

**Commentary**

**Proposed FY-13 DoD Budget**

	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17
Base	528	528	531	525	534	546	556	567
OCO	163	159	115	88	TBD			
Total	691	687	646	614	TBD			

Well, it could have been much worse. This was the underlying thought behind many of the presentations that came out in the aftermath of the release of the U.S. government's FY-2013 budget request. The budget makes a big assumption -- that sequestration will go away. The reality is...how does one plan a budget when you don't know what amount your target is?

The way this will play out is the following:

1. Nothing will be done by the end of the fiscal year. Congress is likely to pass a resolution continuing the previous budget until after the November presidential election results are finalized.
2. It is also likely, regardless of who wins that election, that a law will be passed that will lessen the impact of sequestration or replace it with some other document to guide how cuts in the federal budget will be made. While sequestration would resolve the budget deficit issue, it would throw millions of people out of work and provide a significant negative shock to the U.S. economy leading us to believe it will never come into being. Ultimately, economic growth is the key toward creating a more 'balanced' budget.

What the budget and cuts indicate?

1. Reductions in personnel costs play out over time. When trying to identify near-term cost reductions, it is much easier to stretch out production and procurement contracts or cancel programs that have yet to enter the procurement phase. This is good news for the sector's contractors as many of the cuts have been identified with 'phase 2' focusing more on personnel issues.
2. The Navy was the winner in the current budget mostly because several of the large shipbuilding projects (aircraft carriers, for example) are built over several years and there is no easy way to slow production in the middle of a project. In comparison, the Air Force was hit hard because it was easier to shift production schedules and the delivery date for aircraft.

**Proposed FY-13 DoD Budget**

	FY13	FY14	FY15	FY16	FY17	FY13-17
Nominal Growth	-1.0%	1.5%	2.3%	1.8%	2.1%	6.8%
Real Growth	-2.3%	0.3%	0.6%	-0.2%	0.1%	-1.6%

**SPADE Defense Index Statistics**

2/29/12 Close: 2268.98  
 All-time Close: 2747.67  
 Date of all-time close: 9 October 2007

	SPADE Defense	S&P500
February	3.71%	4.06%
1QTD	9.67%	8.59%
YTD	9.67%	8.59%

3. The reaction by the investment community was fairly benign. Essentially a big yawn as compared to 'Christmas morning' of past years. Analysts knew what was coming and there were few surprises both to the programs that were impacted or the size of the cuts themselves.
4. Dividends and buybacks from many firms provide a sound anchor to prices in this budget environment.
5. There will be some noise during the year, especially since it is an election year, as members of Congress pitch to put things back into the defense budget. What I heard was that in the end, what we see know is likely what is signed into law.

**Stockholm International Peace Research Institute (SIPRI) - Top 100 Arms Producers Report**

- 2010: Sales rose just 1% to \$411.1B
- Weakened economies caused many nations to reduce defense spending.
  - Slowdown follows 8 years of growth
  - From 2002-2010: Sales grew 60% in real terms
  - Report doesn't include data from China, Kazakhstan, Ukraine, etc.
  - Sales by 44 US-based firms totaled more than 60% of the Top 100. 30 firms in Western Europe: approx. 29%
  - Ten largest account for 56% or \$230 billion
  - Military Services (logistics, systems support, training, maintenance, repair, overhaul): grew from \$22.3B (2002) to \$55 billion (2010), up 147% but much could be associated with the Iraq and Afghanistan conflicts

*source: Defense News, SIPRI*

**YTD Top Gainers**

1	Textron	48.78%
2	CSC	34.01%
3	URS Corporation	24.29%
4	Transdigm	24.15%
5	Harris Corp	21.06%
6	OSI Systems	20.95%
7	Ducommun	19.76%
8	Exelis	16.13%
9	Esterline Tech	16.04%
10	Ceradyne	15.42%

**YTD Laggards**

1	NCI Technology	[38.20%]
2	Taser	[21.29%]
3	Digital Globe	[10.11%]
4	Aerovironment	[9.50%]
5	GeoEye	[8.78%]
6	Heico	[6.50%]
7	Key W Holding	[4.05%]
8	Orbital Sciences	[3.30%]
9	SAIC	[0.57%]
10	Moog	[0.05%]

