

Active Indexes Drive PowerShares ETFs

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By choosing novel types of indexes, PowerShares has widened the range of options available for sector and thematic investors.

Starting off with two exchange-traded funds (ETFs) in 2003, PowerShares is emerging as a strong player in the sector ETF arena. The company introduced 22 sector and industry ETFs in 2005. This was followed by another 21 sector and industry ETFs in 2006. PowerShares is expected to expand the lineup of these ETFs further in the current year.

ETF Index Selection

Unlike the majority of ETFs which benchmark well-known market capitalization-based indexes such as those from Dow Jones & Co. and Standard & Poor's, PowerShares sector and industry ETFs use 'active' indexes. PowerShares also offers some unique theme-based ETFs.

1. Intelligent Indexes: A large number of PowerShares' sector and industry ETFs in the Dynamic series benchmark AMEX's Intellidex indexes. Stocks within each sector or industry are assessed using a variety of criteria such as fundamental growth, valuation, investment timeliness, and risk to identify those with high expected capital appreciation potential. From among such identified stocks, a fixed number is selected each quarter for the sector or industry Intellidex. The Intellidex indexes consist of large-cap, mid-cap, and small-cap segments. Each market cap segment is allocated a collective weight and all stocks within the segment are given equal weight.

2. Fundamental Indexes: Nine PowerShares sector ETFs benchmark the corresponding FTSE RAFI sector index. The FTSE RAFI sector indexes consist of the largest U. S. companies in the sector as determined by four fundamental measures, book value, cash flow, dividends, and sales. An overall weight is calculated for each company by equally weighting each fundamental measure. Firms with the highest fundamental weight are selected and each firm is assigned a weight equal to its fundamental weight. The FTSE RAFI indexes are reconstituted annually.

3. Unique Plays: PowerShares offers some unique industry ETFs. Water Resources ETF (Amex: PHO) and Global Water ETF (Amex: PIO) based on Palisades Water and Global Water Indexes, respectively are examples of niche industry ETFs. Some ETFs also focus on specific investment themes. Lux Nanotech ETF (Amex: PXN) ventures into nanotechnology, a process with application potential in health care, information technology, materials, and industrial sectors. The Lux Nanotech index has holdings distributed across companies in these sectors.



INDUSTRY INSIGHT

AlphaProfit Take

By choosing novel indexes, PowerShares has expanded the investment options available for sector ETF investors. These ETFs can be attractive for investors pursuing a GARP, value, or thematic approach to investing.

1. GARP Investors: Sector and industry ETFs in the Dynamic series offer a compromise between actively managed mutual funds and ETFs tracking low-turnover, static benchmarks. The Intellidex indexes used as benchmark for these ETFs apply rules-based criteria to select securities and are reconstituted quarterly. While specifics of the security selection process are kept proprietary, Amex has disclosed that factors such as fundamental growth and valuation are considered in security selection. By balancing growth with valuation-related parameters, the Intellidex indexes appear to seek 'growth at a reasonable price'. As such, the Dynamic series of ETFs may whet the appetite of GARP investors.

2. Value Investors: The weightings for securities in the FTSE RAFI series of ETFs are derived from four fundamental or accounting measures, book value, cash flow, dividends, and sales. By weighting stocks on these four fundamental measures of a firm's size rather than its market capitalization, the FTSE RAFI indexes seek to avoid over-weighting over-valued stocks and under-weighting under-valued stocks. Value investors typically consider the FTSE RAFI index weighting factors on a normalized basis to screen for attractively priced stocks. Given this similarity, the ETFs in the FTSE RAFI series are more in tune with a value investor's security selection process.

3. Thematic Investors: PowerShares offers a group of ETFs that focus on specific investment themes like clean energy and clean technology. The benchmarked indexes are obtained from organizations having in-depth expertise in niche areas. Global Clean Energy ETF (Amex: PBD) and WilderHill Clean Energy ETF (Amex: PBW), for example, are based on indexes constructed by Wildershires, LLC. These ETFs provide investors with vehicles to invest in themes such as renewable energy sources and environmentally friendly technologies. ■