



Defense Appropriations

POLICY PLAYBOOK | Investment Strategy for Key Policy Themes

Defense: Improving Military Readiness; Preparing for Technologically Advanced Battle

82% | 85%

Percentage of House & Senate, respectively, voting to approve FY19 \$716 billion defense authorization bill

\$750 billion

The Trump administration's recent projected FY20 defense budget, after initially projecting \$700 billion

\$576 billion

FY20 defense spending cap under the Budget Control Act of 2011, unless Congress raises the cap

POLICY OVERVIEW | What's Happening?

The Trump administration continues to push for increased defense budgets in both the U.S. and foreign countries. Defense Secretary James Mattis and Republican defense hawks support increased defense spending, pointing to years of underfunding that has decreased military readiness, slowed modernization initiatives, and allowed foreign adversaries (e.g. China) to catch up. In addition, geopolitics surrounding China, Russia, North Korea, and the Middle East are prompting the U.S. to re-evaluate the need for potential military intervention.

OUR TAKE | The Market Opportunity & Investment Case

Congress passed the Budget Control Act of 2011 (BCA) to solve the 2011 debt ceiling crisis. The BCA increased the debt ceiling by \$400 billion in exchange for imposing spending caps, which unless subsequently raised, put in place a ceiling for both defense and non-defense spending. The result was lower defense spending and fewer contract opportunities starting in FY12 and proceeding through FY17.

The Trump administration has reversed the trend of lower defense spending seen during the Obama administration and pushed foreign governments to increase defense spending, both of which may generate additional sales for the U.S. defense industry. The Trump administration is backed by James Mattis and congressional defense hawks, who are anxious to make up for lost defense investment during the early BCA years. The priorities include modernizing the naval fleet, maintaining and building out the military's aircraft fleet, and deploying a more technologically advanced soldier.

In our view, the impact of higher defense budgets can be traced directly to companies operating in the defense industry. Increased spending means more contract opportunities for defense prime contractors, their suppliers, and the outsourced consulting firms that contract with the Department of Defense (DoD).

TIMING | Significant Actions Taken & Next Steps

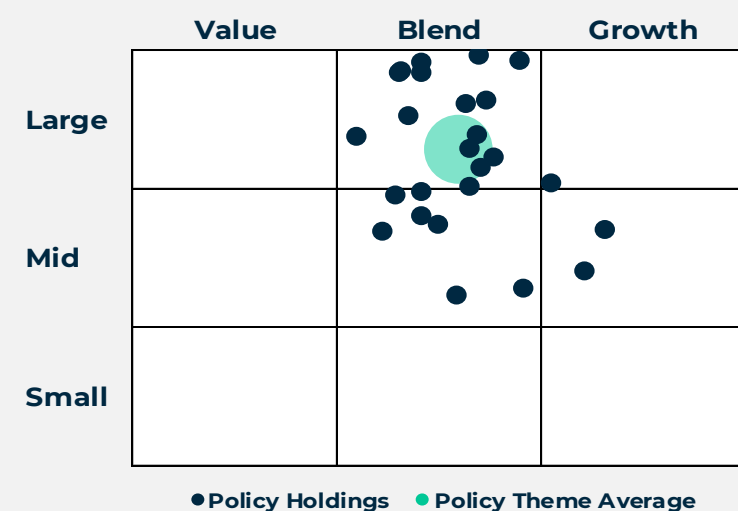
During the first half of 2018, Congress passed the Bipartisan Budget Act of 2018, which increased defense caps under the BCA for FY18 and FY19. However, the legislation did nothing to change the spending caps for FY20 or FY21. This has increased defense budget uncertainty for FY20 and beyond. In the fall of 2018, the Trump administration walked back defense budget expectations and Mick Mulvaney directed the DoD to budget for \$700 billion. Then in December 2019, President Trump switched positions and announced a \$750 billion defense budget. We have two unanswered questions: (1) How does the Democrats taking control of the House impact the probability of raising defense spending caps under the BCA? (2) Will Washington, D.C. continue to increase spending and ignore BCA caps, or will fiscal restraint take hold? We expect the first half of 2019 to provide answers to these questions.

