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Defense ETFs Have Tactical Advantage

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A presidential election year, coupled with the prospects of a recession, may make this an ideal time to be invested in aerospace and defense ETFs such as the **iShares Dow Jones U.S. Aerospace & Defense Fund**ITA or the **PowerShares Aerospace & Defense Fund**PPA.

Although these two ETFs have been around only for a couple of years, the Dow Jones U.S. Aerospace & Defense Index beat the market soundly the last time the U.S. picked a commander-in-chief. It increased by 17.3%, vs. 9.3% for the **S&P 500**.

Because this index dates back only to 2003, I decided to take a look at how some of the largest defense contractors have done in earlier presidential election years.

When looking at the group that includes **Boeing**BA, **Raytheon**RTN, **General Dynamics**GD, **Honeywell**HON, **Lockheed Martin**LMT and **Northrop Grumman**NOC, these stocks have done remarkably well in the last five presidential-election years, dating back to 1988.

In two of those years, five of these six stocks outperformed the market. In the other three years, four of the six outperformed the market. If history proves to be a good indicator, 2008 should be a good year for these stocks.

	2004	2000	1996	1992	1988
Boeing	21.80%	59.30%	35.90%	-15.10%	62.20%
Raytheon	29.20%	16.70%	2.70%	22.90%	0.90%
General Dynamics	16.20%	50.30%	23.00%	96.80%	6.20%
Honeywell	7.10%	-19.10%	41.80%	40.70%	14.60%
Lockheed Martin	8.10%	54.30%	16.80%	25.60%	18.70%
Northrop Grumman	14.00%	54.20%	30.80%	37.40%	13.30%
S&P 500	9.00%	-10.10%	20.30%	4.50%	12.40%

Cai von Rumohr, a senior research analyst for Cowen Group, maintains a favorable outlook for the sector.

Defense is a relatively stable haven," he said. "Defense stocks tend to do well in a presidential election year."

In addition to the election issue, Charles Norton, portfolio manager of the **Vice Fund**VICEX, likes the recession-resistant characteristics of defense contractors.

"They are a good growth story, independent of economic conditions," he said. "Their success is more tied to budgetary cycles as opposed to economic cycles."

Richard Tortoriello, an aerospace and defense analyst for Standard's & Poor's, also holds a bullish outlook on the defense sector.

"The U.S. Defense budget is by far the largest in the world," he said. "We think the threat [environment](#) will

warrant strong defense spending in the future. Standard weapons are also aging and are in need of spending for upgrades."

Norton is also bullish on the commercial aerospace sector. "The sector is experiencing a major upcycle right now," he said. "I think it would take a lot for it to come unglued."

Recent trends in both of these ETFs have made for ideal conditions from a technical standpoint. Marvin Appel, CEO of Appel [Asset Management](#), thinks the recent pullbacks these funds have experienced could be a blessing in disguise.

"Both charts look very favorable, as they have each formed a double-bottom," he said.

Appel is also inclined to advise investors looking to get into these sectors to consider the use of an ETF or mutual fund. "They give you more diversification," he said. "With many of these companies competing against each other for a limited number of government contracts, an ETF or mutual fund will eliminate that single-company risk."

Both of these ETFs have several names that analysts find attractive. Tortoriello has a "Strong Buy" rating on **Rockwell Collins**COL, which is a top holding of both funds.

In late January, the aviation electronics maker's first-quarter results came in ahead of analysts' expectations as total sales rose 12% on a year-over-year basis. Strong contributions from the [company's](#) commercial systems business segment led Rockwell management to raise its full-year forecast for 2008.

Tortoriello also likes **L-3 Communications Holdings**LLL, a top holding of both funds, because it "has good product lines that are well-positioned in the defense sector," he says. "The company generates very strong cash flow and we would expect this trend to continue."

Von Rumohr is bullish on **Precision Castparts**PCP, a top holding of both funds. He also likes the value potential of **SAIC**SAI, a top holding of the PowerShares fund.

"Precision Castparts has a good demand profile, and we think that it has more margin upside than people might think," he says. "SAIC also has margin upside and is a leader in the sector, but it is trading at a P/E that is only about average for the group."

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IDC calculates the Market Cap for the basic symbol to include common shares only. Year-to-date mutual fund returns are calculated on a monthly basis by Value Line and posted mid-month.

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