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## World Peace through Higher Oil Prices

Whether oil prices keep rising or not, one thing we know for sure is that the economies and stock markets of the world are becoming increasingly sensitive to the price of crude. The most obvious beneficiary of rising prices are the energy stocks themselves and if oil keeps rising there probably will be no better way to participate in its strength. However, with oil at \$125, the probability of a significant pullback of 10-20% is high, especially when one considers that crude has risen roughly 40% since February. Therefore, it leaves many asking: Is there a less risky way to benefit from higher energy prices? We believe the answer is yes and one implementation alternative is through the defense industry.

### Global Stability is more important when energy prices are high:

The credit crisis, falling home prices and rising food and energy costs has put the economies of the developed world in fragile shape. In this state, they are more susceptible than ever to external pressures, particularly on the consumer. How do you insulate the economy from price spikes? Increasing spending on defense budgets is one of the more popular approaches. Especially in the counter-terrorism/intelligence fields. We think it is wrong to assume that defense budgets will only increase when there is actual conflict we believe the threat of conflict, or the desire to prevent conflict are equal if not greater motivation.

The desire for increased defense spending does not just come from the U.S. but from around the world. The economies of developed nations like those in Europe are similarly vulnerable to price spikes in crude oil and have an equal desire to maintain global stability. Additionally, many of the developing world economies can attribute their recent fortunes to rising exports of commodities and have no interest in the long-term demand destruction that comes with volatile commodity prices. We think this is one of the reasons there has been rising merger and acquisition activity in the space, including but not limited to the recent bid for DRS Technologies (DRS-N-\$79.25) by an Italian defense firm.

**Valuation:** With the war in Iraq no longer in the forefront of investor's minds, a slowdown in defense spending is being anticipated by the market. While the EPS growth of the major defense companies has chugged along at 25+% since 2003 analysts only expect these companies to grow their earnings at a reduced 15% rate going forward, which we believe may be too pessimistic. Even with the slower growth, we believe the group is still priced attractively at 14.7x 2008 estimates, which is a discount to the 16.2x valuation of the equally-weighted S&P 500.

**Bottom Line:** We believe the defense industry offers a less volatile opportunity to participate in rising energy prices. Since defense expenditures are most often determined through the legislative process, they tend to move in long-cycles and be relatively predictable. With tensions building in many energy-producing regions and gasoline hitting \$4.00 at the pump, legislators are unlikely to pull back on the dollars earmarked to defense programs.

**Strategy:** We believe all defense companies should benefit from this trend, however we favor defense companies with the following characteristics:

1. **Pure-Plays are Better:** The problem with a number of defense companies is that they are also heavily involved in the commercial aerospace industry. The commercial aerospace industry tends to be more economically cyclical and is coming under pressure from the problems plaguing the major carriers.
2. **Information over Iron:** The defense industry of the 21<sup>st</sup> century is becoming much different than that of the 20<sup>th</sup> century. The greatest growth opportunities, we believe, are in the companies making information collection, collaboration and analytical tools. Tanks, subs and ships will always be important, but it will be the information companies that take center-stage going forward.
- **A few of our favorites include: L-3 Communications (LLL-N-\$110.14), Harris (HRS-N-\$60.14), iShares Aerospace & Defense (ITA-A-\$65.82).**

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