



Commentary

Aerospace & Defense Stocks Survive 2011

The year saw a constant flow of negative news regarding the defense sector as the media focused on U.S. budget and debt-reduction issues that threatened to decimate spending at the Pentagon. Combined with the pull-out of troops from Iraq the peak in defense spending that many waited for arrived. Yet when the dust settled, the Aerospace & Defense sector held steady with the broader market. Yes, that's right; 2011 saw the SPADE Defense Index decline by just 2.75% vs. the flat performance by the S&P500.

Although still down nearly 25% from its peak in October 2007, the Powershares Aerospace & Defense ETF (NYSE: PPA) and the SPADE Defense Index (NYSE: DXS) which it tracks, has mimicked the movement of the broader market closely over the passed two years following a decade-long run between 2000-2010 when the sector outperformed the broader market by more than 100%, returning 178%.

In a year that featured significant market swings before finishing flat for the year, the top performing stocks for the year were led by firms that were acquired earlier in the year – EMS Technologies, SRA International, Goodrich, and Integral Systems.

With the P/E, price-to-sales, and price-to-book of many A&D firms below those of the broader market and with dividend yields of many firms between 2% and 4%, and there is hope by some investors that a reversion to the mean indicates upside potential.

Where we are

Analysts and industry executives have known for some time that a peak in defense spending was coming and a flat- to down budget environment would make it necessary for firms to position themselves accordingly; investing into higher growth areas and expanding internationally. Although the defense budget is under pressure, the past weeks have seen multi-billion contracts issues for fighter aircraft, missile defense systems, etc.

Meanwhile the commercial aerospace sector is beginning to hit on all cylinders. The introduction of new projects into the market, expansion by airlines around the globe, and the need to replace aging aircraft with newer, more fuel efficient vehicles have put the sector at the beginning of a decade-long upcycle with backlog at record levels.

Cybersecurity and UAVs, once only discussed among those that followed the defense sector, have received prominence in the mainstream as attacks against computer networks and security installations continue to rise.

Overall, there are a number of analysts and investors who think the valuations of A&D firms remain very attractive. With 2012 being a U.S. pres-

SPADE Defense Index Statistics

12/30/11 Close: 2068.94
 All-time Close: 2747.67
 Date of all-time close: 9 October 2007

	SPADE Defense	S&P500
December	0.77%	0.85%
4Q11	10.96%	11.15%
2011	[2.75%]	0.00%

idential election year, we should see a more moderate stance on budget cuts to the defense sector and the draconian measures proposed by some will be deemed irresponsible. Healthy dividends, buybacks, an increase in international sales as foreign nations cut back on internal development to reduce costs, a booming commercial aerospace market, and, I believe, a recovery in the U.S manufacturing sector could all lead to results in 2012 that surprise to the upside. There is, however, still an element of considerable risk as the government debates how best to reduce its budget deficits. Some think the bottom could be in and some think we'll need a clear and present danger to see an upside. That is the joy of investing – balancing the risk vs. the reward.

Threatwatch: What Will Shift Thinking Back Toward Security Spending?

Budget and economic issues are expected to pressure defense spending for the next several years. After a year of constant negative news regarding possible budget cuts to defense, when the dust settled, the sector held steady with the benchmark SPADE Defense Index, down just 2.75%.

The question is... when and what would lead to a shift back toward security spending and benefit defense contractors such as Lockheed Martin (LMT), General Dynamics (GD), Raytheon (RTN), Northrop Grumman (NOC), and CACI (CACI) or ETFs such as the Powershares Aerospace & Defense ETF (NYSE: PPA)?

Recent news and analyst forecasts for 2012 can provide insight into that.

Threat #1: Iran

Whether its threatening to shut the Straits of Hormuz and

Dec 2011 Top Gainers			Dec 2011 Laggards			2011 Top Gainers			2011 Laggards		
1	Booz Allen	23.48%	1	Taser	[14.95%]	1	EMS Technologies*	66.23%	1	Kratos Defense	[54.67%]
2	Kratos Defense	19.40%	2	Ceradyne	[9.95%]	2	SRA International*	51.20%	2	Computer Sciences	[52.22%]
3	GeoEye	17.01%	3	Key W	[8.98%]	3	Goodrich*	40.46%	3	Key W Holding	[49.56%]
4	Digital Globe	14.83%	4	Mantech	[7.57%]	4	OSI Systems	34.16%	4	NCI Information	[49.33%]
5	Boeing	6.78%	5	American Science	[6.97%]	5	Hexcel	33.83%	5	GeoEye	[47.58%]
6	Ducommun	6.52%	6	FLIR	[6.66%]	6	Transdigm	32.87%	6	Digital Globe	[46.04%]
7	Raytheon	6.17%	7	Comtech	[5.51%]	7	Triumph Group	30.75%	7	Ducommun	[41.46%]
8	LMI Aerospace	5.72%	8	Textron	[4.84%]	8	Teledyne Tech.	24.74%	8	Oshkosh Truck	[39.33%]
9	Moog	5.05%	9	United Technologies	[4.58%]	9	Integral Systems*	22.81%	9	AAR Corp	[30.21%]
10	AAR Corp	4.98%	10	NCI Information	[3.72%]	10	Precision Castparts	18.38%	10	Mercury Computer	[27.69%]

* Acquired

Largest Defense Prime Contractors		
	December	2011
Lockheed Martin	3.52%	15.72%
Boeing	6.78%	12.40%
General Dynamics	0.53%	[6.41%]
Northrop Grumman	2.47%	[9.73%]
Raytheon	6.17%	4.40%
L-3	0.57%	[5.41%]

