



On the Horizon...

- End of Budget Year Contracts Coming
- Presidential Election & Defense Spending
- Emerging from the Wall Street Summer Two Step - Down then Up then Down then...
- Investor Money Flow Moving Back In
- Volumes Flat but Typical of Summer
- A possible machinist strike at Boeing
- FY09 Budget - Confirmation, Delay Until After the Election, or Continuing Resolutions?

Are A&D Stocks Undervalued?

Price to Sales Ratio

24 of 53 companies have a P/S < 1.0

Price to Earnings Ratio

27 of 53 companies have a P/E < 14

20 of 53 companies have a P/E < 12

9 of 53 companies have a P/E < 10

SPADE Defense Index Statistics

8/29/08 Close: 2206.48
 All-time Close: 2747.67
 Date of all-time close: 9 October 2007

	SPADE Defense	S&P500
August	3.70%	1.22%
3rd Quarter	4.06%	0.22%
Year to Date	[14.25%]	[12.64%]

Month in Review

Overall it was a good month for defense stocks with more than 80% of the companies in the Index rising for the month.

SI International led all companies posting a 70.84% gain during the month, fueled by an acquisition offer from SERCO, a U.K.-based company that bid more than 40% above its current share price for the firm. This sends a strong signal on the value of U.S. defense companies.

Homeland security stocks also did well with TASER, L-1 Identity and American Science and Engineering all along the month's leaders.

Laggards were led by Oshkosh Trucks as growth in the armored vehicle market slowed following major runs in past years. The firm also saw reduced demand for large and industrial trucks as oil prices remained at well over \$100 per barrel.

A list of the top 10 leaders and laggards is on page 2.

A complete list of YTD and monthly returns can be found on page 5.

Commentary

Although the summer got off to a rough, volatile start, overall the markets drifted in the standard, quiet, sideways pattern typically exhibited as a large percentage of Wall Street goes on vacation or enjoys the summer months.

The defense sector was no different as volume was low (typically of the summer) and while the value of the index had its ups and downs, it pretty much stayed in a trading range following June's declines.

After seeing a decline in assets in the funds that track the index earlier in the year -- as investors cashed out the sizable gains of the past few years -- the summer saw the Powershares PPA fund level off around the \$200 million level, which it stayed at for the latter summer months.

Inflows Into the Sector

Toward the end of August, we began to see money flow into the sector and the return of at least a few institutional investors. The end of the year tends to be a strong period for the sector as DoD end-of-year contracts come fast and furious in September and October sees the beginning of a new budget cycle. Before we get to comments on the U.S. presidential election and the next budget, we should point out that...

Technical Analysis

...another reason for the inflow could be the index's breakout from its trading range with its value passing its 30-day moving average.

Forthcoming Index Changes

1. SI International has announced its planned acquisition by SERCO of the United Kingdom. Deal is pending upon review by the U.S. government.
2. DRS Technologies is set to be acquired by Finmeccanica of Italy. The acquisition has cleared antitrust analysis but is pending final review by the U.S. government which is anticipated shortly.
3. Shares of Cubic Corporation now list on the New York Stock Exchange, moving from the American.

Mid East Defense Spending Rises ~11.6%

	2006	2007
Bahrain	\$478 M	\$539 M
Egypt	\$3.04 B	\$3.42 B*
Iran	\$6.48 B	\$7.16 B
Israel	\$7.53 B	\$9.45 B
Jordan	\$1.11 B	\$1.59 B
Kuwait	\$3.49 B	\$3.92 B*
Lebanon	\$588 M	\$631 M
Oman	\$3.27 B	\$3.23 B
Qatar	\$2.33 B	---
Saudi Arabia	\$29.54 B	\$33.33 B
Syria	\$1.73 B	\$1.46 B
UAE	\$9.48 B	\$10.08 B
Yemen	\$823 M	\$908 M

* Estimated
 source: Military Balance 2008, Defense News

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August 2008 Top Gainers

1	SI International	70.84%
2	Ladish Co	34.65%
3	TASER	28.97%
4	L-1 Identity	22.35%
5	Mercury Computer	21.07%
6	American Sci & Eng	18.19%
7	Esterline Tech.	15.81%
8	URS Corporation	14.41%
9	GeoEye	14.32%
10	Viasat	13.89%

August 2008 Laggards

1	Oshkosh Truck	[14.52%]
2	FLIR Systems	[12.37%]
3	AAR Corp.	[7.68%]
4	Gencorp	[6.80%]
5	Textron	[5.45%]
6	ITT Industries	[4.79%]
7	Ducommun	[3.43%]
8	Ceradyne	[2.78%]
9	Garmin	[2.55%]
10	Honeywell	[1.32%]

