Clean energy index offers alternative

By Marsha Zapson

When Robert Wilder began looking around in the early '90s for a clean energy index in which to invest, he couldn't find one. So he developed his own. Last August, the American Stock Exchange began publishing the WilderHill Clean Energy Index (AMEX: ECO), and this March, PowerShares launched an ETF (AMEX: PWB) tracking that index. Since ECO went live through mid-February it's up 25.9%. This ETF is unlike any other energy ETF. It shies away from the big oil and gas, equipment and services stocks that make up other energy ETFs, in favor of smaller firms using alternative production methods. Investors now have an alternative to oil- or coal-based funds, and can buy a diversified basket of companies operating in a notoriously volatile sector. Because the index focuses on renewable sources of energy, technologies facilitating cleaner energy, and environmentally friendly companies, many consider it to be a socially responsible investment. While Wilder says he is not surprised it's viewed this way, "we don't mainly promote ECO as an SRI, even though it's the leading green energy index." PWB comes to market at a time when clean energy, according to Clean Energy Research, is predicted to grow to $92 billion by 2013, or about seven times its current size of $13 billion. The combined clean energy markets of solar, wind and fuel cell has delivered a 36% annual growth rate since 2002, when it was a $9.5 billion industry. There are many influences driving the clean energy markets, not the least of which is new legislative initiatives.

Fourteen states in the US have created special funds to support clean-energy projects and are expected to spend nearly $4 billion by 2012, while a growing number of states are requiring utilities to purchase a portion of their power from renewable sources. Against that backdrop, oil prices are spiking, the US has had rolling brown and black outs, and after September 11, oil supplies have become more vulnerable and less certain.

At the same time, clean energy has become more cost effective, hovering around four or five cents per kilowatt hour for wind power, and making it cost competitive with coal, says Wilder.

Looking to small caps

After a decade-and-a-half journey, investors now have an alternative to oil or coal-based funds. Index and ETF hold 37 publicly traded, small and micro companies belonging to six industry groups: renewable energy supplies, energy storage, cleaner fuels, energy conversion, greener utilities, and power delivery and conservation. ECO is a modified equal weighted index in which industry groups are weighted according to their importance and technological relevance. "We weighted renewable energy harvesting at 15%, which is a significant sector weighting, because we believe it's more important than cleaner fuels, for example, which are weighted less," says Wilder. In mid-February, the index's five largest holdings accounted for less than 20% of the portfolio. In order to ensure that a few stocks do not overwhelm ECO definitions and so skew performance, all components are returned to 3% maximum weight at quarterly rebalancings. The top five holdings in other energy ETFs, including XLE, the Energy Select Spider which tracks the S&P Energy Select Sector Index; IYE, an iShares product that tracks the Dow Jones US energy sector index; VDE, Vanguard's recently introduced energy product; and OIH, the Merrill Lynch oil service sector HOLDRs basket, account for over 50%. Interestingly, ECO's most heavily weighted stock is Evergreen Solar (NASDAQ: ESLR) at 4.4%. It's also a company with a smaller market capitalization ($256.2 million) than the majority of stocks in the index. Most index components have a market cap of $200 million and above, although smaller companies with $50 million to $200 million may also be included. "That's one reason why ECO is doing so well, we allow small caps to outperform," says Wilder. "There's much more market inefficiency in the small cap arena, and we take advantage of that inefficiency." There is a strong bias in favor of the p u re-play companies in wind power, solar power, hydrogen and fuel cells, biofuels, and related field. Companies in relevant fields such as hydroelectric, geothermal, wave, waste heat recapture and others will be considered with respect to carbon content, impacts on marine and terrestrial biodiversity, and the degree to which they advance or reflect the clean energy sector.

Enter PowerShares

The original iteration of what is now the WilderHill Clean Energy index began life as a hydrogen fuel cell index in 1999, designed by Wilder and Joshua Landess, who is ECO's director of securities research. "After selecting a group of technically relevant companies in renewably- made hydrogen and fuel cells and analyzing them from green as well as business perspectives, we laid out what we deemed appropriate weightings to arrive at a simple working first index unlike any other," says Wilder. The index was posted on the Net and not long afterwards was getting about 100,000 hits a month, he says. Then began a steady stream of emails from investors asking if the index was investable, and Wilder began to think it should be the basis for a mutual fund. However, the large mutual fund houses as well as the socially responsible ones were not interested "because it was outside the mainstream." Then PowerShares Capital Management, a privately held company based in Wheaton, Ill, stepped in. PowerShares, which is doing some of the more innovative work in the ETF industry these days with its enhanced indexing concept, approached Wilder with the idea of creating an ETF. PowerShares' two initial products, Dynamic Market Portfolio (PWC) and Dynamic OTC Portfolio (PWO), were launched in 2003 and have achieved their stated goal of out-performing conventional benchmarks. Despite holding just 100 stocks, the broad market Dynamic Market Portfolio returned 18.1% last year, compared with the 10.7% return of the SPDR and the 12.8% gain of the Total Market VIPERs (VTI). The Dynamic OTC Portfolio was up 12.6%, compared with the 10.5% gain in QQQQ. PWC's out-performance is due to its index design, says Bruce Bond, PowerShares' president. Its indexes, which are called Intellidexes, are designed and calculated by the Amex and are "the first of their kind," he says. "Regardless of the market, Intellidexes select stocks in any given size and style universe that have the greatest capital appreciation potential of the group," he says. It's a factor that brings a hint of active management to the ETF world. PowerShares has big ambitions. It added two ETFs in late 2004—the High Yield Equity Dividend Achievers Portfolio (AMEX: PEY), and the Golden Dragon Halter USX China Portfolio (AMEX: PGJ)—and plans to introduce six value and growth products, and 17 narrowly based sector products, all using the Intellidex methodology, in the first half of 2005. PWB, which is part of this traunch, is too young to have a meaningful track record. But it will be interesting going forward, to see how the ETF (and ECO) does and whether it offers uncorrelated returns to the energy sector and other energy ETFs.