

Staying the Course

Aerospace and defense continues to be one of the strongest elements in the global economy. As mentioned in the previous letter, we expected a pause following the near 50% returns in 2013 and 4.3%+ returns in quarter one and the results of the middle two quarters proved just that, coming in essentially flat. Market volatility in October is likely and we anticipate that the final months of 2014 won't see any surprises with results in the range of guidance that most firms have already given for the year. Companies are already beginning to discuss what they expect for 2015 (the government fiscal calendar year starts in 2015) but with a Congressional election in November and a possible changeover to Republican control of the Senate, comments related to 2015 are being moderated until the results are known. A republican win will likely lead to inflows into defense companies as it is widely believed there is more support among Republicans for defense initiatives, however as we detailed in a prior letter analyzing stock performance vs. which party is in control of the White House, returns relate more toward world situations than they do to political party. Recent history has indicated gridlock and even if the Republicans control both houses of Congress, the expectation for gridlock between Congress and the White House is anticipated.

Revisiting the Trends

The first newsletter of the year provided some expectations for 2014. Although we still have a quarter left, let's take a look at how our expectations for 2014 are performing so far.

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

HIT: Revenues at Boeing are up and the firm just announced that they delivered 186 planes in their third quarter. On the downside, they report that costs for the 787 are not declining as fast as they had hoped.

2. Continued international growth for defense products as Congress has shown a willingness for approving sales and relaxing export licensing rules.

HIT: Continues to be true. Lockheed indicated that international sales could total 25% within the next few years.

3. A budget for 2014 will enable the Department off Defense to make cuts with a scalpel vs. the hatchet of sequestration.

SPADE Defense Index Statistics

12/31/13 Close: 3567.72
 9/30/14 Close: 3711.32
 All-time Intraday High: 3876.52
 Date of All-Time High: 9 June 2014

	SPADE Defense	S&P500
2013	48.27%	29.60%
1Q14	4.33%	1.30%
2Q14	[0.32%]	4.69%
3Q14	0.03%	0.61%

HIT: Announcement regarding drastic cuts to the budget or specific programs have been quiet as the focus on the sector has shifted to analysis of global problems.

4. ...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.

MISS: Deal flow has been relatively quiet.

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.

A HIT and a MISS (so far). Cyber is regularly in the news as hackers attack a number of firms but there is a distinction between companies that support the military/intelligence community and those that support private sector companies. The biggest cyber firms only generate at most 10-15% from government while government contractors do little business commercially.

3Q14 Results

1	TASER	16.09%	27	Alliant Techsystems	-4.69%
2	Lockheed Martin	13.72%	28	OSI Systems	-4.90%
3	Transdigm	10.21%	29	Viasat	-4.90%
4	Huntington Ingalls	10.17%	30	Aerovironment	-5.44%
5	Booz Allen	10.17%	31	Orbital Sciences	-5.92%
6	Raytheon	10.16%	32	Textron	-6.01%
7	Northrop Grumman	10.14%	33	Precision Castparts	-6.15%
8	General Dynamics	9.04%	34	Moog	-6.16%
9	Cubic Corp	5.14%	35	Triumph Group	-6.83%
10	Ducommun	4.90%	36	Kaman	-8.02%
11	Digital Globe	2.52%	37	United Technologies	-8.53%
12	CACI Int'l	1.51%	38	Mantech	-8.71%
13	Ball Corp	0.94%	39	Intelsat	-9.02%
14	Rockwell Collins	0.46%	40	FLIR Systems	-9.76%
15	Honeywell	0.18%	41	Heico	-10.09%
16	SAIC	0.16%	42	Leidos	-10.46%
17	Boeing	0.12%	43	Sparton	-11.14%
18	Comtech	-0.48%	44	Vectrus	-11.23%
19	L-3	-1.52%	45	Key W Holdings	-11.93%
20	LMI Aerospace	-2.14%	46	AAR Corp	-12.23%
21	Exelis	-2.59%	47	Harris Corp	-12.34%
22	Mercury Computer	-2.91%	48	Kratos Defense	-15.90%
23	Hexcel	-2.93%	49	Gencorp	-16.39%
24	Computer Sciences	-3.24%	50	Engility	-18.53%
25	Teledyne Tech	-3.25%	51	American Science	-20.42%
26	Esterline Tech	-3.34%	52	Oshkosh Truck	-20.49%

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.

