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Why Defense Stocks Are on the Offensive

A proposed military spending hike has defense contractors and shareholders taking aim at higher profits.

By Lou Carlozo, Contributor |

Four ballistic missiles launched during a military drill in North Korea earlier this year. (STR/AFP/Getty Images)

What happens when North Korea shakes its nuclear fist at the world? While most might think of the answer in terms of stockpiles rather than stock markets, Tom Vilord of Turnersville, New Jersey, sees the latest military machinations through the lens of a value investor.

Hence, he's just written about the very subject on his website, in a piece entitled "North Korea Launches Another Missile, A Defensive Opportunity."

"If we go to war with North Korea, there will be a lot more military spending," says Vilord, the president and CEO of Wall Street Value, an investor education company dedicated to the methods made popular by Warren Buffett.

Vilord notes that the Trump administration "already plans on spending $54 billion on our military and defense. There will be a lot of companies that could benefit from such spending."

The figure amounts to a 10 percent hike in the U.S. defense budget – thus it's no stretch to imagine military contractors gaining that much in revenue, if not much more. Companies such as Northrop Grumman Corp. (NYSE: NOC) already enter this era of proposed new spending in fine shape; NOC has risen close to 30 percent over the last 12 months and currently trades at about $272 per share.

Chicago-based Boeing Co. (BA) is flying even higher. The aerospace giant – already one of the world's largest defense contractors – has gained close to 85 percent during the same period to $240 per share.

No wonder, then, that the defense sector as a whole is clear for takeoff.

"The aerospace and defense industry, up 28 percent year-to-date, is the main driver of the S&P 500 industrials sector performance this year," says Jennifer Olson, senior financial analyst at Apriem Advisors and based in Irvine, California.

Like Vilord, Olson points to proposed military expansion as reason to be bullish, especially when placed in context of global current events. "Heightened geopolitical tensions across the world, international terrorist attacks, as well as domestic tensions, add to opportunities for defense contractors," she says.

To be certain, some exchange-traded funds reveal potential yellow flags in the defense market.

"Using SPDR Aerospace and Defense ETF (ticker: XAR), the industry is expensive compared to the market as a whole," Olson says. "But sad as it may sound, as global uncertainties rise so does the defense industry. We will not be surprised to see defense stocks soaring higher."

Another ETF, iShares U.S. Aerospace & Defense (ITA), spiked 10 percent in the hours after Election Day. It's not looked back since, up 20 percent for 2017, says Angelo DeCandia, professor of business and accounting at Touro College in New York City.

That said, DeCandia cautions investors who make too direct a correlation between dire headlines and stock ticker screen crawls.

"The problem with such an investment strategy is that investors buy defense stocks based on the latest news cycle: North Korea just tested its latest ballistic missile, or Trump is pro-military – hence he'll OK every defense contract that passes his desk," DeCandia says. "Dramatic headlines do sometimes spur more defense spending but investing requires a more nuanced approach."

To that end, DeCandia advises looking at stocks that are well suited to grow at a steady clip. He identifies Huntington Ingalls Industries (HII) as one of those companies; its ship design, construction and maintenance functions serve the U.S. Navy and Coast Guard.

"Like all stocks in this sector, HII has experienced a quadrupling in price over the past five years despite the fact that revenues have increased at a tepid rate," he says.

HII has also benefited from big stories both directly and indirectly.

"Huntington Ingalls announced it was selected to repair the recently damaged USS Fitzgerald," DeCandia says. "It's a follow-up to its having repaired the USS Cole – and while these events are not game changers, they show that Huntington Ingalls is the 'go-to' firm for the U.S. Navy, a sign that it's in the thick of things."

But no matter what the numbers say – and on Wall Street, big numbers might as well give a victory speech – some investors can't stomach the thought of making money based on military gyrations of any magnitude.

"As a socially responsible asset manager, we don't invest in defense stocks," says Joshua Brockwell, investment communications director at Azzad Asset Management in Falls Church, Virginia. "But we do monitor market sectors to stay on top of trends. And in our opinion, it isn't necessary to buy the defense sector to outperform."

As for why, "Studies on the value of socially responsible investing bear that out," Brockwell says. "So consider eschewing the sector altogether. A clean conscience could help investors sleep better at night."