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## Current Views

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We have recently allocated a portion of the portfolio to the defense industry. While we believe that both of the individual stocks which we purchased have significant upside potential on their own merits, we also view the aggregate exposure as a part of our risk management strategy. In this commentary we discuss why we believe defense stocks may be effective portfolio hedges.

There are several criteria that we look for when screening securities for risk management effectiveness. A good place to begin is beta; a measure of a stock's sensitivity to overall market movements. Here we like to see low betas, as these are the stocks that are less likely to decline significantly in an adverse market environment. These are also the companies that tend to exhibit a low correlation with the business cycle; a key consideration when determining the usefulness of a security as a risk management tool. Valuation multiples (such as the price-to-earnings ratio) are another important factor to consider. Stocks which trade at lofty PE ratios are often expected to show outsized earnings growth. Should the company be unable to meet these aggressive expectations precipitous share price declines often follow. Therefore for a stock to fit into our risk management classification, we look for low valuation ratios, both in the absolute and relative to historical averages. A final consideration is how the security reacts to unexpected geopolitical events. Positive price movements in response to acts of war and terrorism are one of the attributes that has historically made gold an effective portfolio hedging tool.

The defense industry currently scores well on each of these parameters. Many defense stocks carry low betas. They also have very little correlation with the business cycle, as the key driver for the industry isn't the overall economy but instead the outlook for the defense budget. In this regard, the recently released defense budget request was above consensus expectations, and it appears likely that the base budget will grow steadily over the next several years. In terms of valuation, the group is trading at a meaningful discount to its average over the last twenty years. Additionally, defense stocks are one of the few groups to provide a strong geopolitical hedge to the portfolio. Unlike the market at large, they tend to react favorably to unexpected geopolitical events. As a final test, we looked at how the group performed during 2008, the worst year for the S&P 500 since the Great Depression. The industry meaningfully outperformed the broader market in 2008 as we would have expected, given its aforementioned characteristics. For all of these reasons, we are comfortable utilizing certain defense stocks as a part of our risk management tool kit.

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