



**Commentary**

**After Nearly 50% Gains in 2013, We Look Toward 2014**

What a year! You could probably count on one hand (and they'd be lying) the number of people who thought the aerospace and defense sector would gain 48.27% in 2013, but that was the gain in the benchmark SPADE Defense Index (NYSE: ^DXS). It handily beat the broader market, with the S&P500 gaining 'just' 29.60%.

Even the most optimistic did not see this coming. Publicly, the news was resoundingly negative throughout the year focusing on political confrontations, sequestration budget cuts to the Department of Defense, a federal government shutdown, the lack of a budget for most of the year, a challenge to the debt ceiling, and an economy that felt like an old car trying to start on a winter's day (sputtering to start but you knew that it would get there eventually). Still the A&D sector moved higher and higher, setting all time records throughout the year and ending near its peak.

**What fueled the sector in 2013?**

Last year's forecast cited (1) gains in commercial aerospace (which are at the beginning of what is seen as a multi-year run for manufacturers) combined with (2) growing international defense sales would offset anticipated defense budget cuts in the near term. We felt that unlike the previous downturn following the end of the Cold War when Lockheed and Northrop almost had to merge, defense companies have had plenty of time to prepare for the backside of the budget peak; get their balance sheets in order, divest slow growth divisions, and acquire small positions that were better to maintain sales and growth in a downward cycle. All turned out to be correct. All that we missed was our belief that the sector was positioned for stability (not massive declines that many foresaw); instead it outperformed the broader market by nearly 20%.

In the end, all 50 companies in the SPADE Defense Index finished positive for the year (with the exception of OSI Systems (OSIS) which fell 26.8% in a single day in December due to a cancelled TSA order and the two 4Q13 spun-out divisions of SAIC (SAIC and LDOS) which were listed only briefly. In fact, 37 of the 50 companies in the index beat the S&P500 in 2013.

**Leaders for the year were:**

- 1. Gencorp (GY) 96.94%
- 2. Alliant Techsystems (ATK) 96.38%

**SPADE Defense Index Statistics**

|                         |                  |
|-------------------------|------------------|
| 12/31/12 Close:         | 2406.23          |
| 12/31/13 Close:         | 3567.72          |
| All-time Close:         | 3567.72          |
| Date of all-time close: | 31 December 2013 |

|      | SPADE Defense | S&P500 |
|------|---------------|--------|
| 2013 | 48.27%        | 29.60% |
| 4Q13 | 12.64%        | 9.92%  |

- 3. Huntington Ingalls (HII) 86.73%
- 4. Ducommun (DCO) 84.35%
- 5. Boeing (BA) 83.55%

Overall, large cap stocks did particularly well. Of the large primes: Lockheed (LMT) gained 61.08%, Northrop Grumman (NOC) (69.59%), Raytheon (RTN) (57.57%), and General Dynamics (GD)(37.94%). Many funds overweight in the large cap stocks like Boeing and these large primes have outperformed the benchmark for a few years now but, with higher valuations, the possibility that the cycle will shift is gaining traction.

**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 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 of 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

## 2013 Results

|    |                     |        |    |                     |         |
|----|---------------------|--------|----|---------------------|---------|
| 1  | Gencorp             | 96.94% | 26 | Teledyne Tech       | 41.17%  |
| 2  | Alliant Techsystems | 96.38% | 27 | CSC-Computer Sci    | 39.53%  |
| 3  | Huntington Ingalls  | 86.73% | 28 | L-3                 | 39.47.% |
| 4  | Ducommun            | 84.35% | 29 | United Technologies | 38.76%  |
| 5  | Boeing              | 83.55% | 30 | General Dynamics    | 37.94%  |
| 6  | Taser               | 77.63% | 31 | Booz Allen          | 37.57%  |
| 7  | Engility            | 73.42% | 32 | URS Corporation     | 34.97%  |
| 8  | Oshkosh Truck       | 69.92% | 33 | FLIR Systems        | 34.86%  |
| 9  | Northrop Grumman    | 69.59% | 34 | AeroVironment       | 34.04%  |
| 10 | Orbital Sciences    | 69.21% | 35 | Intelsat *          | 33.23%  |
| 11 | ITT Exelis          | 69.12% | 36 | CACI                | 33.05%  |
| 12 | Anaren              | 68.41% | 37 | Heico               | 29.47%  |
| 13 | Digital Globe       | 68.37% | 38 | Rockwell Collins    | 27.08%  |
| 14 | Hexcel              | 65.76% | 39 | Comtech             | 24.15%  |
| 15 | Moog                | 65.59% | 40 | Mercury CComputer   | 19.02%  |
| 16 | Lockheed Martin     | 61.08% | 41 | Transdigm           | 18.08%  |
| 17 | Viasat              | 61.05% | 42 | Triumph Group       | 16.49%  |
| 18 | Esterline Tech      | 60.29% | 43 | Ball Corporation    | 15.44%  |
| 19 | Raytheon            | 57.27% | 44 | Mantech Intl        | 15.38%  |
| 20 | Kratos              | 52.68% | 45 | American Science    | 10.27%  |
| 21 | AAR Corp            | 49.95% | 46 | Cubic Corp          | 9.78%   |
| 22 | Textron             | 48.29% | 47 | Key W Holdings      | 5.91%   |
| 23 | Honeywell           | 43.96% | 48 | Leidos **           | -4.40%  |
| 24 | Harris              | 42.59% | 49 | SAIC **             | -10.26% |
| 25 | Precision Castparts | 42.17% | 50 | OSI Systems         | -17.07% |

