

# SPADE INVESTOR



March 2007

Defense \* Homeland Security \* Space

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[w/homelanddefensestocks.com](http://w/homelanddefensestocks.com)

## Commentary

What a wild ride its been for the market the past two weeks. With economic issues in China, Japan, and the U.S. housing market, stocks have taken a downturn and is producing the largest correction since last May.

What does this mean for investors in the defense sector, probably not much in the long term. In fact, the roughly 6% decline in the SPADE Defense Index from its high brought us back to levels reached in...January 2007!

Even with the decline, the SPADE Defense Index ended the month of February up 3.02% for the year compared with a loss of 0.81% for the S&P500.

The year started off strong driven in large part by the forthcoming release of the Department of Defense's fiscal year 2008 budget which occurred in early February and which came in pretty much where everyone had expected it to.

The administration, as promised, also released their request for supplemental war funding at the same time -- bringing the total for FY07 and FY08 to \$300+ billion. The core DoD budget also forecasted steady growth through FY13, rising \$65 billion from today's levels.

The wildcard to future defense spending is, of course, the supplemental budget. The DoD budget office graciously provided us a copy of

*(continued on page 2)*

## SPADE Defense Index Statistics

YTD Return: 3.02%  
 February Return: 0.02%  
 2/28/07 Close: 2170.16

Intraday All-time High\*: 2277.59  
 Date: 23 Feb 2007

## Index Performance Summary

	SPADE (DXS)	S&P500
2006	19.33%	13.62%
4Q06	8.79%	6.17%
3Q06	3.21%	5.17%
2Q06	[4.03%]	[1.91%]
1Q06	10.65%	3.73%

## ETF Assets Under Management (AUM) Continue to Surge

### Powershares Aerospace & Defense ETF (PPA):

- AUM rise 66%+ YTD  
 - Increase of \$72.4 Million to \$181 M

## AFCEA Homeland Security Conference

We attended this February 2007 event in Washington DC and were surprised to see more than 400 people. Most appeared to be from small, privately-held high-tech companies all seeking a piece of the pie. The event featured all of the key DHS leadership and most of the sessions were program-by-program Q&A.

Not much to relay from an investor standpoint but we did hear the 'coolest' company name. - SNVC. Seems that a few years back the company's president was involved with classified work and needed business cards but couldn't say who he worked for -- hence, SNVC...Some Northern Virginia Technology Company.

To get on our list: [info@spadeindex.com](mailto:info@spadeindex.com)

## FY-2008 Department of Defense - Discretionary Budget Authority (\$B)

	FY07	FY08	FY09	FY10	FY11	FY12	FY13
Military Personnel	111.1	116.3	124.1	127.5	132.5	137.3	142.0
Operations & Maintenance	149.2	164.7	173.8	179.9	184.0	189.1	195.4
Procurement	81.3	101.7	110.5	114.8	117.7	123.8	125.3
RDT&E	75.1	75.1	77.2	77.1	72.6	70.7	68.1
Military Construction	9.3	18.2	18.4	16.3	14.0	11.3	10.4
Family Housing	4.0	2.9	3.2	2.4	2.0	2.0	1.9
Working Capital Funds	2.4	2.5	3.8	3.3	4.5	1.8	2.9
TOTAL	432.4	481.4	511.0	521.3	527.3	536.0	546.0

The above budget represents an 11.3% increase in the core funding for the Department of Defense. The 'plan' is that supplemental budgets will decline with FY-08.

## Defense Supplemental Funding (1999 - 2008 est)

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Budget	273.2	295.5	315.7	344.8	382.7	400.5	420.0	441.5	442.8	481.0*
Supplemental	19.1	8.6	19.8	17.3	72.6	65.3	75.9	65.8	170*	145*
Total	292.3	304.1	335.1	362.1	455.3	465.8	520.9	557.3	612.8+*	626.0*

Source: OMB / Defense News (Dec 06), \* Feb08 White House Announcement

## FY-2008 DoD - Total Budget Authority (\$B) - Discretionary+ Receipts

	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13
TOTAL	483.913	593.748	507.031	483.248	513.051	523.494	529.544	538.429	548.502