Key Statistics

Sector	Industrials
Sub-Industries	Defense Contractors, Suppliers Consulting & I.T., Technology
Holdings	25
Average Market Cap (\$B)	\$25.4
Price to Earnings (P/E)	26.3x
Price/Book	8.6x
Price/Sales	2.2x
Price/Cash Flow	32.8x
Dividend Yield %	1.10%

Price Returns	S&P 500	Basket
3 Month	-8.75%	-11.75%
6 Month	-4.55%	-3.40%
1 Year	-0.52%	9.78%

Holdings Style Map



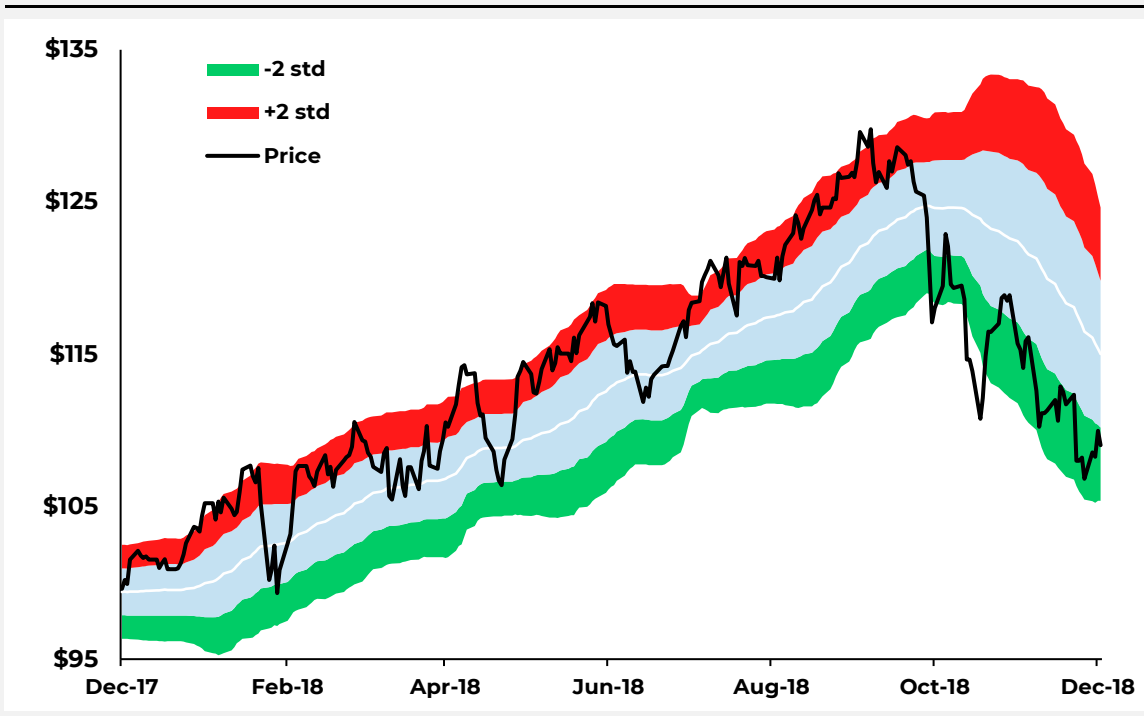
Source: FactSet (as of 12/11/2018)