HIT and a MISS: This was true for the first part of the year but in 3Q14, large cap companies have returned to leading the sector higher.

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

MISS: Well we got the region right but the real threat at the moment is ISIS/ISIL which not only is creating havoc in the Middle East but has the resources from oil sales and raiding local banks to finance terror cells around the globe at levels that Al Qaeda only dreamed about. Still, Iran having access to nuclear weapons puts the world on tremendously shaky ground. Iran's nukes with ISIS/ISIL's resources...and I don't want to think how fast things can go south. Regarding Asia, North Korea has been essentially quiet and occasional Chinese flareups have been dwarfed by the news coming from Russia and the Ukraine.

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.

HIT: Proving correct; assets of the Powershares ETF have nearly doubled from the bottom as money flows in.

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

Exchange / Ticker Symbol: NYSE / PPA
 Assets (9/30/14) \$152 M
 Closing Price (9/30/14) \$32.36
 Yield (12-Month Yield) 1.1%
 3Q2014 Volume 2,419,500
 Turnover 9%

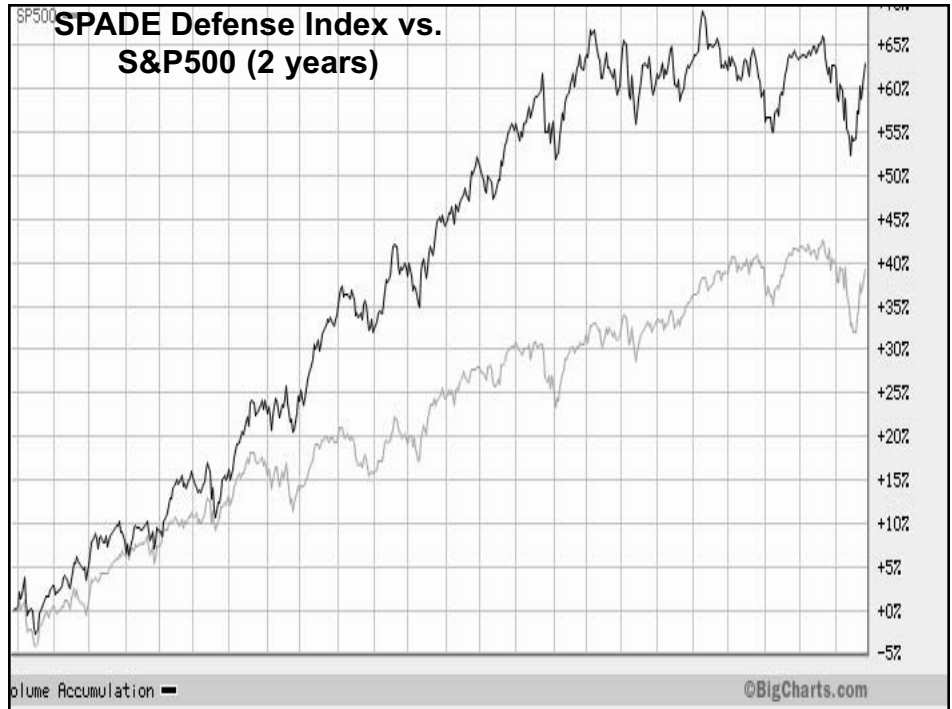
source: Marketwatch

Portfolio Price / Earnings*	16.03
Portfolio Price / Book*	1.71
Portfolio Price / Sales*	1.12
Portfolio Price / Cash Flow*	1.13
Earnings Growth Rate*	10.15%
Beta (3 year)*	0.76
Alpha (3 year)*	12.62
R-squared (3 year)*	61.94

Yahoo Finance - 9/30/14

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.

