



Commentary

This commentary comes a few days late as how can one write about the sector in the midst of the market mayhem that has come during the first days of August.

When it comes to investing in the aerospace and defense sector, the mood on Wall Street is now essentially mixed with analysts issuing both upgrades and downgrades to firms operating in the sector. The analysts upgrading see the sector's stocks as beaten down beyond where the news would justify and cite valuations and dividend yields as the reason to tip back in. The analysts downgrading are fearful that reduced government spending will impact defense stocks and seek to get their estimates in line with current prices not wanting to have price targets that seem too lofty.

How we got here....

After the positive news from June's Paris Air Show, fear once again entered the market and drove defense-focused stocks down significantly, dropping more than 6% in July (and like the rest of the market, down significantly more in the first days of August; although there has been a bit of a rebound)

As the debt ceiling negotiations reached resolution, the sector continues to sell-off in fear that the deficit reduction will lead to significant declines in the sector. The devil of course, is in the details. However, as the market takes a plunge in early August due to poor economic forecasts and trouble with the European economies, it may not matter that the aerospace and defense sector could have been oversold.

Initial estimates call for a \$28 billion reduction in the FY-2012 budget and for \$350 billion coming from defense over the next decade, a manageable figure and one that even offers top line growth if that figure is based on current funding levels which includes Iraq and Afghanistan.

Where are we going

This is still open to debate but here's how our wall of worry stands -- the good and the bad so that you can make your own decision.

1. The Global Recession

Economists are mixed on the likelihood of this, but if the world were to enter a global recession, business spending would be impacted and we'd likely see airlines delay deliveries of new aircraft. HOWEVER, a global recession would reduce oil prices which is good for airline operators so they likely won't have to make any rash decisions. Also, the backlog at Boeing is several years long so while they might have to slow/delay increased production rates, manufacturing operations should remain solid for the next few years.

SPADE Defense Index Statistics

7/31/11 Close: 2164.30
 All-time Close: 2747.67
 Date of all-time close: 9 October 2007

	SPADE Defense	S&P500
July	[6.67%]	[2.15%]
QTD	[6.67%]	[2.15%]
YTD	1.66%	2.75%

2. Debt / Deficit Reduction

DoD knows its budget will be reduced. Their contractors know it will be reduced. And many investors know it will be reduced-- yet, a panic still ensued.

Here is what we know. \$35 billion is coming out of the FY-12 budget which is roughly the savings from reduced troops in the Afghan region. Additional pullouts over the next three years will lead to \$100 billion less in annual defense spending compared to FY-11 through the end of the decade. An additional \$30+ billion annually in reduced health/retirement/personnel costs is coming. This greatly exceeds any current and planned deficit/debt reductions and provides adequate funding for DoD procurement and R&D to maintain readiness levels for the next threat. Things could change but right now the fear of reductions is greater than the magnitude of it.

3. The Next Threat

Some point to Chinese naval aggression in the Pacific Region. Some see a resurgence of al Qaeda or another radical Islamic group; and some think it is Iran. Just as likely, the next threat could just as easily come from internal issues such as unemployment. This year alone we saw armed rebellion in the Middle East and the overthrow of governments by people wanting more -- freedom, jobs, and/or services. In the European Union there have been riots in Greece and this past week in London by the disillusioned who burned cars and looted shops. And a home-grown terrorist in Norway killed nearly 100 people because he was upset with political policies regarding the economy, immigration, and other issues.

4. Meanwhile...

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July 2011 Top Gainers			July 2011 Laggards			YTD Top Gainers			YTD Laggards		
1	AAR Corp	8.31%				1	EMS Technologies	66.23%	1	Triumph Group	[39.78%]
2	Ducommun	6.95%	2	FLIR Systems	[18.54%]	2	SRA International*	51.20%	2	Oshkosh Truck	[29.57%]
3	GeoEye	6.84%	3	Aerovironment	[18.44%]	3	LMI Aerospace	43.78%	3	Computer Sciences	[28.87%]
4	ViaSat	3.84%	4	Ceradyne	[16.88%]	4	Esterline Tech.	30.35%	4	Key W Holdings	[23.93%]
5	Orbital Sciences	2.79%	5	Oshkosh Truck	[14.24%]	5	Transdigm	25.08%	5	Digital Globe	[17.63%]
6	Digital Globe	2.79%	6	Northrop Grumman	[12.75%]	6	Teledyne Tech	23.33%	6	Kratos Defense	[17.46%]
7	American Science	1.41%	7	Gencorp	[11.84%]	7	Integral Systems*	22.81%	7	Force Protection	[17.06%]
8	Ball	0.88%	8	Harris Corp	[11.52%]	8	Precision Castparts	15.93%	8	Taser	[12.55%]
9	Esterline Tech	[0.04%]	9	Honeywell	[10.89%]	9	Ball Corp	14.03%	9	Alliant Techsystems	[12.36%]
10	EMS Technologies	[0.27%]	10	Kratos	[10.61%]	10	OSI Systems	13.56%	10	Harris Corp	[11.74%]