**Feb 2007 Leading Gainers**

1	Orbital Sciences	15.94%
2	FLIR Systems	12.46%
3	Applied Signal Tech	10.11%
4	SafeNet	9.76%
5	L-1 Identify Systems	9.49%
6	Garmin	9.04%
7	Argon ST	7.64%
8	Cogent	7.01%

**Feb 2007 Laggards**

1	Herley	-7.74%
2	MTC Technologies	-7.70%
3	DirecTV	-7.54%
4	Gencorp	-7.35%
5	Stanley	-6.80%
6	American Science	-6.45%
7	SRA International	-6.32%
8	Ceradyne	-4.59%

**YTD 2007 Leading Gainers**

1	OSI Systems	19.45%
2	Precision Castparts	16.08%
3	Armor Holdings	15.88%
4	SafeNet	14.66%
5	Applied Signal	14.65%
6	Viasat	14.59%
7	Ladish	12.73%
8	Argon ST	12.49%

**YTD 2007 Laggards**

1	CACI	-17.70%
2	American Science	-14.03%
3	SI International	-13.57%
4	SRA International	-11.37%
5	Stanley	-10.82%
6	MTC Technologies	-10.36%
7	DirecTV	-9.58%
8	Ceradyne	-8.67%

**Index and Industry Statistics**

**ETF Statistics (AMEX: PPA)**

**Powershares Aerospace & Defense**

Exchange / Ticker Symbol:	AMEX / PPA
Fee	60 basis
Assets (2/28/07)	\$181.7 M
Closing Price 2/28/07	\$19.13
Trading Volume (Feb 07)	3,121,800

**Powershares Aerospace & Defense ETF(PPA)**

Average Portfolio Market Cap*	\$12.49 Billion
Portfolio P/E*	17.54
Portfolio P/S*	1.21
Portfolio P/B*	2.81
Portfolio P/Cash Flow*	9.84
Earnings Growth Rate (ttm)*	14.19%
3 month Avg Daily Trading Volume	124,921

source: Yahoo! Finance - ETF Center \* 31 Jan 07

**"In our judgment, with a \$14.2 trillion economy, the nation has a lot to protect, and we might see even more funds flow in,"**

**Bob Stevens,  
Lockheed Martin's Chairman/CEO**

*Commentary (continued)*

its TOTAL Budget Authority in advance of the release of the Green Book. While usually pretty close to the Discretionary Budget Authority (which is what is usually quoted in the media), the TBA is comprised of the discretionary budget along with 'receipts' and the total can be greatly altered depending on other, supplemental items.

When you look at this table, you see that the total budget authority for FY08 is similar in size to that in FY05. (fyi - the Total Budget Authority does not include expectations for future receipts or supplementals until they are approved).

So we decided to look at the details of the supplemental GWOT budget that has been proposed to combat the 'Global War on Terror' to see where exactly the funds are going. As anticipated, I noticed that a significant percentage goes towards personnel issues--specifically the increased costs associated with maintaining personnel around the world as well as for combat-related pay. The other large cost area relates to replenishing spent items such as munitions, weapons, missiles, etc. But while this benefits a few companies, the attention it is receiving is much greater than its true impact on the broader defense community.

In fact, some companies have suffered in the current environment. At the heart of DoD's modernization plans developed earlier in the decade and a core part of the current QDR, has been the development of new information-based technologies that enable the soldier to have access to more information with the intent to take both the soldier and their equipment and systems further out of harm's way. The engagement in Iraq has diverted funds away from these efforts. In most cases, the contracts that have been signed have simply been modified to spread the funding out to future years and using current funds to support the war effort. Looking at the performance of the defense IT firms, and you can see the impact that restructuring these initiatives is having.

Meanwhile, the large cap prime contractors -- Lockheed Martin, General Dynamics, Raytheon, Northrop Grumman, and Boeing -- continue to have banner performances as the hardware they manufacture require upgrading, repair, or replacement as the war requires.

Eventually, DoD will refocus its efforts on modernization. But looking at the YTD laggards, it appears that many investors do not think it will in the short-term. In chatting with one contrarian investor, he has begun to wonder if the markets have taken the sell-off too far but even he was not sure when that turnaround will start.