YTD Top Gainers

1	DRS Technologies	46.71%
2	AeroVironment	38.26%
3	Argon ST	34.54%
4	Mantech Int'l	34.39%
5	Applied Signal Tech	21.87%
6	American Sci & Eng	17.71%
7	Teledyne Tech.	16.88%
8	FLIR Systems	14.06%
9	SI International	13.69%
10	CACI	13.13%

YTD Laggards

1	Oshkosh Truck	[67.37%]
2	Garmin	[64.16%]
3	AAR Corp.	[58.27%]
4	TASER	[54.83%]
5	Mercury Computer	[42.58%]
6	Textron	[42.36%]
7	DynCorp	[41.26%]
8	Ladish	[38.27%]
9	Triumph Group	[33.53%]
10	Gencorp	[33.02%]

Index and Industry Statistics

ETF Statistics (AMEX: PPA)

Powershares Aerospace & Defense
 Exchange / Ticker Symbol: AMEX / PPA
 Fee 60 basis
 Assets (8/29/08) \$ 202 M
 Closing Price (8/29/08) \$ 19.42
 August 08 Volume 1,392,000

Powershares Aerospace & Defense ETF(AMEX: PPA)

Average Portfolio Market Cap* \$12.56 Billion
 Portfolio P/E* 13.39
 Portfolio P/S* 0.94
 Portfolio P/B* 2.51
 Portfolio P/Cash Flow* 8.51
 Earnings Growth Rate (ttm)* 13.02%
 3 month Avg Daily Trading Volume** 88,244
source: Yahoo! Finance, [30 July 08 data] - [** 4 Sept 08]*

SPADE Defense Index

	2008	2007	2006	2005	2004
June	[13.51%]	0.63%	[1.04%]	1.34%	3.41%
July	0.35%	0.60%	[0.12%]	3.62%	[2.35%]
Aug	3.70%	3.14%	0.27%	0.46%	0.60%
Sept	TBD	6.35%	3.65%	0.33%	4.65%

S&P 500

	2008	2007	2006	2005	2004
June	[8.60%]	[1.78%]	0.01%	[0.01%]	[1.68%]
July	[0.99%]	[3.20%]	0.51%	3.60%	1.21%
Aug	1.22%	1.29%	2.13%	[1.12%]	[1.41%]
Sept	TBD	3.57%	2.46%	0.69%	[0.88%]

Alpha Return of SPADE (vs S&P500)

	2008	2007	2006	2005	2004
June	[4.91%]	2.41%	[1.05%]	1.35%	5.09%
July	1.34%	3.80%	[0.63%]	0.02%	[3.56%]
Aug	2.48%	1.85%	[1.90%]	1.58%	2.01%
Sept	TBD	2.78%	1.19%	[0.36%]	5.53%

Largest Defense Prime Contractors

	Aug	YTD
Lockheed Martin	11.61%	10.62%
Boeing	7.28%	[25.04%]
General Dynamics	3.54%	3.72%
Northrop Grumman	2.17%	[12.45%]
Raytheon	5.38%	[1.17%]

The next president will inherit the most daunting security environment an incoming commander in chief has ever been handled.

Michele Flournoy, former Pentagon strategy planner during the Clinton administration

Commentary (continued)

...Combined with a positive increase in money flow, this is a strong indicator to market technicians that the sector is set to rise. Passing its 200-day average would suggest that the sector is ready for another run.

The Irrationality of the Market

After the Index rose to new multi-year heights, it has fallen more than 20% from these levels since last October -- even while companies involved with aerospace, defense, and homeland security continue to report strong fundamentals. The sector is still one driven by perception -- one of the few on Wall Street -- where long-term changes and shifts can be more important than short-term results. How else can one explain declines in a sector whose companies report ever increasing revenues and profits and backlog and share buy-

backs while seeing declines in share prices due to possible budget declines two and three years hence?

Politics & the 2008 Presidential Election

Which brings us of course to the 2008 presidential election in November. (so that you don't have to guess, I am an independent voter and have not decided my vote yet.)

Prior commentaries have discussed how the defense budget is as much (or more) a function of world situation than political party. Time has proven that the defense budget has more to do with the world in which we live than who is in charge. For those that question this, WWII and the Vietnam War both took place with Democratic commanders in chief. Even recently, defense budget declines started in the final years of the George Bush-41 presidency and rose in the

final years of the Clinton presidency (when it became clear that they had cut too much).