**Feb 12 Top Gainers**

1	CSC	22.96%
2	Transdigm	13.64%
3	OSI Systems	9.81%
4	Gencorp	9.29%
5	Textron	7.97%
6	Lockheed Martin	7.40%
7	Mercury Computer	7.32%
8	United Technologies	7.05%
9	Harris	6.41%
10	Esterline Tech	6.21%

**Feb 12 Laggards**

1	Taser	[15.34%]
2	GeoEye	[7.49%]
3	KeyW Holding	[6.95%]
4	Ceradyne	[6.59%]
5	Kratos	[6.46%]
6	SAIC	[4.98%]
7	Huntington Ingalls	[4.78%]
8	Mantech	[4.55%]
9	Oshkosh Truck	[4.00%]
10	Orbital Sciences	[3.04%]

**Largest Defense Prime Contractors**

	February	2012
Lockheed Martin	7.40%	9.28%
Boeing	1.04%	2.18%
General Dynamics	5.8*	10.27%
Northrop Grumman	3.03%	2.27%
Raytheon	5.27%	4.42%
L-3	[0.69%]	5.35%

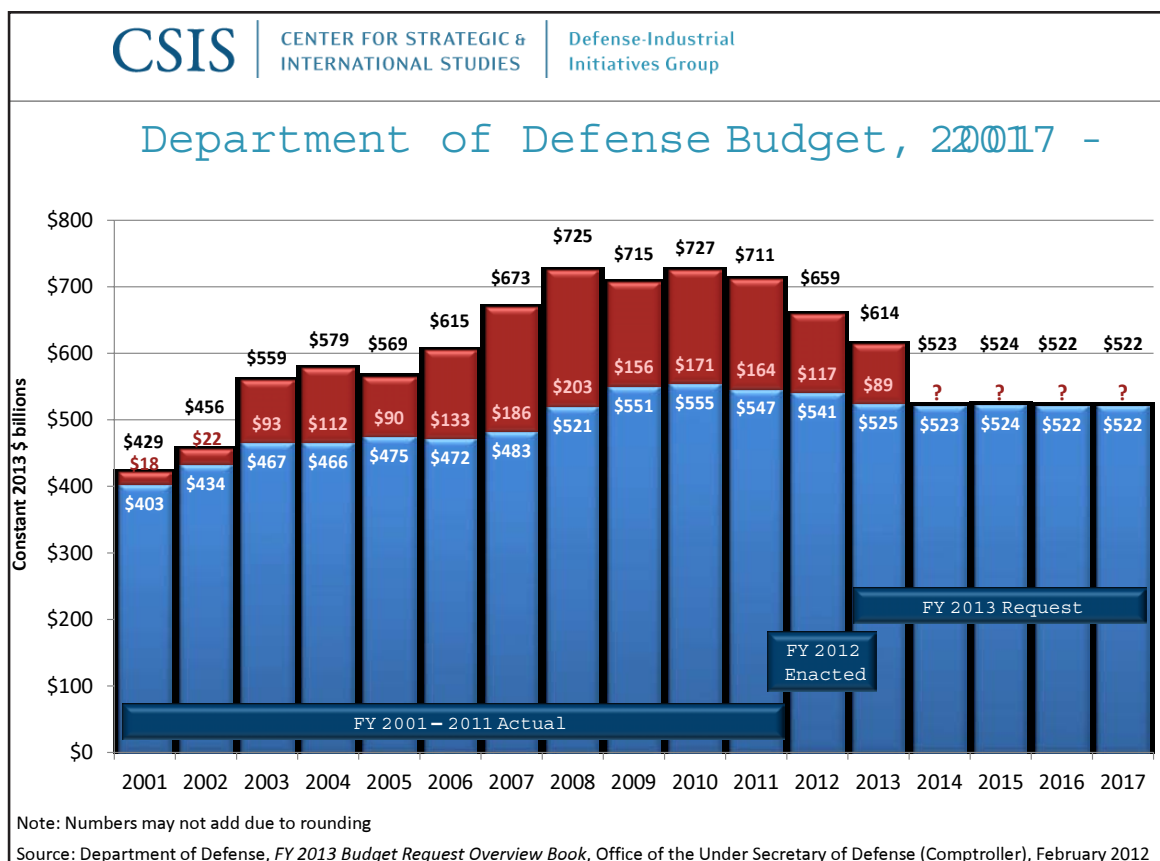
**ETF Statistics (NYSEarca: PPA)  
Powershares Aerospace & Defense**