\* 2013 IPO

\*\* Leidos and SAIC were spun-out from NYSE:SAI in 4Q13

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. Over the past year, data revealed that investors wanting exposure to the A&D sector chose to invest in a single company instead of allocating resources into funds. [Even after posting 50% gains in 2013, the two largest ETF products saw managed assets decline from a peak of \$1.1 billion in 2008 to roughly \$350 million today.] After the substantial gains in 2013, the expectation that one can choose individual companies to outperform the benchmark is not as high; especially as investors seek mid-cap and small-cap firms as well as those operating in non-industrial areas like communications, surveillance, border security, and cyber. As such, we'd expect an inflow into the various ETF products including the InvescoPowershares Aerospace & Defense ETF (NYSE: PPA) that tracks our index. Although management fee of the competitor is a bit lower, ITA lacks significant exposure to cyber, C4ISR, border security, and non-industrial defense activities -- all areas we see as benefiting in the coming year. Additionally, PPA is more diversified to handle a flattening of the returns from large manufacturers and is highly liquid.

## ETF Statistics (NYSEarca: PPA)

## Powershares Aerospace &amp; Defense

Exchange / Ticker Symbol: NYSE / PPA  
 Assets (12/31/13) \$92 M  
 Closing Price (12/31/13) \$19.26  
 Yield (12-Month Yield) 1.3%  
 2013 Volume 6,436,300  
 Turnover 12%

source: Marketwatch

|                              |        |
|------------------------------|--------|
| Portfolio Price / Earnings*  | 16.38  |
| Portfolio Price / Book*      | 3.42   |
| Portfolio Price / Sales*     | 1.07   |
| Portfolio Price / Cash Flow* | 11.33  |
| Earnings Growth Rate*        | 11.37% |
| Beta (3 year)*               | 0.83   |
| Alpha (3 year)*              | 10.98  |
| R-squared (3 year)*          | 68.02  |

Yahoo Finance - 12/31/13\*

### Performance (ex div)

|      | SPADE Defense Index | S&P500          |
|------|---------------------|-----------------|
| 2013 | <b>48.27%</b>       | 29.60%          |
| 2012 | <b>16.30%</b>       | 13.41%          |
| 2011 | <b>[2.75%]</b>      | <b>[0.00%]</b>  |
| 2010 | 9.62%               | 12.78%          |
| 2009 | 21.71%              | 23.45%          |
| 2008 | <b>[38.03%]</b>     | <b>[38.49%]</b> |
| 2007 | <b>22.17%</b>       | 3.53%           |
| 2006 | <b>19.33%</b>       | 13.62%          |
| 2005 | <b>5.30%</b>        | 3.00%           |
| 2004 | <b>20.47%</b>       | 8.99%           |
| 2003 | <b>37.27%</b>       | 26.38%          |
| 2002 | <b>[2.87%]</b>      | <b>[23.37%]</b> |
| 2001 | <b>0.94%</b>        | <b>[13.04%]</b> |
| 2000 | <b>4.98%</b>        | <b>[10.14%]</b> |
| 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 publishes a variety of private and public sector and regional indexes. Public indexes listed on the NYSE 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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