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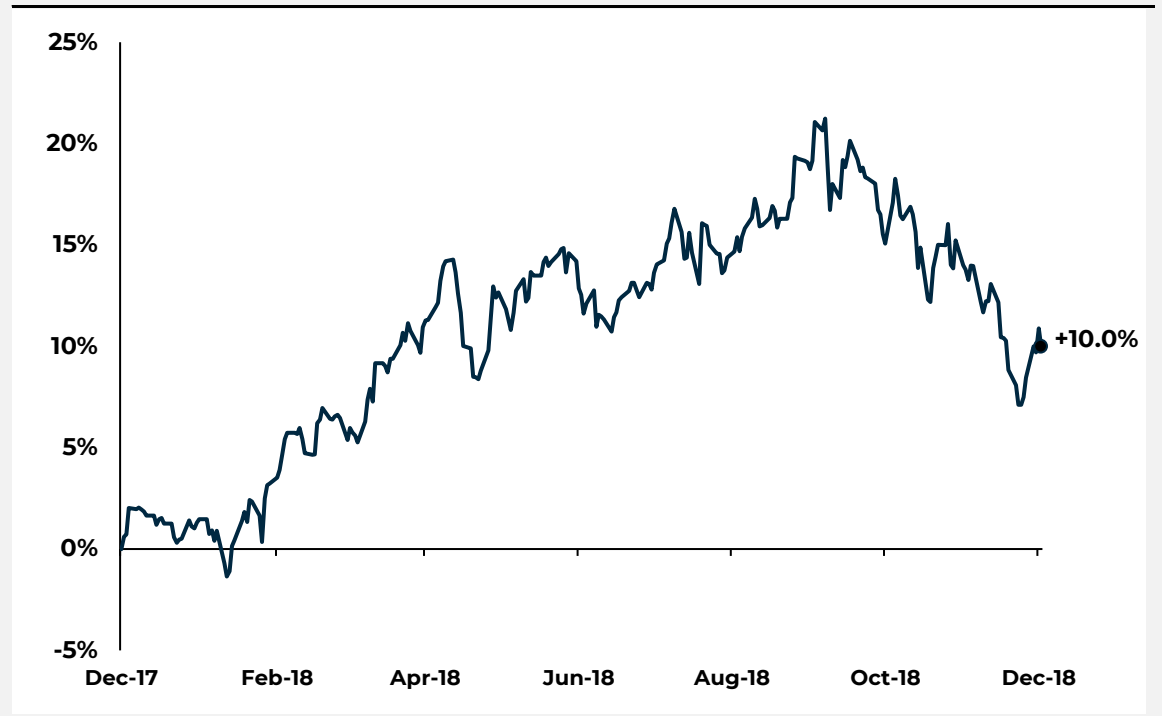
CHARTS: Defense Appropriations Policy Basket

Trading Range (Equal Weight Basket)



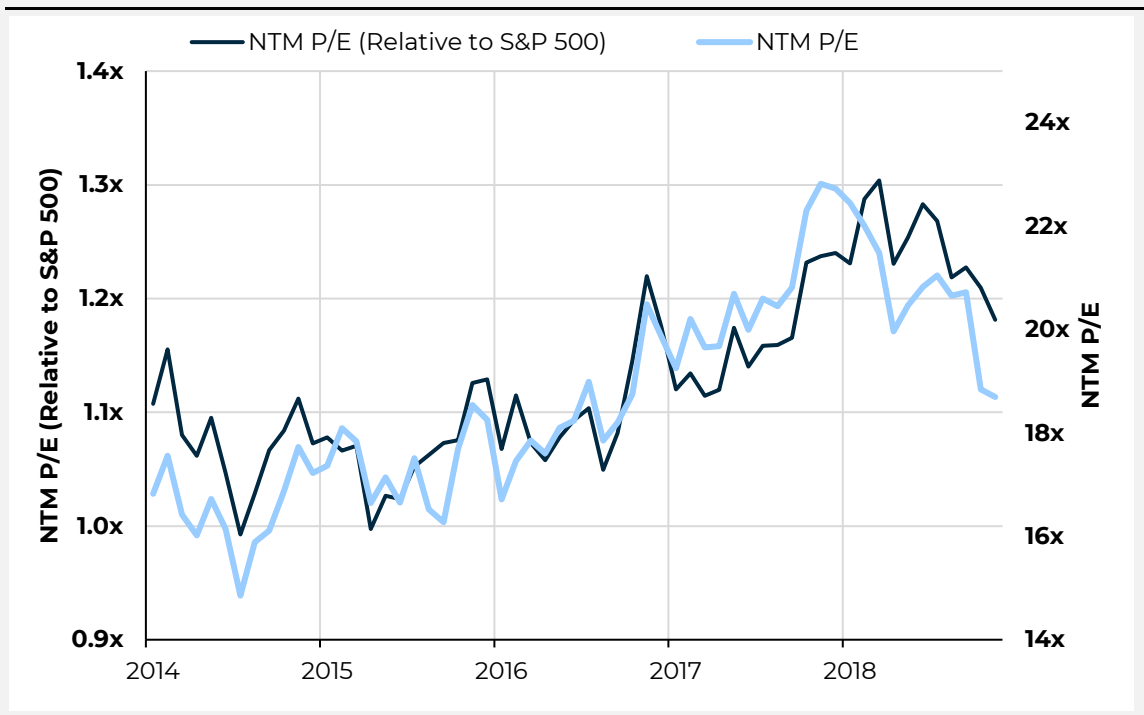
Source: FactSet (last 12-month; as of 12/11/2018)