Exchange / Ticker Symbol: NYSE / PPA  
 Assets (2/29/12) \$60 M  
 Closing Price (2/29/12) \$20.03  
 SEC Yield (30-day Yield) 1.20%  
 February 2012 Volume 282,400  
 Turnover 12%

source: Marketwatch

Portfolio Price / Earnings	12.86
Portfolio Price / Book	2.29
Portfolio Price / Sales	0.77
Portfolio Price / Cash Flow	8.39
Earnings Growth Rate	5.31%
Beta (3 year)	1.06
Alpha (3 year)	[4.18]
R-squared (3 year)	86.01

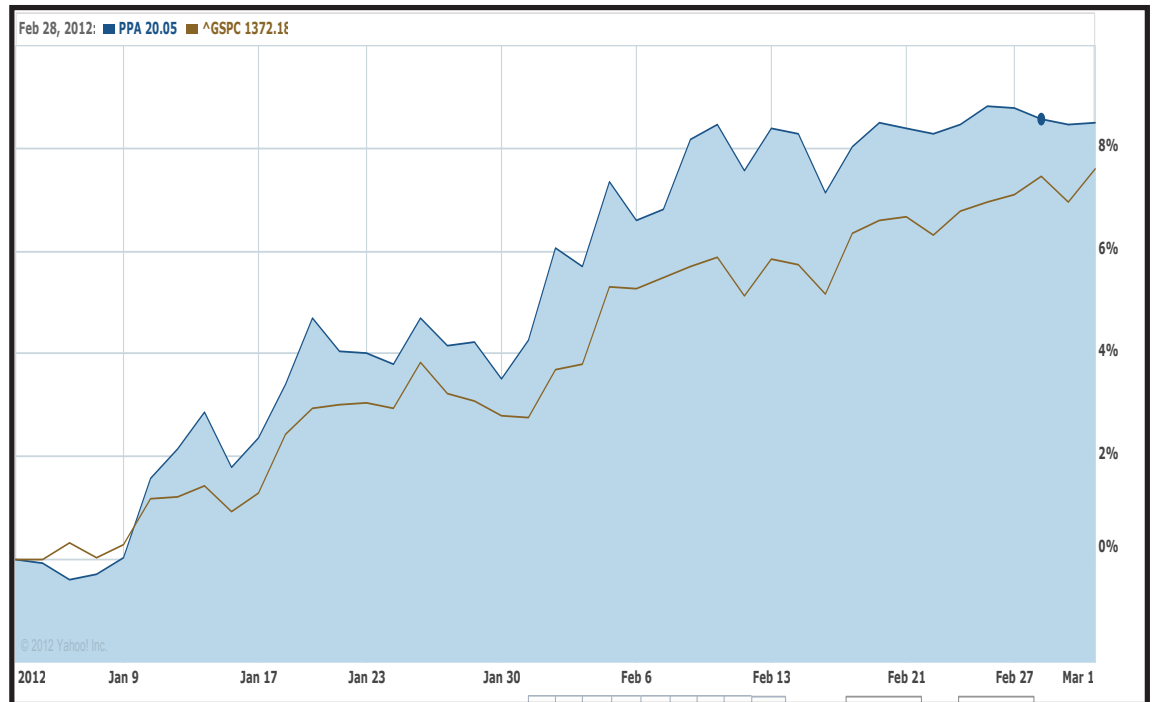
Yahoo Finance



As you can see from this chart, core defense budget remains flat for the next several years. The biggest declines felt by the sector will come from declines in spending on the wars in Iraq and Afghanistan. Much of this will be in reductions for supply transportation and personnel costs. As such, the impact of cuts felt by defense companies can be mitigated.

PPA (blue)

S&amp;P500 (brown)



### YTD - the SPADE Defense Index is Outperforming the S&P500

1. A&D stocks have been following the general pattern of the S&P500 since the beginning of the year.
2. The price level for sector is currently above the 50-day and 200-day moving averages.