 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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Sep-14		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-Sep-14	27-Jun-14	30-Sep-14	YTD	QTD	intraday	(ttm)	ttm	mrq	expected	forward %	
TASER International Inc.	TASR	0.32%	13.30	15.44	-2.77%	16.09%	0.79	34.55	5.21	7.01	1.51		
Lockheed Martin	LMT	6.51%	160.73	182.78	22.95%	13.72%	54.49	14.57	1.23	12.80	1.64	3.40%	
Transdigm	TDG	3.82%	167.26	184.33	14.48%	10.21%	9.39	21.17	4.06		1.87		
Huntington Ingalls	HII	2.00%	94.59	104.21	15.78%	10.17%	4.67	11.59	0.66	2.89	0.62	0.80%	
Booz Allen & Hamilton	BAH	1.39%	21.24	23.40	22.19%	10.17%	3.72	15.42	0.68	15.93	1.53	1.70%	
Raytheon Co	RTN	4.53%	92.25	101.62	12.04%	10.16%	30.49	12.94	1.31	2.56	1.27	2.50%	
Northrop Grumman	NOC	4.57%	119.63	131.76	14.96%	10.14%	26.18	12.88	1.07	2.54	1.86	2.30%	
General Dynamics	GD	5.88%	116.55	127.09	33.01%	9.04%	41.70	15.20	1.33	3.11	1.92	2.10%	
Cubic Corp	CUB	0.49%	44.51	46.80	-11.13%	5.14%	1.22	15.53	0.91	1.58	2.24	0.50%	
Ducommun	DCO	0.12%	26.13	27.41	-8.05%	4.90%	0.32	14.04	0.42	1.20	2.16		
Digital Globe	DGI	0.85%	27.80	28.50	-30.74%	2.52%	2.19	111.77	3.29	1.53	805.84		
Caci Intl	CACI	0.66%	70.21	71.27	-2.66%	1.51%	1.68	13.03	0.47	1.22	1.33		
Ball Corp	BLL	3.46%	62.68	63.27	22.47%	0.94%	9.38	16.48	1.07	7.56	1.67	0.80%	
Rockwell Collins	COL	3.98%	78.14	78.5	6.20%	0.46%	10.52	15.52	2.10	5.32	1.74	1.60%	
Honeywell Intl	HON	6.30%	92.95	93.12	1.92%	0.18%	72.61	15.14	1.74	3.72	1.59	2.00%	
SAIC	SAIC	0.82%	44.16	44.23	33.75%	0.16%	2.13	14.13	0.54	5.75	3.21	2.50%	
Boeing Co	BA	6.29%	127.23	127.38	-6.67%	0.12%	91.52	14.88	1.01	6.38	1.41	2.40%	
Comtech	CMTL	0.24%	37.33	37.15	17.90%	-0.48%	0.59	17.90	1.66	1.45	1.16	3.40%	
L-3 Communications Hldgs	LLL	4.05%	120.75	118.92	11.29%	-1.52%	9.35	12.63	0.76	1.58	4.14	2.20%	
LMI Aerospace	LMIA	0.07%	13.08	12.80	-13.16%	-2.14%	0.17	15.35	0.42	1.11	2.29		
ITT Exelis	XLS	1.23%	16.98	16.54	-13.22%	-2.59%	3.1	12.94	0.66	1.74	-2.12	2.60%	
Mercury Computer Sys	MRCY	0.15%	11.34	11.01	0.55%	-2.91%	0.40	28.59	1.94	1.16	4.50		
Hexcel	HXL	1.51%	40.90	39.70	-11.17%	-2.93%	3.77	16.05	2.08	3.19	1.53		
Computer Sciences	CSC	3.50%	63.20	61.15	9.43%	-3.24%	8.55	11.73	0.63	2.05	1.57	1.60%	