Largest Defense Prime Contractors		
	July	2011
Lockheed Martin	[6.47%]	8.32%
Boeing	[4.68%]	7.98%
General Dynamics	[8.56%]	[3.97%]
Northrop Grumman	[12.75%]	[6.59%]
Raytheon	[10.27%]	[3.47%]

Powershares Aerospace & Defense ETF (NYSE: PPA)
Modern Portfolio Theory (vs the S&P500)
 Beta (3 year) 1.06
 Alpha (3 year) [1.18]
 R-squared (3 year) 85.53%
 Yahoo Finance - 6/30/11

ETF Statistics (NYSEarca: PPA)
Powershares Aerospace & Defense
 Exchange / Ticker Symbol: NYSE / PPA
 Fee 60 basis
 Assets (7/29/11) \$116 M
 Closing Price (7/29/11) \$19.02
 Yield (Distribution Yield) 1.17%
 July 2011 Volume 2,533,600
 Turnover 12%
 source: Yahoo Finance

Portfolio Price / Earnings	13.59
Portfolio Price / Book	2.29
Portfolio Price / Sales	0.86
Portfolio Price / Cash Flow	9.74
Earnings Growth Rate	3.38%
Yahoo Finance - 6/30/11	

Commentary (continued from page 1)

Companies operating in the sector remain flush with cash and are using assets to make small acquisitions that round out their product/service portfolios to position for the future and we are seeing valuations last seen... at the bottom of the peace dividend that followed the fall of the Soviet Union.

So What Does this All Mean...

The truth is, the next threat could come from anywhere. Since there is no greater responsibility of government than to protect its citizens and its way of life, there is one thing we can be sure of is. While the defense sector will take some hits as budget priorities are re-evaluated, cuts in defense spending will never be as severe as some shout out and a booming commercial aerospace sector will mitigate the impact for many firms.

Index Changes (July 2011)

1. Kratos (KTOS) acquired Integral Systems (ISYS)
2. Providence Equity Partners closed its acquisition of SRA International (SRX).
3. Safran closed its acquisition of L1 Identity (ID).

It's sell first, ask questions later...The sector has been taken back to the woodshed but I don't think they deserve to be there...I think the selloff is overdone.

Guy Adami

CNBC Fast Money 1 Aug 11

2011 Defense News Top 100 US Public Companies in the Top 20

		2010 Defense Revenues	2009 Defense Revenues	Total Revenues
1	Lockheed Martin	\$42.8 B	\$42.0 B	\$45.8 B
3	Northrop Grumman	31.2 B	30.7 B	34.8 B
4	Boeing	30.9 B	31.9 B	64.3 B
5	General Dynamics	26.6 B	25.9 B	32.5 B
6	Raytheon	23.4 B	23.1 B	25.2 B
9	L-3 Communications	13.1 B	13.0 B	15.7 B
10	United Technologies	11.6 B	11.1 B	54.3 B
12	SAIC	8.7 B	8.4 B	11.1 B
13	Oshkosh Truck	7.2 B	2.6 B	9.8 B
14	ITT	5.5 B	5.7 B	11.0 B
15	Honeywell	5.4 B	5.4 B	33.4 B
16	Booz Allen	4.7 B	4.2 B	5.6 B
17	Computer Sciences	4.5 B	4.2 B	16.0 B

Selected 2Q11 Earnings

Lockheed Martin

- Raised FY11 earnings/share to \$7.35-\$7.55 from \$6.95-\$7.25
- Earnings \$2.14 vs. \$1.94 estimate (\$2.22 previous year)
- \$77.3 Billion backlog (vs \$78.4B end of 2010)
- Cash on hand: \$3.27 Billion