### 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.

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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

**Major Program Cuts (FY2013) - Budget Preview Release**

Program	Prime Contractor	Notes
RQ-4 Global Hawk	Northrop Grumman	Cancel remaining Block-30. AF still buying Block-40. Lockheed could see upgrade to U-2
C-5A	Lockheed Martin	Retire 27. Upgraded cockpits cancelled.
C-27J	L-3/Alenia	Cancelled.
C-130	Lockheed Martin	Retire 65 legacy C-130s. Boeing cockpit upgrade cancelled
Defense Weather Satellite	Northrop Grumman	Cancelled
F-35 JSF	Lockheed Martin	Purchases slowed. Overall buy not cut.
A-10	Lockheed/Boeing/Northrop	Retire 5 squadrons (3 guard, 1 active, 1 reserve). Boeing re-winged contract likely canceled or reduced.
F-15	Boeing	Retire one training squadron.
F-16	Lockheed Martin	Retire one Guard squadron.
Humvee Recap	Not awarded	Cancel. Focus on Joint Light Tactical Vehicle
Joint Air to Ground Missile	Not Awarded	Reduce buy. Purchase more Lockheed Hellfire. Lockheed competing against Raytheon for JAGM.
JLENS	Raytheon	Curtail. Current systems future unclear.
Ground Combat Vehicle	BAE / General Dynamics	Delay due to contract award protest. Future unclear.
Helicopter Modern.	TBD	Delayed 3-5 years
Navy Cruisers	U.S. Navy Operated	Retire seen. Reduce cruiser force.
Large-Deck Amphibious	Huntington Ingalls	Delayed one year.
Virginia submarine	Electric Boat/Newport News	Shift one sub from 2014 to 2018.
Littoral Combat Ship	Austal USA / Marinette Marine	Buy two fewer over next five years
Joint High Speed Vessel	Austal USA	Eliminate 8+, cap program at 10.
Amphibious Ships	U.S. Navy Operated	Retire two early / Defer replacement
SSBN(X) Ohio-class Submarine	Not Awarded	Delay development by two years

Credit: *Defense News* 30 Jan 12

**Tables courtesy of CSIS**

Budget is flat for 5 years adjusted for inflation through FY-17.

**Base Budget**

RDTE	down 2.8%	71.3	69.4
P-1	down 5.5%	104.5	98.8
O&M	up 5.9%	197.2	208.8
Personnel	down 14.7%	141.8	135.1

**Base Budget + OCO**

RDTE	down 3.1%	71.9	69.7
P-1	down 10.0%	120.6	108.5
O&M	down 4.0 %	284.0	272.7
Personnel	down 2.6%	153.1	149.2

**As a Share of the Budget**

	Budget	Cuts
RDTE	11%	7%
P-1	18%	38%
O&M	44%	35%
Personnel	24%	12%
Other	2%	7%

**By Service / Agency**

	Budget	Cuts
Air Force	11%	23%
Army	18%	53%
Navy	25%	7%
Defense-wide	17%	17%

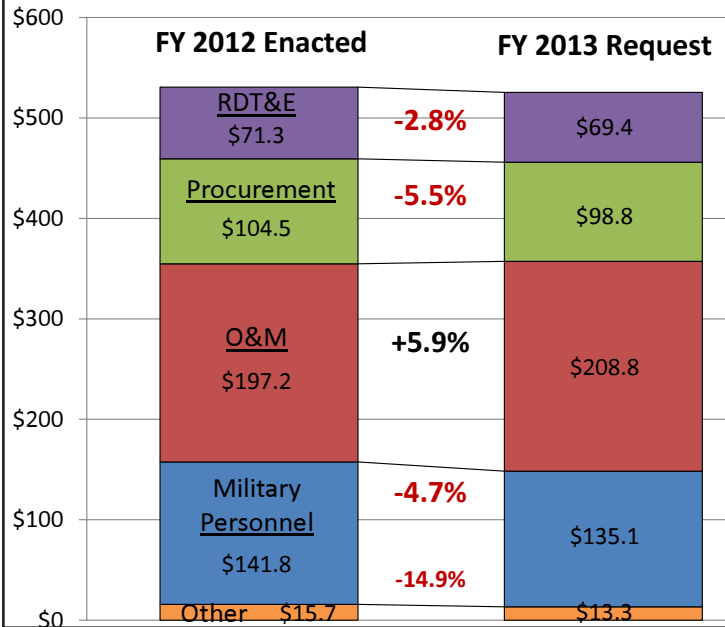
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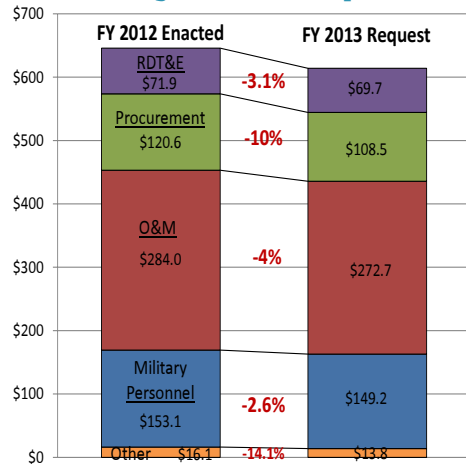
**Contact Information**