*Key Industry Trends*

**DoD Budget:** No surprises. Growth of \$65 billion from FY07 - FY13

**DHS Budget:** No surprises. Dep't of Homeland Security budget has been rising about \$2 billion annually.

**IT/Modernization:** Budget continues to defer to Iraq spending

**A Military Space Race Coming?** China test which shot down a satellite raised eyebrows in Washington DC.

**Commercial Aircraft:** Remains strong. Politically charged as Russia uses a Boeing aircraft buy as leverage for political issues. Airbus problems have so far been Boeing's (and their suppliers) gains.

**Satellite Equipment:** Supplemental budget spending for satellite communications equipment and GPS hardware for soldiers adds nearly a 1/3 to the total typically spent in the core DoD budget.

**Politics:** They may have gotten sticker shock, but Congressional support appears steady and unlikely to affect spending in the sector until at least after the FY08 election.

Year	SPADE	S&P500
2007	3.02%	[0.81%]
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%

Quarter	SPADE	S&P500
4Q06	8.79%	6.17%
3Q06	3.21%	5.17%
2Q06	[4.03%]	[1.91%]
1Q06	10.65%	3.73%
4Q05	[0.47%]	1.59%
3Q05	4.44%	3.15%
2Q05	3.91%	0.91%
1Q05	[2.52%]	[2.59%]
4Q04	9.80%	8.73%
3Q04	2.81%	[2.30%]
2Q04	6.34%	1.30%
1Q04	0.36%	1.29%
4Q03	18.97%	11.64%
3Q03	5.27%	2.20%
2Q03	19.03%	14.89%
1Q03	[7.92%]	[3.60%]
4Q02	3.39%	7.92%
3Q02	[17.04%]	[17.63%]
2Q02	[2.86%]	[13.73%]
1Q02	16.57%	[0.06%]
4Q01	14.59%	10.29%
3Q01	[10.40%]	[14.29%]
2Q01	5.91%	5.52%
1Q01	[7.18%]	[12.11%]
4Q00	[0.05%]	[8.09%]
3Q00	12.14%	[1.24%]
2Q00	[7.11%]	[2.93%]
1Q00	0.83%	2.00%
4Q99	7.57%	14.54%
3Q99	[10.18%]	[6.56%]
2Q99	21.39%	6.71%
1Q99	[1.68%]	4.65%
4Q98	13.70%	20.87%
3Q98	[16.88%]	[10.30%]
2Q98	[1.88%]	2.91%
1Q98	14.99%	13.53%

**HomelandDefenseStocks.com Interview**

– March 6, 2007

**HDS:** Hi this is Ann Marie Fleming with HomelandDefenseStocks.com. We are once again joined by Scott Sacknoff, manager of the SPADE Defense Index (AMEX: DXS), who will give us his thoughts on the FY-08 Department of Defense budget and how investors can take advantage of this. Mr. Sacknoff, thank you for joining us.