ETF Statistics (NYSEArca: PPA) Powershares Aerospace & Defense	
Exchange / Ticker Symbol:	NYSE / PPA
Fee	60 basis
Assets (11/30/11)	\$54.6 M
Closing Price (12/30/11)	\$18.20
Yield (12-Month Yield)	1.52%
December 2011 Volume	8,281,100
Turnover	12%
source: Marketwatch	

Portfolio Price / Earnings	11.69
Portfolio Price / Book	1.93
Portfolio Price / Sales	0.73
Portfolio Price / Cash Flow	8.32
Earnings Growth Rate	3.77%
Beta (3 year)	1.05
Alpha (3 year)	[1.22]
R-squared (3 year)	81.76
Yahoo Finance - 12/31/11	

disrupt the world's energy suppliers or threats to use nuclear weapons on neighbors such as Israel; or the possibility that Israel could pre-emptively destroy facilities in Iran before they can be used to create global devastation; and the region is highly unstable and threat #1 on most people's list.

Threat #2: The Arab Spring Aftermath

Throughout 2011, people of nations throughout North Africa and the Middle East sought greater freedoms and overthrew oppressive regimes and those not assisting the economic needs of the populace. The problem is the old-saying regarding the devil you know. What will evolve in the region – more stable democracies, religious rhetoric, a new military leadership group, or turmoil and chaos – is still to be seen.

Threat #3: North Korea

The death of Kim Jong Il also puts the Asia region into unfamiliar territory with a new leader taking control of a government that oppresses its people and has access to rockets and nuclear material.

Threat #4: Iraq

We left, so isn't everything stable? Not really. The U.S. was a stabilizing element between parties that have been in conflict for generations. The absence of the U.S. in the region keeps an element of instability.

Threat #5: Hackers and Cybersecurity

When you depend on technology – economically and militarily – protecting it become more and more critical. Increasingly, people gaining access to databases and systems are becoming commonplace. While more of an annoyance at the moment, the threat is significant which is why it is gaining so much attention.

Threat #6: Pakistan

The weakness of the government to remove radical elements from its territory has created a division within the nation between those aligned with more with the West (U.S. and Europe) and those who focused on regional power and the Taliban. Ultimately anytime a nation has rockets and nuclear weapons and the possibility that elements of the region could overthrow or destabilize the local government and the situation generates fear.

Threat #7: China

China has been flexing its muscles and using resources from its economic growth to fuel development of a 21st century Navy, Air Force, space program, etc. The fear that China could become a true threat similar to what the Soviet Union represented from the 1950s-1980s is generating a lot of attention. The reality is that the near-term likelihood of them going on the offensive is relatively small (outside of course in their own backyard, ie. Taiwan, for example). Still, eyes need to be focused on any nation seeking to become a world power with the resources and technology that

PPA (blue)

S&P500 (red)



When looking at a one-year chart for 2011:

1. A&D stocks followed the pattern of the S&P500 throughout the year, outperforming the first six months, and then underperforming when the market collapsed in July/August, tracking the market over the final quarter.
2. The price level for PPA is currently above the 50-day and 200-day moving averages and currently sits at the 200-day.
3. As we start 2012, MACD for PPA is positive and rising

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

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China possesses.

Threat #8: The Unknown

Globalization has brought greater awareness of events around the world. However the increasing ease of the spread of information can enable threats that 100 years ago would not have been possible. For many, the events of 9-11 and the possibility of suicide bombers on U.S. soil, were not envisioned. Neither were the Oklahoma City bombings, the events in London, Madrid, etc., or the actions of a lone lunatic in Norway. Diligence can only go so far.

Ultimately, there is no greater function of government than to protect its people and its way of life. As long as Congress remembers that, cuts to defense spending may happen from time-to-time but the cycle of growth will return.

FY-12 Budget

It took a while but Congress finally passed the 2012 defense authorization bill on December 16th.

Details

Base Budget: \$518 billion
 Military Construction: \$ 13 billion
 Total: \$531 billion

Overseas Contingency Operations: \$115 B (down \$2.8B from President's request and \$43 billion from last year)

Operations: \$163 Billion (down \$2.5B)
 R&D: \$ 72 billion (down \$2.5B)
 Procurement \$105 billion (up \$2.5B)
 Military Pay Raise: 1.6% (as requested)

F-35 JSF:

Down \$346M from \$9.4B - includes 18 F35s for Air Force, 7 for Navy, and 6 for Marines

M1 Abrams tanks:

\$255M for 42 more keeping the GD Land Systems production line in Ohio open.

Army's Ground Combat Vehicle:

Cut \$435M from Pentagon \$884M

Army's Network Integration Evaluation:

\$300M for this new effort to test electronic network gear before fielding it.

	2011 Enacted	2012 Request	2013
FY12 Base Budget President	528.95	553.02	570.72
Fiscal Guidance		525.35	523.89
Savings		27.67	46.82
Base Budget Adjustment		---	[0.47]
FY13 Base Budget	528.95	553.02	523.42
FY13 OCO Budget	159.06	117.58	82.53
Total	688.01	670.60	605.96

Analyst Comments

Troy Lahr, Stifel Nicolaus --

Demand for [commercial] aircraft remains robust. Increased interest from domestic airlines looking to recapitalize their aging fleet following years of underspending. Renewed investor interest in many defense companies.

Many investors seem to be drawn toward relatively low valuations (7-8 P/E) attractive dividend yields (3-5%), and meaningful share repurchase. Announced daily DoD contracts were significantly higher during 3Q compared to awards last quarter. Total awards announced for the five major defense companies totaled \$20.3B compared to \$11.9B during 2Q11 and \$14.1B in 1Q11.

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