General Dynamics

- Raised full-year 2011 earnings from continuing operations to \$7.15-\$7.20 share
- Beat analyst estimates previous four quarters
- Net income \$653 Million vs \$6.48 Million
- Revenue down 2.5% to \$7.9 billion

Northrop Grumman

- Revenue: Down 9.6% to \$6.56 Billion vs. \$6.97 Billion estimate
- Income: Down \$520M (\$1.81M) vs \$740M (\$2.44/sh)

Boeing

- Raised full year profit to \$3.90/sh to \$4.10/sh; up 10c on each end.
- Full year revenue forecast \$68B - \$71B
- Backlog: 3300 planes valued at \$262 Billion
- Defense: Profit up 12% to \$798 Million
- Sales up \$16.5 Billion vs. \$15.6 Billion
- Buoyed by higher commercial jet revenue and deliveries



Aerospace and Defense stocks quickly moved into correction territory after a late-July selloff in the sector preceded the market carnage in early August. PPA (blue) has fallen below the 50-day and the 200-day moving average (green).

PPA = Powershares Aerospace & Defense ETF

After outperforming for most of the year, defense stocks (blue) began selling off in late-July at a steeper rate than the S&P500 (red).

PPA = Powershares Aerospace & Defense ETF



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The Next Cold War?

The South China Sea has seen a number of incidents recently between China and other nations. This includes 1) A frigate firing warning shots at Filipino fishing boats (2/25); 2) Two maritime patrol vessels threatening to ram a Philippine government energy research vessel (3/2); 3) Announcing a unilateral fishing ban in the northern part of the South China Sea; 4) Allegedly firing on four Vietnamese fishing vessels (May); 5) Allegedly flew two fighter jets near Palawan Island (May 11); 6) Harassed a vessel owned by PetroVietnam inside Vietnam's Exclusive Economic Zone (May 26); and) Rammed a PetroVietnam vessel conducting an oil sur-

vey (June 9).

Impact of Planned 30K Afghan Troop Reductions

According to the CSBA, the Pentagon will save \$17 billion in 2012

- Pentagon had budgeted for 98k troops, not 68k troops
- Request will be \$77-\$83B in 2013
- Trucks and Small-arms weapons will take the biggest hits
- War spending \$162B/2010, \$159B/2011, \$126B/2012

Excerpts from the Senate Armed Services Bill (Defense News 20 June 11)

Added \$322M to upgrade 40 M1A2 Abrams tanks to keep the production line open longer.

Cut funding for the MEADS Medium Extended Air Defense System joint effort with Italy and Germany.

Gave \$884M to the Army to develop a Ground Combat vehicle

Cut \$452M for the Army EMARSS (Enhanced Medium Altitude

Recon and Surveillance System) citing program delays

Cut \$200M from the Joint Tactical Radio System JTRS reflecting program delays

Cut \$35M to replace an AH-64 Apache aircraft that won't be delivered until after the war effort is completed.

Provided \$500M for East Africa & Yemen counterterrorism efforts.

Required Lockheed Martin in the next contract for the F-35 JSF Fighter to be responsible for 100% of cost overruns.

\$2.7 Billion Deal - The U.S. decided to sell Israel F-35 JSF fighter jets to be delivered in late 2016.

\$1.1 Billion - United Launch Alliance, a joint venture of Lockheed and Boeing received a contract to launch the EELV launch vehicle from July 11 to Sept 12.

F-16 Jets - The UAE is considering buying F-16 fighter jets from Lockheed Martin instead of the Rafale jets as expected.

Smart Microgrid Market - According to *National Defense* magazine, Lockheed and Boeing are planning to enter this market to integrate renewable and conventional energy networks.

Exoatmospheric Kill Vehicle - The Missile Defense Agency got support from the Senate Armed Services Committee to halt production after several test failures

Humvee Changes - The Pentagon asked to shift \$182 million

from buying new Humvees toward improving survivability and mobility enhancements of existing vehicles.

Inside the Tanker Contract - Air Force officials confirmed that they thought Boeing would exceed its cost ceiling by as much as \$300 million (6%) on the initial contract to develop and build the aerial refueling tankers. The \$4.9 billion engineering, manufacturing, and development contract includes four aircraft with 14 more to be delivered by 30 September 2017. Boeing is responsible for all costs over the \$4.9 billion price. The contract also provides Boeing with 40 cents of every dollar saved below this amount.