SPADE Indexes  
 1725 'I' Street, NW, Suite 300  
 Washington, DC 20006  
 Tel: (202) 349-3917  
 info@spadeindex.com  
 http://www.spadeindex.com  
 Scott Sacknoff: Index Manager

## Base Budget Authority

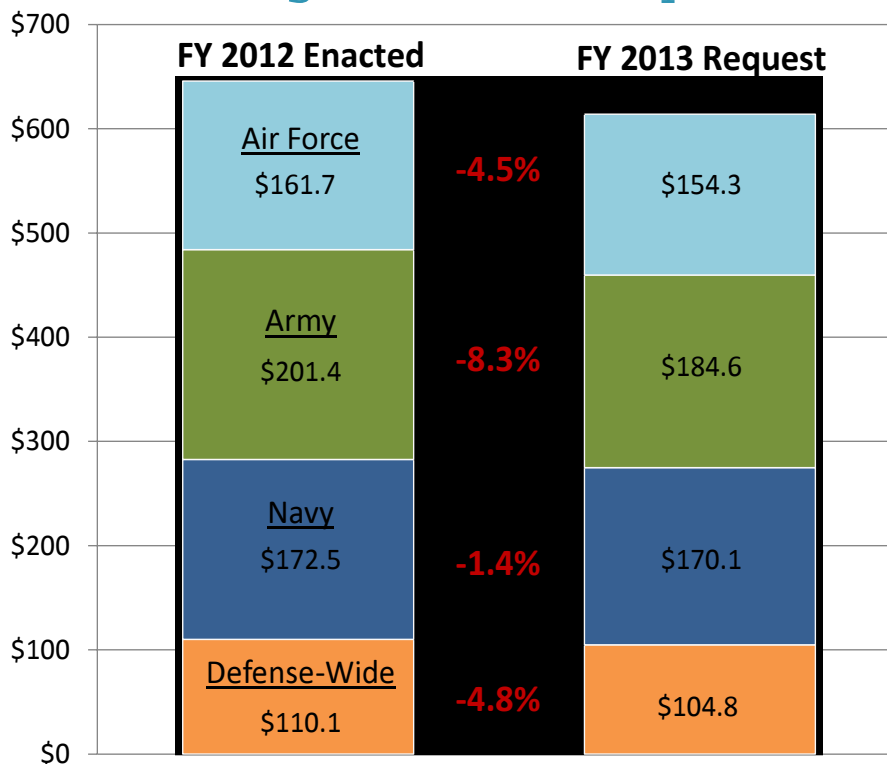


## Total Budget Authority (Base + OCO)



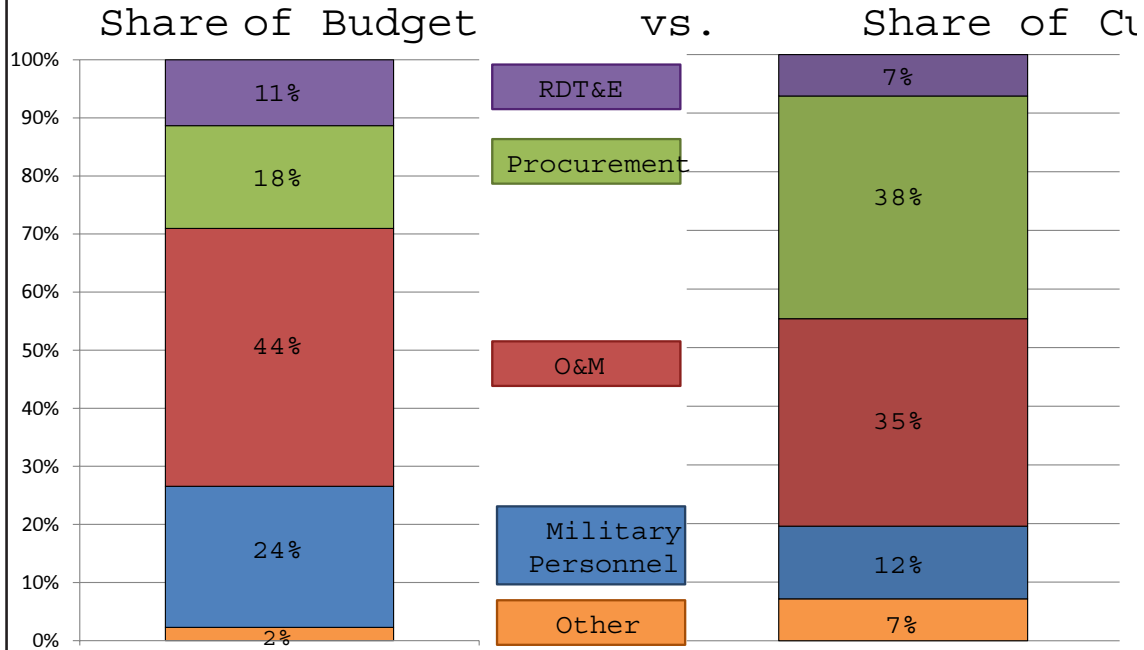
Note: Numbers may not add due to rounding  
 Source: Department of Defense, FY 2013 Budget Request Overview Book, Office of the Under Secretary of Defense (Comptroller), February 2012