Relative Returns to S&P 500 (Equal Weight Basket)



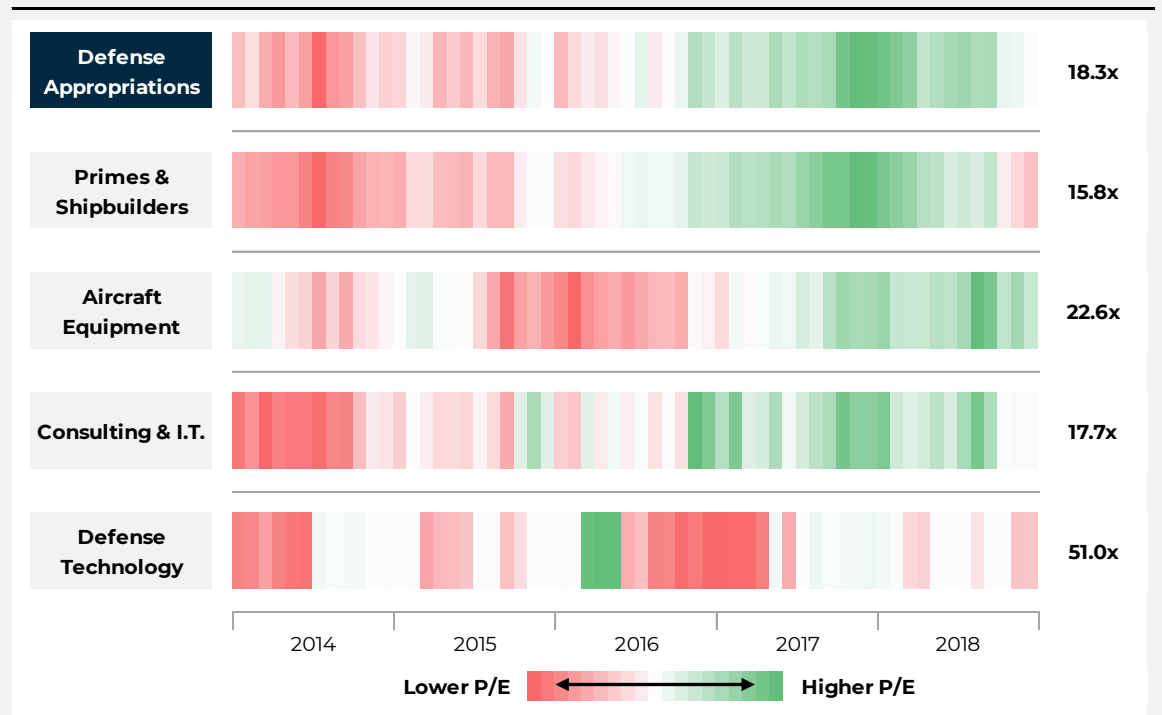
Source: FactSet (last 12-month; as of 12/11/2018)