**SMS:** My pleasure Ann Marie.

**HDS:** The government released its FY-08 budget for the Department of Defense. What did you think?

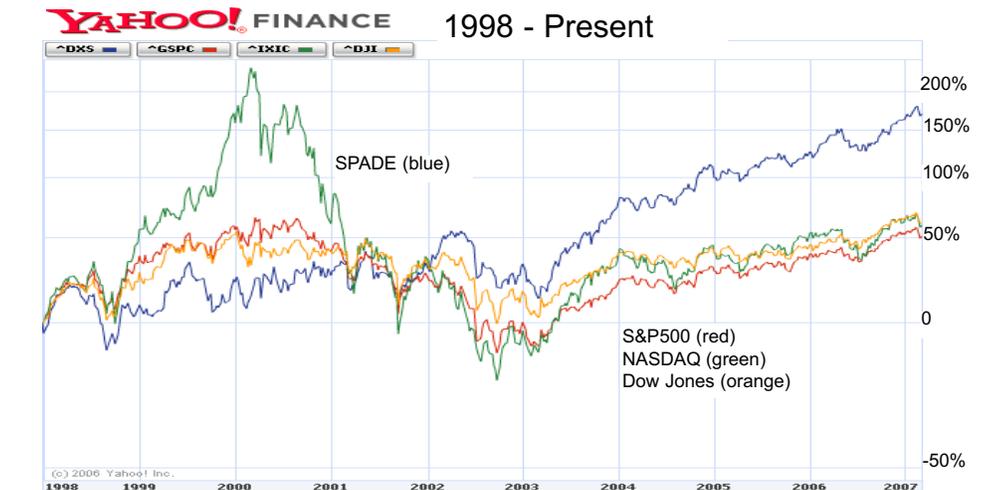
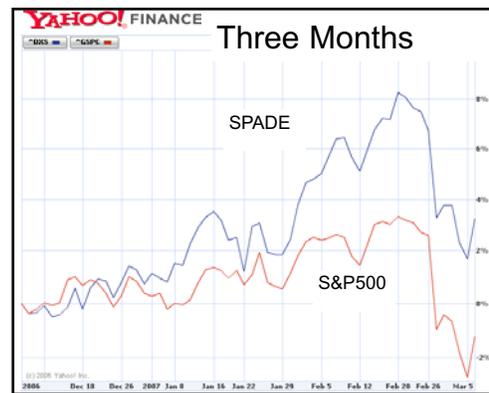
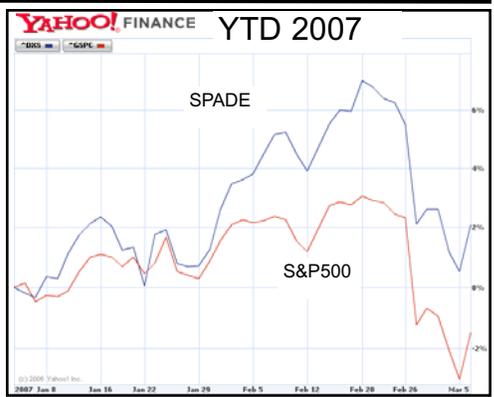
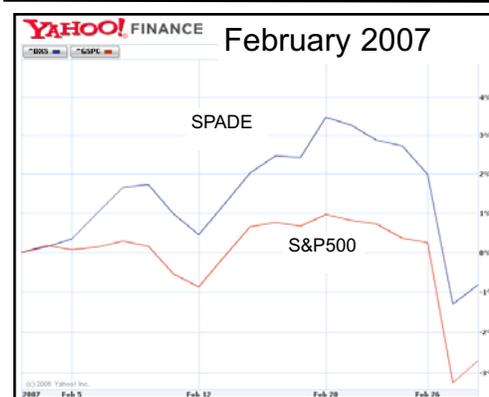
**SMS:** Well, unlike last year, which came in

stronger than anticipated, the FY-08 budget didn't present any surprises. Overall, the \$481 billion in discretionary budget authority is 11% higher than the FY07 request with much of that increase targeted to the Army and the Marines.

**HDS:** This is the largest defense budget in American history, correct?

**SMS:** In absolute, current dollar terms, yes, but this still represents only roughly 4-5% of U.S. GDP. In comparison to years with war efforts, the overall cost to the economy is much smaller, totaling roughly 11.7% in Korea, 8.9% in Vietnam, and 34.5% of GDP during World War II. Imagine the scale of an effort today requiring the output of more than 1/3 of the U.S. economy. So while the

(continued on page 4)



**About the Chart to the Right**

Five-year returns by the Dow 30, S&P500 and NASDAQ have all converged to a return of slightly more than 20%...whereas the SPADE Defense Index was up in excess of 100%!

If you didn't receive an email alert that the latest newsletter is available and want to get on our list. Email us at: info@spadeindex.com

**About**

The SPADE Defense Index (AMEX: DXS) provides an investment benchmark for companies involved with defense, homeland security, and space.

The Index value is available through financial websites using the ticker symbol 'DXS' with historical data and charting back to December 30, 1997. Some sites may require a character (eg. ^ on Yahoo) to identify it as an Index.

**Licensed Products**

**Exchange Traded Fund (ETF)**

The Powershares Aerospace & Defense Portfolio ETF (AMEX: PPA) is designed to track the performance of the SPADE Defense Index

**Options**

ETF options are traded by the American Stock Exchange using the underlying symbol.