## Total Budget Authority (Base + OCO)



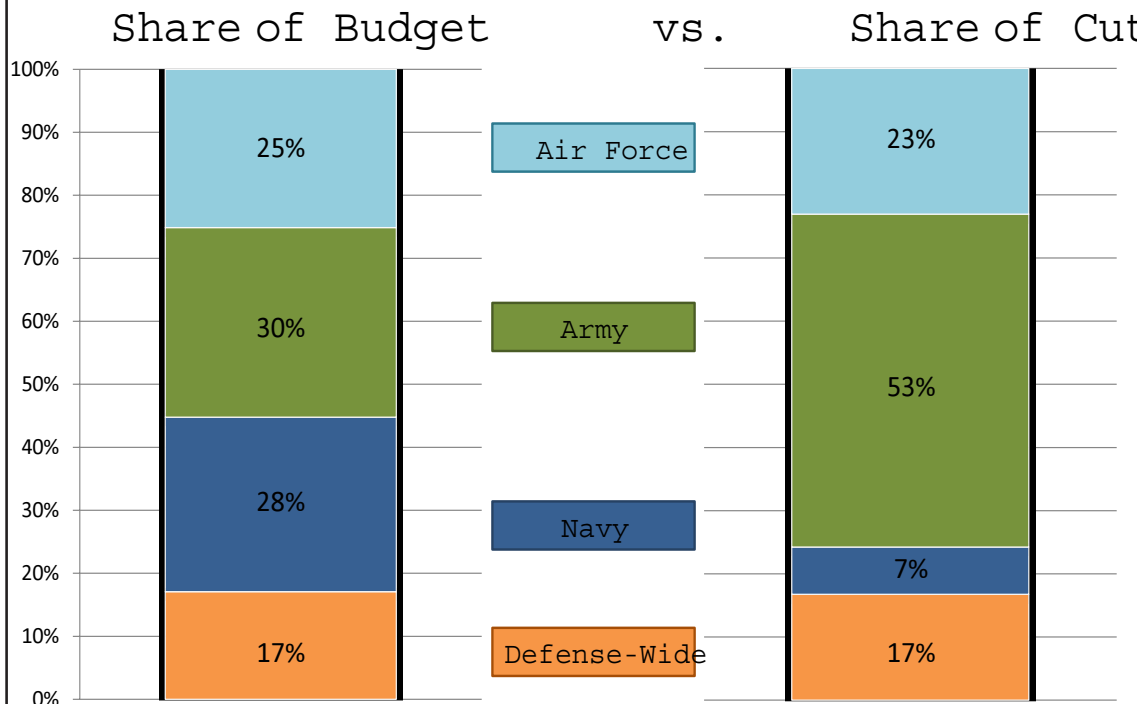
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Mar-12		52 SPADE Defense Index					Market	Forward	Price/	Price/	PEG	
Company	Ticker	Float %	Price	Price	% Ch	% Ch	Cap	P/E	Sales	Book	5 yr	Div Yld
		29-Feb-12	31-Jan-12	29-Feb-12	2012	MTD	intraday	(ttm)	ttm	mrq	expected	forward %
AAR Corp	AIR	0.53%	21.19	22.05	15.02%	4.06%	0.85	9.19	0.46	1.00	0.72	1.30%
American Science & Engineering	ASEI	0.39%	71.50	72.70	6.74%	1.68%	0.65	22.16	2.84	2.53	1.72	2.70%
Alliant Techsystems	ATK	1.18%	59.41	60.00	4.97%	0.99%	1.98	8.37	0.43	1.50	5.11	1.30%
AeroVironment	AVAV	0.37%	27.87	28.48	-9.50%	2.19%	0.62	19.11	1.84	2.25	1.06	
Boeing Co	BA	5.37%	74.18	74.95	2.18%	1.04%	55.89	13.22	0.82	15.92	1.28	2.30%
Booz Allen & Hamilton	BAH	1.57%	17.60	18.41	6.72%	4.60%	2.44	10.46	0.42	2.14	0.70	2.00%
Ball Corp	BLL	3.88%	39.26	40.08	12.24%	2.09%	6.26	11.88	0.72	5.27	1.77	1.00%
Caci Intl	CACI	0.93%	58.69	59.14	5.76%	0.77%	1.57	9.57	0.42	1.33	0.80	
Comtech	CMTL	0.39%	30.86	32.27	12.75%	4.57%	0.66	23.90	1.21	1.26	0.73	3.40%
Rockwell Collins	COL	3.94%	57.89	59.29	7.08%	2.42%	8.67	11.79	1.80	6.89	1.39	1.60%
Ceradyne Inc	CRDN	0.45%	33.09	30.91	15.42%	-6.59%	0.75	10.77	1.38	1.08	1.54	1.90%
Computer Sciences	CSC	2.93%	25.83	31.76	34.01%	22.96%	4.93	9.23	0.31	1.57	12.97	2.50%
Cubic Corp	CUB	0.76%	46.24	47.80	9.66%	3.37%	1.28	14.35	0.98	2.25	0.90	0.40%
Ducommun	DCO	0.10%	14.45	15.27	19.76%	5.67%	0.16	7.41	0.33	0.64	1.51	2.10%