Teledyne Technologies	TDY	1.39%	97.17	94.01	2.34%	-3.25%	3.4	17.14	1.49	2.22	1.73		
Esterline Technologies	ESL	1.40%	115.12	111.27	9.13%	-3.34%	3.54	16.63	1.65	1.74	1.88		
Alliant Techsystems	ATK	1.61%	133.92	127.64	4.90%	-4.69%	4.15	10.04	0.82	2.03	0.81	1.00%	
OSI Systems	OSIS	0.50%	66.75	63.48	19.53%	-4.90%	1.26	16.57	1.35	2.31	2.15		
Viasat Inc	VSAT	1.02%	57.96	55.12	-12.02%	-4.90%	2.61	32.32	1.90	2.67	1.75		
AeroVironment	AVAV	0.28%	31.80	30.07	3.19%	-5.44%	0.66	52.18	2.50	1.90	-152.58		
Orbital Sciences Corp	ORB	0.66%	29.55	27.80	19.31%	-5.92%	1.77	21.85	1.28	2.04	1.61		
Textron	TXT	3.97%	38.29	35.99	-2.09%	-6.01%	10.55	14.53	0.77	2.24	0.90	0.20%	
Precision Castparts	PCP	4.70%	252.40	236.88	-12.04%	-6.15%	33.17	14.30	3.32	2.75	1.26	0.10%	
Moog Inc.	MOGA	1.16%	72.89	68.40	0.68%	-6.16%	3.13	16.94	1.14	1.99	2.08		
Triumph Group	TGI	1.32%	69.82	65.05	-14.49%	-6.83%	3.20	9.46	0.84	1.32	2.92	3.60%	
Kaman	KAMN	0.42%	42.73	39.30	-1.08%	-8.03%	1.14	14.38	0.66	2.12	1.11	1.60%	
United Technologies	UTX	6.32%	115.45	105.60	-7.21%	-8.53%	93.33	13.79	1.45	2.75	1.31	2.30%	
Mantech International'a'	MANT	0.40%	29.52	26.95	-9.96%	-8.71%	1.03	17.74	0.51	0.89	2.63	3.10%	
Intelsat	I	0.71%	18.84	17.14	-23.96%	-9.02%	1.92	7.35	0.76				
Flir Systems	FLIR	1.75%	34.73	31.34	4.12%	-9.76%	4.21	17.64	2.80	2.5	1.58	1.40%	
Heico	HEI	1.23%	51.94	46.70	-19.41%	-10.09%	3.33	25.13	2.88	4.83	1.81	0.20%	
Leidos	LDOS	1.00%	38.34	34.33	-26.16%	-10.46%	2.56	13.83	0.48	2.67	1.91	3.70%	
Sparton	SPA	0.10%	27.74	24.65	-11.81%	-11.14%	0.23	11.38	0.68	2.09	1.12		
Vectrus	VEC	0.08%	22.00	19.53	-11.23%	-11.23%		7.35					
KEY W Holding	KEYW	0.16%	12.57	11.07	-17.63%	-11.93%	0.39	41.94	1.41	1.31	-2.76		
AAR Corp	AIR	0.38%	27.56	24.19	-13.64%	-12.23%	0.96	11.72	0.47	0.94	1.19	1.20%	
Harris Corp	HRS	2.74%	75.75	66.40	-4.88%	-12.34%	6.96	13.17	1.35	3.74	4.33	2.90%	
Kratos Defense & Security	KTOS	0.15%	7.80	6.56	-14.58%	-15.90%	0.37	10.4	0.42	1.56	1.46		
Gencorp	GY	0.37%	19.10	15.97	-11.38%	-16.39%	0.98	27.31	0.58		-1.21		
Engility	EGL	0.22%	38.26	31.17	-6.68%	-18.53%	0.63	12.65	0.45	1.36			
American Science & Engineering	ASEI	0.17%	69.59	55.38	-22.99%	-20.42%	0.40	38.52	2.20	2.05	-6.23	4.00%	
Oshkosh Truck	OSK	1.48%	55.53	44.15	-12.37%	-20.49%	3.75	10.74	0.53	1.63	0.96	1.40%	