Excerpt from Wall Street Journal, October 5, 2009
http://online.wsj.com/article/SB10001424052970204518504574418683155971954.html?mod=googlenews_wsj

The Price of Green

Specialized funds invest in alternative energy and avoid polluters. But a narrow scope can mean big risk.

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Some financial planners and green-investing professionals say the near future bodes well for companies involved in green industries because of what many see as an eco-friendly White House, economic-stimulus money earmarked for alternative-energy technology, and proposed legislation in Congress that seeks to cut greenhouse-gas emissions and establish standards for energy efficiency.

The "policy and regulatory environment is going to be a boon for green investing, as companies across industries scramble to realign their carbon intensity and how they perform energy-efficiency-wise," says Bennett Freeman, the senior vice president for sustainability research and policy at Calvert Asset Management Co., a longtime participant in socially responsible investing and the manager of the Calvert Global Alternative Energy fund.

But investors tempted by green investing need to choose funds carefully and understand that some of these sectors can be very volatile, as illustrated by the bankruptcy of multiple ethanol and biofuel producers, as well as struggles among small solar-power companies, amid a drop in oil prices over the past year. It is also important to recognize that buying into green businesses and shunning those that are harder on the Earth's resources won't benefit the environment directly.

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A wide range of fund strategies fall under the green label, says Morningstar analyst Michael Herbst. The narrowest funds and ETFs are dedicated to specific sectors, such as solar power or water treatment. Others hold a mix of such stocks and "because they are a little more broadly diversified, their performance tends to be less volatile over time," he says. Less common are funds that consider green factors in their stock selection but also include a broad enough range of stocks to serve as a core holding in an investment portfolio. Most green mutual funds and ETFs are on the smaller side, with all but a few having less than $300 million in assets; a couple of the narrow sector ETFs are among the largest portfolios.

Green Sector Bets

Among the narrow and volatile green portfolios are two ETFs that focus on solar energy: … and …. They are both down 45% over the past 12 months, while the Standard & Poor's 500-stock index declined 6.9%.

"Any time you make a sector bet, you are making a very narrow bet that has lots of opportunities to go wildly wrong," says Milo Benningfield, founder of Benningfield Financial Advisors in San Francisco. Just make sure you are "comfortable with that and have the capacity to take on that risk."

A drop in the price of oil, which made alternative energy sources less viable economically and less attractive to investors, weighed heavily on the solar sector and other alternative-energy areas in the past year. But Claymore Securities Inc. President Christian Magoon says that if the U.S. passes legislation favorable to alternative energy, solar-energy stocks could get a big pop. "There's a lot of volatility in solar stocks," he says.

PowerShares WilderHill Clean Energy, a somewhat broader alternative-energy portfolio, has also taken investors for a bumpy ride. The ETF gives investors exposure to areas including ethanol, solar and wind power, and energy efficiency. Over the past year, the fund—one of the larger green portfolios, with a recent $783 million in assets—returned a negative 27%. Over the past three years, it has declined an average 13.5% a year, trailing the S&P 500 by more than eight percentage points.

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