\$1.35 Billion Armored Vehicle Plan - DoD officials approved the Army plan to develop a new class of Ground Combat Vehicles--1,874 vehicles to replace the Bradley infantry fighting vehicle, a successor to the cancelled manned vehicle portion of the Future Combat Systems program. The service plans to pick three winners for the development phase and one for production contract.

About the SPADE Defense Index

The SPADE Defense Index (NYSE-amex: 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.

SPADE Indexes publishes a variety of private and public sector and regional indexes. Public indexes listed on the NYSEamex include: the SPADE Defense Index (ticker: DXS), the SPADE Oklahoma Index (ticker: OKLAH); and the SPADE Texas Index (ticker: 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

Aug-11		52 SPADE Defense Index					Market		Forward	Price/	Price/	PEG	
Company	Ticker	Float %	Price	Price	% Ch	% Ch	Cap	P/E	Sales	Book	5 yr	Div Yld	
		30-Jul-11	30-Jun-11	29-Jul-11	YTD	MTD	intraday	(ttm)	ttm	mrq	expected	forward %	
AAR Corp	AIR	0.57%	27.09	29.34	6.81%	8.31%	1.13	11.33	0.63	1.33	1.10	1.00%	
American Science & Engineering	ASEI	0.35%	80.00	81.13	-4.81%	1.41%	0.75	16.90	2.68	2.79	1.08	1.50%	
Alliant Techsystems	ATK	1.06%	71.33	65.23	-12.36%	-8.55%	2.19	7.42	0.45	1.89	2.14	1.20%	
AeroVironment	AVAV	0.31%	35.35	28.83	7.45%	-18.44%	0.63	19.88	2.13	2.36	1.07		
Boeing Co	BA	7.13%	73.93	70.47	7.98%	-4.68%	52.22	13.32	0.81	11.06	1.46	2.40%	
Booz Allen & Hamilton	BAH	1.23%	19.11	18.19	-6.38%	-4.81%	2.33	10.45	0.42	2.58	0.61		
Ball Corp	BLL	3.18%	38.46	38.80	14.03%	0.88%	6.52	12.01	0.81	4.26	1.37	0.70%	
Caci Intl	CACI	0.84%	63.08	59.08	9.81%	-6.34%	1.78	12.62	0.52	1.43	1.10		
Comtech	CMTL	0.35%	28.04	26.96	-2.88%	-3.85%	0.70	24.95	0.99	1.07	0.36	3.70%	
Rockwell Collins	COL	3.87%	60.84	55.09	-5.39%	-9.45%	8.47	12.13	1.74	5.04	1.47	1.60%	
Ceradyne Inc	CRDN	0.40%	38.99	32.41	2.79%	-16.88%	0.81	10.35	1.63	1.12	0.70		
Computer Sciences	CSC	2.65%	37.96	35.28	-28.87%	-7.06%	5.47	6.90	0.34	0.73	0.86	2.30%	
Cubic Corp	CUB	0.64%	50.20	48.54	2.95%	-3.31%	1.30	15.22	1.00	2.50	0.91	0.40%	
Ducommun	DCO	0.12%	20.57	22.00	1.01%	6.95%	0.23	8.59	0.57	0.90	0.63	1.40%	
Digital Globe	DGI	0.58%	25.41	26.12	-17.63%	2.79%	1.21	30.73	3.75	2.41	10.07		
EMS Tech	ELMG	0.25%	32.97	32.88	66.23%	-0.27%	0.50	23.49	1.41	1.91	1.40		
Esterline Technologies	ESL	1.16%	76.40	76.37	30.35%	-0.04%	2.33	13.66	1.42	1.44	1.05		
Eibit Systems	ESLT	0.96%	47.88	46.89	-11.74%	-2.07%	2.00	9.42	0.74	2.12	0.99	0.70%	
Flir Systems	FLIR	2.14%	33.71	27.46	-7.70%	-18.54%	4.39	15.51	2.88	2.72	1.34	0.90%	
Force Protection	FRPT	0.16%	4.97	4.57	-17.06%	-8.05%	0.32	9.93	0.49	0.99	1.27		