Digital Globe	DGI	0.42%	15.69	15.38	-10.11%	-1.98%	0.71	20.51	2.22	1.4	6.69	
Esterline Technologies	ESL	1.18%	61.15	64.95	16.04%	6.21%	1.99	10.63	1.18	1.29	0.83	
Flir Systems	FLIR	2.43%	25.75	26.17	4.39%	1.63%	4.07	13.92	2.67	2.61	1.07	1.10%
General Dynamics	GD	4.63%	69.16	73.23	10.27%	5.88%	26.13	9.49	0.79	1.96	1.53	2.60%
GeoEye	GEOY	0.27%	21.91	20.27	-8.78%	-7.49%	0.45	9.01	1.35	0.94	0.59	
Goodrich Corp	GR	4.24%	124.75	125.97	1.84%	0.98%	15.85	15.87	1.96	4.26	1.18	0.90%
Gencorp	GY	0.21%	5.49	6.00	12.78%	9.29%	0.35	23.08	0.37			
Heico	HEI	1.36%	55.60	54.68	-6.50%	-1.65%	2.31	23.77	2.91	3.61	1.75	0.20%
Huntington Ingalls	HII	1.04%	37.68	35.88	14.71%	-4.78%	1.75	12.29	0.26	1.5	0.66	
Honeywell Intl	HON	5.76%	58.04	59.57	9.60%	2.64%	46.19	11.90	1.27	4.28	0.92	2.50%
Harris Corp	HRS	3.01%	41.00	43.63	21.06%	6.41%	4.97	8.14	0.83	2.18	4.34	2.60%
Hexcel	HXL	1.48%	25.07	25.27	4.38%	0.80%	2.51	15.89	1.80	3.1	1.66	
KEY W Holding	KEYW	0.11%	7.63	7.10	-4.05%	-6.95%	0.18	22.90	0.97	1.02	3.58	
Kratos Defense & Security	KTOS	0.13%	6.81	6.37	6.70%	-6.46%	0.22	19.91	0.35	0.66	-0.25	
L-3 Communications Hldgs	LLL	3.86%	70.74	70.25	5.35%	-0.69%	7.00	8.07	0.46	1.06	2.96	2.80%
LMI Aerospace	LMIA	0.14%	19.79	20.35	15.95%	2.83%	0.24	10.65	1.01	1.5	1.03	
Lockheed Martin	LMT	5.08%	82.32	88.41	9.28%	7.40%	28.38	10.39	0.61	28.45	1.37	4.50%
Mantech International'a'	MANT	0.74%	35.14	33.54	7.36%	-4.55%	1.24	9.53	0.44	1.16	1.28	2.40%
Moog Inc.	MOGA	1.20%	42.62	43.91	-0.05%	3.03%	1.99	11.87	0.85	1.65	1.59	