Historical P/E Multiples (Basket Average)



Source: FactSet (as of 12/11/2018)

Rolling NTM P/E (Sub-industry and Basket Averages)



Source: FactSet (as of 12/11/2018)

FUNDAMENTALS: Defense Appropriations Policy Basket

Average Rank	Company	Valuation NTM P/E	Size Market Cap (\$B)	Profitability EBITDA Margin	Cash Flow Yield	Leverage Debt / EBITDA	Liquidity Cash / Sales	Payout Div. Payout Ratio
1	Boeing	18.5x	\$184.83	13.0%	6.3%	0.7x	10.2%	42.3%
2	Raytheon	15.0x	\$49.07	18.0%	3.1%	1.0x	7.8%	45.9%
3	Accenture	22.2x	\$106.65	16.5%	4.9%	0.0x	12.2%	42.0%
4	FLIR Systems	19.1x	\$6.07	22.5%	4.0%	0.9x	32.6%	77.9%
5	Leidos	12.7x	\$8.75	10.1%	7.0%	2.8x	5.7%	53.8%
6	Lockheed Martin	15.4x	\$83.12	15.1%	1.1%	1.7x	1.6%	108.3%
7	General Dynamics	14.7x	\$50.64	14.4%	4.0%	2.4x	3.0%	35.1%
8	Textron	14.6x	\$12.14	10.5%	5.1%	2.4x	9.1%	7.0%
9	Harris Corporation	18.3x	\$17.47	22.4%	3.1%	2.6x	4.8%	38.6%
10	TransDigm	21.0x	\$18.36	47.3%	4.6%	6.2x	54.4%	-
11	Northrop Grumman	14.9x	\$46.50	15.1%	3.6%	2.9x	4.3%	34.0%
12	Huntington Ingalls	12.4x	\$8.58	15.1%	2.8%	1.1x	0.9%	24.1%
13	Hexcel	17.9x	\$5.09	22.6%	3.2%	1.7x	2.2%	15.2%
14	Esterline Technologies	27.1x	\$3.59	14.8%	6.0%	2.1x	18.9%	-
15	BWX Technologies	17.4x	\$4.16	16.8%	-0.6%	1.9x	4.2%	28.6%
16	Booz Allen Hamilton	18.9x	\$7.17	9.8%	5.4%	2.7x	5.4%	34.1%
17	Aerojet Rocketdyne	26.1x	\$2.74	14.5%	9.2%	2.7x	30.8%	-
18	AeroVironment	106.0x	\$1.76	17.4%	1.9%	0.0x	87.2%	-
19	HEICO	40.8x	\$4.35	25.1%	2.5%	1.3x	3.9%	-
20	Moog Inc.	14.6x	\$2.53	13.0%	0.3%	2.1x	4.6%	28.0%
21	Axon Enterprise	58.0x	\$2.64	10.3%	1.2%	0.0x	81.2%	-
22	Science Applications	17.9x	\$2.96	7.6%	7.2%	3.0x	4.2%	30.8%
23	CACI International	17.0x	\$4.01	9.9%	6.1%	2.5x	1.7%	-
24	OSI Systems	20.1x	\$1.34	14.5%	4.3%	2.3x	7.9%	-
25	Kratos	76.6x	\$1.51	8.1%	-1.3%	4.2x	28.6%	-