General Dynamics	GD	5.39%	74.52	68.14	-3.97%	-8.56%	24.65	8.86	0.76	1.76	1.26	2.80%	
GeoEye	GEOY	0.44%	37.40	39.96	-5.73%	6.84%	0.89	16.38	2.65	1.95	1.18		
Goodrich Corp	GR	4.30%	95.50	95.14	8.03%	-0.38%	11.89	13.75	1.58	3.09	1.17	1.20%	
Gencorp	GY	0.16%	6.42	5.66	9.48%	-11.84%	0.33	20.96	0.38				
Heico	HEI	1.08%	54.74	52.26	2.41%	-4.53%	2.18	28.1	3.19	4.3	2.02	0.20%	
Honeywell Intl	HON	6.79%	59.59	53.10	-0.11%	-10.89%	41.55	11.64	1.16	3.44	1.03	2.50%	
Harris Corp	HRS	2.46%	45.06	39.87	-11.99%	-11.52%	5.07	7.73	0.90	2.03	0.93	2.50%	
Itt Indus	ITT	3.96%	58.93	53.34	2.36%	-9.49%	9.82	10.32	0.90	2.11	1.13	1.90%	
KEY W Holding	KEYW	0.14%	12.39	11.16	-23.93%	-9.93%	0.89	18.60	2.31	1.65	1.69		
Kratos Defense & Security	KTOS	0.18%	12.16	10.87	-17.46%	-10.61%	0.26	24.7	0.53	1.05			
L-3 Communications Hldgs	LLL	3.86%	87.45	79.12	12.24%	-9.53%	8.40	8.83	0.54	1.25	1.24	2.30%	
LMI Aerospace	LMIA	0.14%	24.43	22.99	43.78%	-5.89%	0.26	11.91	1.19	1.72	1.14		
Lockheed Martin	LMT	5.55%	80.97	75.73	8.32%	-6.47%	25.23	8.71	0.54	7.63	1.17	4.00%	
Mantech International'a'	MANT	0.72%	44.42	40.80	-1.28%	-8.15%	1.50	10.43	0.53	1.46	1.34	2.10%	
Moog Inc.	MOGA	0.95%	43.52	40.95	2.89%	-5.91%	1.86	12.80	0.83	1.54	1.43		
Mercury Computer Sys	MRCY	0.25%	18.68	16.79	-8.65%	-10.12%	0.51	23.32	2.21	1.53	1.83		
NCI Information Technology	NCIT	0.15%	22.72	21.48	-6.57%	-5.46%	0.29	11.02	0.48	1.86	0.88		
Northrop Grumman	NOC	4.27%	69.35	60.51	-6.59%	-12.75%	16.83	8.36	0.50	1.39	1.07	3.30%	
Orbital Sciences Corp	ORB	0.48%	16.85	17.32	1.11%	2.79%	1.01	15.19	0.76	1.67	1.55		
Osi Systems	OSIS	0.38%	43.00	41.29	13.56%	-3.98%	0.79	18.43	1.25	2.23	1.41		
Oshkosh Truck	OSK	1.11%	28.94	24.82	-29.57%	-14.24%	2.26	7.03	0.28	1.47	0.71		
Precision Castparts	PCP	4.97%	164.65	161.38	15.93%	-1.99%	23.22	16.07	3.68	3.19	1.65	0.10%	
Raytheon Co	RTN	4.39%	49.85	44.73	-3.47%	-10.27%	15.93	8.04	0.64	1.52	1.00	3.80%	
SAIC	SAI	2.73%	16.82	16.03	1.07%	-4.70%	5.66	10.76	0.51	2.38	1.37		
TASER International Inc.	TASR	0.13%	4.55	4.11	-12.55%	-9.67%	0.25	45.67	2.91	2.24	2.76		
Transdigm	TDG	2.21%	91.19	90.07	25.08%	-1.23%	4.50	17.46	4.56	6.74	1.41		
Teledyne Technologies	TDY	0.98%	50.36	54.23	23.33%	7.68%	1.99	14.74	1.13	2.28	0.92		
Triumph Group	TGI	1.31%	99.58	53.84	20.43%	8.13%	2.61	11.36	0.84	1.49	0.82	0.30%	
Textron	TXT	3.06%	23.61	23.13	-2.16%	-2.03%	6.39	13.07	0.59	2.08	0.89	0.30%	
URS Corporation	URS	1.58%	44.74	40.83	-1.87%	-8.74%	3.21	10.18	0.35	0.80	1.02		
United Technologies	UTX	7.01%	88.51	82.84	5.23%	-6.41%	75.28	13.32	1.32	3.32	1.31	2.30%	
Viasat Inc	VSAT	0.92%	43.27	44.93	1.17%	3.84%	1.88	24.96	2.33	2.22	3.25		

Data Provided by Yahoo Finance & Capital IQ, and Forward P/E by Thompson