**Rules**

The Index was designed to be RIC (Registered Investment Company) compliant for the purpose of enabling financial products. Full details can be found at [www.spadeindex.com](http://www.spadeindex.com)

- \* Market Cap: Minimum \$100M
- \* Share Price: Minimum \$5.00
- \* Liquidity: 50,000 avg daily trading

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**HomelandDefenseStocks.com Interview (continued)**

... \$481 billion is a significant figure, it is still a tiny fraction of the overall economy.

**HDS:** With defense spending rising more than 65% since 2001, do you believe this will continue?

**SMS:** Taking into account supplemental spending on the war, defense sector spending has increased for the last decade. But looking at the core total budget authority, spending from FY05 to FY08 has been relatively flat. If we peer into the details of the budget we see the core budget increasing each year from FY08 to FY13, growing some \$65 billion. But there are growing concerns inside the agency that even this may prove to not be enough for the DoD to maintain its current state of readiness. It is possible that we could see further increases down the road as DoD states its case and tries to balance personnel-related costs with meeting its modernization plans.

**HDS:** ...Meaning that spending in defense could rise even in the absence of a presence in Iraq?

**SMS:** Correct. DoD is facing a number of issues that will add to the cost of its maintaining a state of readiness. First of all, there are numerous personnel-related issues such as rising costs for health care and military pensions. Personnel costs are expected to rise 22% by FY13 whereas the rest of the budget is due to rise only 10.8%. Coming out of our stay in Iraq, we will likely see increased costs associated with recruiting and retaining military personnel as well as increased long-term costs associated with medical and war service benefits. Although it has been discussed, having military retirees pay for a portion of their health-care is seen as political suicide and is therefore unlikely. From an operational standpoint, resources to pay for the war were diverted from a number of programs designed to improve the efficiency and capabilities of the military and enable us to take action while putting people and equipment further out of harm's way. Many in the military have cited the need for significant reinvestment in equipment and supplies to replace that which has been damaged or worn out. This could be a lengthy and costly activity.

**HDS:** With public opinion calling for a pullout of Iraq, won't Congress provide greater scrutiny to future budgets?

**SMS:** Absolutely, and they will have to find a balance between what is necessary to modernize the military and putting the overall government budget in further balance. It is going to be an interesting challenge for whoever is the next President.

**HDS:** Looking at the budget and your comments, how does this effect companies operating in the sector?

**SMS:** Using recent history and the current budget as a guide, there are still a number of positive factors. First of all is the \$65 billion in growth in the core DoD budget. While R&D funding shows a slight decline in today's dollars and a large decline if factoring in inflation, the combination of procurement and RDT&E still shows a \$17 billion gain over the next five years. Secondly, there has been an ongoing trend by the military to out-source in the area of operations and maintenance, a budget area due to grow by \$24 billion. This reflects a range of day-to-day activities, including skilled positions, where former military personnel working for private contractors work side-by-side or in place of their military counterparts..

**HDS:** Before we close out, tell us what's been the effect on defense stocks.

**SMS:** The year started out strong, likely in anticipation of the early February release of the budget. The SPADE Defense Index continued to reach new all-time highs and the Powershares Aerospace & Defense ETF (AMEX: PPA) saw inflows of nearly 70%. This of course was stopped short in the last days of February as the world markets declined due to economic issues in China, Japan, and the U.S. real-estate sector – all of which are unrelated to the defense sector itself. But when investors decide to exit markets and take profits, very few sectors were unaffected. Considering the run in defense since the market's last pullback in May of 2006, the roughly 6% drop is relatively minor taking the Index back to its January levels.

**HDS:** This has been great. Thank you for joining us today. If you are interested in getting more information about the SPADE Defense Index, please visit [www.spadeindex.com](http://www.spadeindex.com). Historical data for the index can be found using the index symbol 'DXS'.

And as always, the information presented in this interview is for information purposes and should not represent a solicitation or an offer to purchase an investment product. Investors interested in the Powershares ETF trading under the ticker 'PPA' should visit the [powershares.com](http://powershares.com) website for a prospectus.

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