Mercury Computer Sys	MRCY	0.26%	13.39	14.37	8.13%	7.32%	0.44	17.74	1.91	1.37	1.28	
NCI Information Technology	NCIT	0.06%	7.32	7.20	-38.20%	-1.64%	0.10	21.18	0.18	0.60	---	
Northrop Grumman	NOC	4.22%	58.05	59.81	2.27%	3.03%	15.11	8.85	0.57	1.47		3.30%
Orbital Sciences Corp	ORB	0.49%	14.49	14.05	-3.30%	-3.04%	0.83	11.61	0.61	1.28	0.89	
Osi Systems	OSIS	0.69%	53.73	59.00	20.95%	9.81%	1.17	21.07	1.66	2.92	0.85	
Oshkosh Truck	OSK	1.27%	24.28	23.31	9.03%	-4.00%	2.13	10.74	0.28	1.32	3.81	
Precision Castparts	PCP	4.29%	163.68	167.43	1.60%	2.29%	24.30	16.71	3.50	3.00	1.35	0.10%
Raytheon Co	RTN	4.32%	47.99	50.52	4.42%	5.27%	17.17	9.05	0.69	2.10	1.23	3.40%
SAIC	SAI	2.48%	12.86	12.22	-0.57%	-4.98%	4.17	8.86	0.39	1.80	7.43	
TASER International Inc.	TASR	0.13%	4.76	4.03	-21.29%	-15.34%	0.22	25.19	2.58	2.83	1.99	
Transdigm	TDG	3.56%	104.53	118.79	24.15%	13.64%	6.02	16.8	4.47	6.67	0.98	
Teledyne Technologies	TDY	1.31%	56.76	59.60	8.66%	5.00%	2.22	14.16	1.16	2.3	2.63	
Triumph Group	TGI	1.86%	62.57	63.80	9.15%	1.97%	3.12	11.97	0.93	1.73	0.95	0.30%
Textron	TXT	4.56%	25.48	27.51	48.78%	7.97%	7.69	12.07	0.69	2.83	0.40	0.30%
URS Corporation	URS	2.07%	41.15	43.65	24.29%	6.08%	3.48	10.08	0.37	1.01	1.00	
United Technologies	UTX	6.02%	78.35	83.87	14.75%	7.05%	76.23	12.43	1.30	3.46	1.37	2.30%
Viasat Inc	VSAT	1.16%	47.53	46.13	0.02%	-2.95%	1.98	48.05	2.35	2.23	2.13	
ITT Exelis	XLS	1.16%	9.99	10.51	16.13%	5.21%	1.94	6.61	0.33	0.99	-0.89	3.90%
Data Provided by Yahoo Finance & Capital IQ, and Forward P/E by Thompson												