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PBW: Strong Performance, High Level of Risk

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With a 58.5% market return in 2007, Power- Shares WilderHill Clean Energy Portfolio ETF (PBW) ranked sixth among all ETFs, according to Morningstar. It's currently the top ranked fund in our PowerShares Momentum Tracker newsletter.

PBW, one of four PowerShares funds focused on green technology and alternative energy, rode a tide of sky-high oil prices, investor sentiment for alternative energy stocks, and the successful efforts of many solar stocks—most notably First Solar, the fund's top holding, which saw share prices rise nearly eightfold in 2007—to post a return that was more than 10 times better than that of the S&P 500.

As society, driven by environmental concerns and high energy prices, moves toward cleaner energy, the fund and its alternative-energy brethren have been among the top performers in a jittery market. Established in March 2005, PBW is the oldest and largest such fund, with nearly $1.4 billion in total assets, up from just $300 million in March 2006.

The massive inflow and the otherworldly returns came as crude oil prices shot through the roof. While the fund has recently focused heavily on the stocks of solar power firms, it also invests in the stocks of firms developing technologies in wind energy, transportation, and renewable fuels.

Bottom line? PBW tends to rise in concert with crude oil prices, which jumped 57% in 2007, hitting a record $99.29 per barrel on Nov. 21 and closing the year a hair below $96.

Historically, oil prices are notoriously hard to predict. So, too, is another key to PBW's performance: the movements of the U.S. and world governments to tighten environmental regulations.

The fund's latest boost, a gain of 23.1% from Nov. 23 to the end of 2007, came from the passage of (and buildup to) the Energy Independence and Security Act of 2007, signed into law just before Christmas. The law calls for a quadrupling of alternative fuel use over the next 15 years and once again boosted investor sentiment toward alternative energy.

China followed by announcing plans to up its use of renewable energy over the next 12 years, aiding the entire alternative energy sector, especially China-based firms including three of PBW's top holdings: Suntech Power, JA Solar, and Yingli Green Energy. The three stocks averaged a 22.3% return in the last month (through Dec. 31), and a one-year gain of 234.3%.

Those types of returns weren't unusual. PBW's top 10 holdings posted an average gain of 251.7%, and the worst performer among them—MEMC Electronic Materials, which makes wafers for semiconductors— posted a 2007 gain of 126%.

Top holding First Solar, whose shares gained 795%, was one of the biggest stock stories of the year. The company strode toward making solar power cost-competitive with conventional forms of electricity generation, a key to long-term success for the company, the sector, and the fund. Share prices shot up from about $20 at the firm's 2006 IPO to a 52-week high of $283 in late December.

Despite PBW's success, investors here should be prepared for extraordinary volatility. The combination of stocks from small, often unproven firms, a tight connection to oil prices, and the uncertain effect of government policy almost guarantees that PBW will have violent swings.

The fund's NAV has risen 77.3% since inception, but not necessarily smoothly. In its 11-quarter history, the fund has gained or lost 8.5% or more in all but two. The gains (six) outdo the losses (three), but the volatility is notable.

Even in 2007 PBW felt some nasty downdrafts. The fund closed out the year with a 23.1% gain from Nov. 23. But right before that, PBW's NAV fell 8.9% in less than a month. From July 13 to Aug. 3, the fund's NAV dropped 9.4%.

PBW carries an average market cap of just over $2 billion, but that number—which may be skewed by First Solar's $20.7 billion cap—belies the fund's concentration in smaller stocks. In fact, the fund holds no giant cap stocks, and nearly 63% of assets were plugged into small (45.5% of assets) or micro cap stocks, according to Morningstar.

During such a run-up investors should keep an eye on how expensive the sector's stocks and the fund have become. Among the 67 ETFs that posted 2007 gains of 20% or better, PBW's price-toprospective earnings ratio of 27.82 ranked second highest.

Some stocks, such as First Power (192.3), carry P/E ratios that may be reminiscent of some tech stocks just before the bubble burst. PBW has a lot going for it in both the short and long term, but because of its high risk level it's most likely suited to be no more than a niche holding.

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