow*	11.10
Earnings Growth Rate*	11.37%
Beta (3 year)*	0.82
Alpha (3 year)*	10.55
R-squared (3 year)*	70.29

Yahoo Finance - 3/31/14

Performance (ex div)

	SPADE Defense Index	S&P500
2013	**48.27%**	29.60%
2012	**16.30%**	13.41%
2011	**[2.75%]**	[0.00%]
2010	9.62%	12.78%
2009	21.71%	23.45%
2008	[38.03%]	[38.49%]
2007	**22.17%**	3.53%
2006	**19.33%**	13.62%
2005	**5.30%**	3.00%
2004	**20.47%**	8.99%
2003	**37.27%**	26.38%
2002	**[2.87%]**	[23.37%]
2001	**0.94%**	[13.04%]
2000	**4.98%**	[10.14%]
1999	15.31%	19.53%
1998	6.63%	26.67%

About the SPADE Defense Index

The SPADE Defense Index **(NYSE: DXS)** provides an investment benchmark for the value that the market ascribes to companies involved with defense, homeland security, and space.

The Index is designed to reflect the broad diversity of activities that is representative of companies involved with the sector – including industrial firms that manufacture aircraft, tanks, ships, and missiles; and those involved with current and next generation systems related to network centric warfare and information technology; intelligence, surveillance, and reconnaissance; satellites; border security; and defense systems that protect the lives of our servicemen and servicewomen.

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SPADE Indexes has developed a number of equity indexes including sector indexes focused on aerospace & defense, and cybersecurity; and regional indexes such as those for Oklahoma and Texas.

Licensed Products

Exchange Traded Fund - ETF

Licensed to Invesco Powershares, the Powershares Aerospace & Defense Portfolio ETF **(NYSE: PPA)** is designed to track the performance of the SPADE Defense Index.

Rules

The Index was designed to be RIC (registered investment company) compliant for the purpose of enabling financial products. Companies are required to meet a variety of eligibility criteria including market valuation, liquidity, and listing on a major U.S. exchange. Full details are available on our website.

* Market Cap: Minimum $100M
* Share Price: Minimum $5.00
* Sufficient Liquidity

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