In looking at the candidates this year, I've stated that whoever is elected, they will have no choice but to maintain the currently forecasted budget levels as the military recapitalizes, replaces damaged and worn equipment, funds overseas activities, and invests in new systems. The percent devoted to each activity will vary depending on whoever is elected. The timing of when we pull out of Iraq and the rate of withdrawal, will free up funds and shift it toward the aforementioned activities. But the overall level of funding is if anything at a *bare minimum* advocated by the military leadership. Reducing spending on homeland security or defense and then being faced with any sort of future attack would be *political suicide* for the ruling party. Hence, changes reducing the defense budget are unlikely.

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Year	SPADE	S&P500
YTD	[14.25%]	[12.64%]
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 (AMEX: DXS) provides an investment benchmark for 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 defense, homeland security, and space – 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.

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

ETF Options

Traded by the American Stock Exchange using the underlying ticker.

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
- * Liquidity: 50,000 shares/day avg

Commentary (continued)

Congress and the White House will likely keep each other in check on this as neither wants to lose power.

However, while the core budget is unlikely to change, I'd be deficient if I didn't state that the supplemental budgets afforded the military will not remain as high in a post-Iraq environment. Although spending on the war is costing between \$8 and \$12 billion a month depending on estimates, there are several things to consider. First, there are always defense supplementals added to the core budget for one reason or another -- through not at the \$50 to \$100 billion level of recent requests. With the military needing to recapitalize a number of systems, Congress providing additional budget via supplementals is one way for them to give the appearance of keeping the defense budget down while providing an increase of funds to meet needs. Secondly, a large percentage of the supplemental budget has gone toward items that will not make its way to private companies. Although dollars have flown to companies that manufacture armaments, missiles, armored equipment, etc. supplemental spending also goes toward gasoline and fuel (the U.S. military spends more than \$1 billion per month on an estimated 340,000 barrels a day), soldier hazard pay, increased medical expenditures, transportation of supplies, etc.

As far as the candidates themselves, Senator John McCain has been perceived as the strongest supporter of defense due to his military career, his support for continued action in Iraq, and as a member of the Senate Armed Services Committee. His VP candidate, Sarah Palin, has stated that she has not been very interested in international politics so, should she become president at any point, her support of the sector is largely an unknown. As VP, her opinion would likely defer to McCain's positions.

Senator Barrack Obama has said he would pull out of Iraq but keep defense spending stable, taking advice from the military leadership on how quickly to leave Iraq and where to spend available resources. His VP choice, Senator Joe Biden, is a member of the Foreign Relations Committee and considered a knowledgeable and strong supporter of defense and intelligence activities. Although neither has direct military experiences (as a disclaimer, the closest I come is having worked at the Pentagon for a few years and having several friends who are active military), any perceived weakness by Sen. Obama in the area of defense is more than made up by Sen. Biden's appearance on the ticket.

So which candidate team is best for defense?

Ultimately I believe it is a draw. It is more a matter of direction than budget. Companies benefitting from an increased presence in Iraq will benefit from a McCain presidency. Companies benefitting when resources are devoted to R&D, IT and network-centric warfare, and development for next generation technologies and systems, likely benefit from an Obama presidency (the logic being that if the budget is stable, what isn't being spent on war consumables will be spent elsewhere). Either way, I don't see either candidate as having a material impact on defense company revenues, profits, or backlog. The impact from perception, well that's another story. It'll be interesting to listen to their answers when the debates start later this month and into October.

Get ready for an interesting fall

I think we're going to see a lot of volatility for the rest of the year in the market, both in the defense sector and the market as a whole. Considering the fundamentals of the sector, and if the market cooperates, I believe that the sector will see net gains through the end of the year. Getting there though might be interesting ride.

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Military Costs of Major U.S. Wars
(Include Appropriations Enacted through 30 June 2008)