HOLDINGS: Defense Appropriations Policy Basket

Ticker	Company	Market Cap (\$B)	Price to Earnings (P/E)	Price/Book	Price/Sales	Price/Cash Flow	Dividend Yield %	Stock Price	52 Week Range
Prime Contractors & Navy Shipbuilders									
BA	Boeing	\$184.8	18.5x		1.9x	12.4x	2.10%	\$325.47	\$394.28 - 292.60
GD	General Dynamics	\$50.6	14.7x	4.0x	2.0x	16.6x	2.18%	\$171.01	\$230.00 - 164.76
HII	Huntington Ingalls	\$8.6	12.4x	4.7x	1.5x	12.4x	1.72%	\$199.69	\$276.69 - 194.61
HRS	Harris Corporation	\$17.5	18.3x	5.4x	2.8x	23.2x	1.85%	\$148.44	\$175.50 - 134.30
LMT	Lockheed Martin	\$83.1	15.4x	88.1x	1.8x	34.4x	3.01%	\$292.23	\$363.00 - 277.20
NOC	Northrop Grumman	\$46.5	14.9x	5.1x	2.1x	15.3x	1.79%	\$267.85	\$360.88 - 245.57
RTN	Raytheon	\$49.1	15.0x	4.3x	2.2x	18.8x	2.01%	\$172.43	\$229.75 - 162.31
BWXT	BWX Technologies	\$4.2	17.4x	10.6x	3.6x	61.4x	1.52%	\$42.18	\$72.18 - 40.22
Aircraft Equipment									
ESL	Esterline Technologies	\$3.6	27.1x	2.0x	1.4x	16.8x	0.00%	\$121.70	\$122.00 - 67.15
HEI	HEICO	\$4.3	40.8x	8.1x		37.1x	0.15%	\$81.49	\$94.12 - 57.95
HXL	Hexcel	\$5.1	17.9x	3.7x	2.9x	13.1x	1.01%	\$59.15	\$73.42 - 56.34
MOG.A	Moog Inc.	\$2.5	14.6x	2.2x	1.1x	27.1x	1.28%	\$77.89	\$93.93 - 68.37
TDG	TransDigm	\$18.4	21.0x		5.4x	18.9x	0.00%	\$348.08	\$377.67 - 265.29
TXT	Textron	\$12.1	14.6x	2.2x	1.1x	9.7x	0.16%	\$49.97	\$72.87 - 49.83
Consulting & IT									
ACN	Accenture	\$106.7	22.2x	9.9x	2.7x	17.4x	1.82%	\$160.25	\$175.64 - 146.05
BAH	Booz Allen Hamilton	\$7.2	18.9x	11.1x	0.9x	15.5x	1.51%	\$50.37	\$52.88 - 35.21
CACI	CACI International	\$4.0	17.0x	1.8x	1.0x	12.5x	0.00%	\$161.19	\$200.85 - 131.70
LDOS	Leidos	\$8.8	12.7x	2.5x	1.0x	10.7x	2.19%	\$58.44	\$72.30 - 57.50
SAIC	Science Applications	\$3.0	17.9x	7.3x	0.7x	12.2x	1.78%	\$69.67	\$93.31 - 63.15
Defense Technology									
AAXN	Axon Enterprise	\$2.6	58.0x	5.7x	4.2x	47.4x	0.00%	\$45.12	\$76.45 - 24.50
AJRD	Aerojet Rocketdyne	\$2.7	26.1x	6.7x	1.2x	9.6x	0.00%	\$35.00	\$38.92 - 24.41
AVAV	AeroVironment	\$1.8	106.0x	4.0x	4.8x	36.1x	0.00%	\$73.42	\$121.32 - 41.60
FLIR	FLIR Systems	\$6.1	19.1x	3.1x	3.6x	16.4x	1.46%	\$43.90	\$63.88 - 43.22
KTOS	Kratos	\$1.5	76.6x	2.9x	1.3x	309.6x	0.00%	\$14.55	\$16.09 - 8.90
OSIS	OSI Systems	\$1.3	20.1x	2.8x	1.3x	14.5x	0.00%	\$73.89	\$82.94 - 50.50

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