source: Congressional Research Service

		War Cost % GDP in Peak Year	Total Defense % GDP in Peak Year of War
American Revolution Current Year \$ Constant \$ FY08	1775-1783 101 million 1.825 billion	---	---
War of 1812 Current Year \$ Constant \$ FY08	1812-1815 90 million 1.177 billion	1813 2.2%	2.7%
Mexican War Current Year \$ Constant \$ FY08	1846-1849 71 million 1.801 billion	1847 1.4%	1.9%
Civil War: Union Current Year \$ Constant \$ FY08	1861-1865 3.183 billion 45.199 billion	1865 11.3%	11.7%
Civil War: Confederacy Current Year \$ Constant \$ FY08	1861-1865 1.000 billion 15.244 billion	---	---
Spanish American War Current Year \$ Constant \$ FY08	1898-1899 283 million 6.848 billion	1899 1.1%	1.5%
World War I Current Year \$ Constant \$ FY08	1917-1921 20 billion 253 billion	1919 13.6%	14.1%
World War II Current Year \$ Constant \$ FY08	1941-1945 296 billion 4.114 trillion	1945 35.8%	37.5%
Korean War Current Year \$ Constant \$ FY08	1950-1953 30 billion 320 billion	1952 4.2%	13.2%
Vietnam War Current Year \$ Constant \$ FY08	1965-1975 111 billion 686 billion	1968 2.3%	9.5%
Persian Gulf War Current Year \$ Constant \$ FY08	1990-1991 61 billion 96 billion	1991 0.3%	4.6%
Iraq Current Year \$ Constant \$ FY08	2003-Present 616 billion 648 billion	2008 1.0%	4.2%
Afghanistan/GWOT Current Year \$ Constant \$ FY08	2001-Present 159 billion 171 billion	2007 0.3%	4.0%
Post-9/11 Security Operation Noble Eagle Current Year \$ Constant \$ FY08	2001-Present 28 billion 33 billion	2003 0.1%	3.7%
Total Post 9/11- Iraq, Afghanistan/GWOT, ONE Current Year \$ Constant \$ FY08	2001-Present 809 billion 859 billion	2008 1.2%	4.2%

Possible Strike by Boeing Machinists

“Unless both sides are suicidal they’ll come to an agreement.” I heard this comment by someone on CNBC as I was writing this and couldn’t agree more. Boeing is over a barrel as a strike would cost them an estimated \$100 million per day and further 787 delays could begin to have an impact on the company. To date only one carrier has canceled an order, Azerbaijan Airlines. That said, it does look like the union is trying to squeeze every last dollar from the company and Boeing does need to ensure its future competitiveness. The Union is fighting the globalization of the commercial aerospace sector and trying to hold on as long as they can. Regardless, I find it difficult to believe that the machinist union would push the issue with an extended strike.

Border Security Market to hit \$14 Billion

A report from the Homeland Security Research Corp., “2007-2011 U.S. Homeland Security (Government & Private Sectors) Market Outlook” states that the total market will hit \$13.98 billion, representing a compound growth rate of 19.5% as demand from government and private sectors rises. Sectors such as U.S. border and perimeter protection, airport security, information technology, cyberterror, port security, maritime security perimeter production, explosives detection, nuclear screening portals, biometrics, RFID and electronic hardware could enjoy market growth of over 100% during the next five years.

Government IT Spending to Rise \$24 Billion

As reported in the Aug 11th *Washington Technology*, business advisory firm EquaTerra states that public-sector spending on commercial IT and support services will grow from \$66 billion (2007) to \$90 billion (2013).

Contracts

\$35 Billion - The tanker deal remains in limbo as the Air Force revises its criteria, Boeing debates not submitting a new bid unless a six month extension is given, and Northrop Grumman evaluates how it can change its proposal under the new guidelines to improve its bid and reduce costs.

\$10.1 Billion - Eight companies including Computer Sciences, L-3, and Northrop Grumman won prime contracts from the Air Force to provide inspection, maintenance, modernization, and repair services.

\$4.3 Billion - to Boeing under a five-year contract for as many as 215 modernized F-model Chinook helicopters.

\$1.5 Billion - Anticipated to Boeing and Raytheon by the Government of Australia for F/A-18 fighter jet support services and equipment and could include Sidewinder missiles and EW countermeasure systems.

\$1.2 Billion - General Dynamics to produce 615 Stryker vehicles for delivery by 2011.

\$900 Million - Six companies including CACI and SAIC won spots on a five-year contract to handle advisory and assistance tasks for Strategic Command’s programs and strategies.

\$391 Million to Computer Sciences for managed data center services for the Dep’t of Homeland Security’s facility at Stennis, Mississippi.

\$275 Million to Mantech - \$151 million over 5 years to provide support services to the Naval Sea Systems Command and \$124 million over five years to assist the State Department on network modernization.

\$200 million to AeroVironment for hand-launched, unmanned aerial systems to be used by the Special Operations Command.

Defense and war costs remain a small percent of GDP. At roughly 25% of total defense spending, the percentage devoted to the conflict is consistent with post-WWII expenditures.

