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Alternative Energy: Time To Invest?

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The PS Wilderhill Clear Energy ETF (AMEX:PBW - News) has traded for just three months. Investors cheered PBW's introduction to the ETF world as an efficient new tool for investors to diversify a bet on rising energy prices. Many investors reasoned that high oil prices and rising world demand for oil should make the business model of companies pursuing alternative energy technologies like those held in the PBW portfolio more viable. Since its introduction however PBW has lost ground quickly. Is it still too early to invest in alternative energy technologies?

The chart below compares PBW to a traditional oil sector ETF, the Energy Select Sector SPDR (AMEX:XLE - News) as well as the benchmark Standard and Poor's Depositary Receipts (AMEX:SPY - News).

As the chart above shows, on a 7-day basis PBW and XLE seem to track each other closely. Both hit their 3-month lows in mid-May, with XLE down over 10% and PBW down 15%, but while XLE has recovered since then to trade higher than the benchmark SPY, PBW continues to lag.

While PBW has been in existence just three months, it is designed to track the Wilderhill Energy Index, known as ECO. A look at the ECO index may provide some direction for PBW. The two-year chart below compares the ECO index with the price of a barrel of crude oil, a key input for energy ETFs. The crude price is shown in blue below, Wilderhill Index in black.

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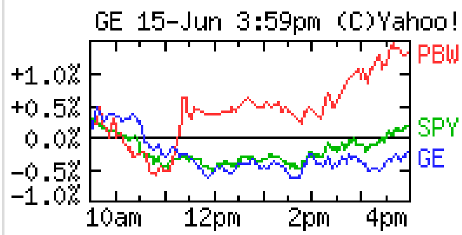

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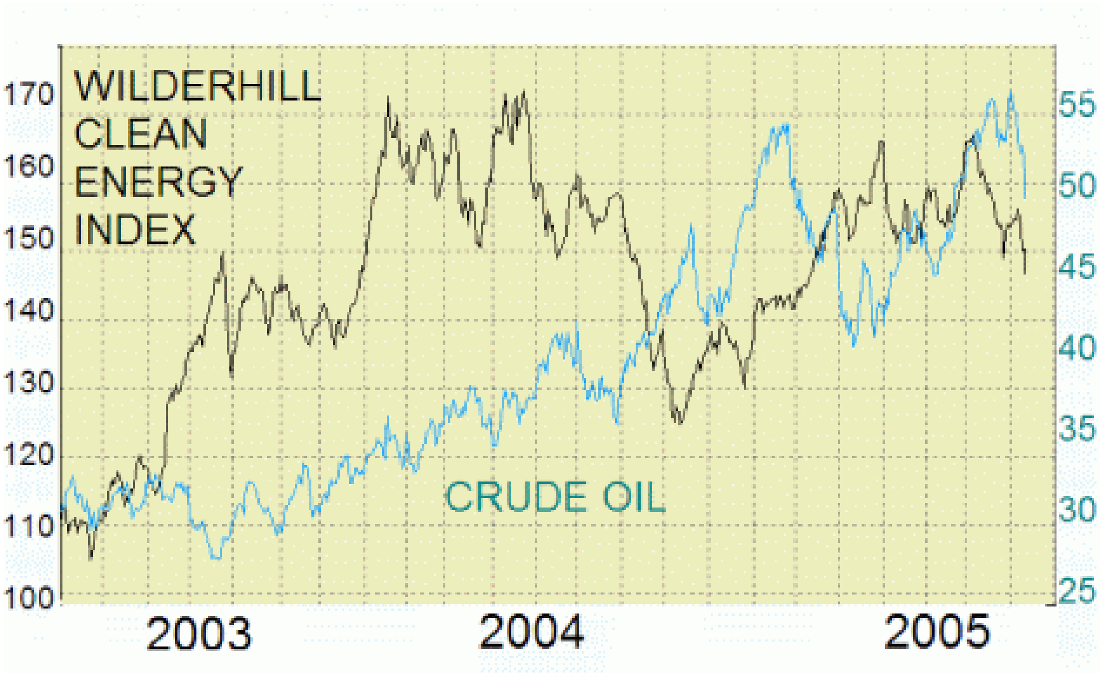

Over the two-year period represented in the chart, Wilderhill Index correlates with the price of crude, though on greater volatility. However, while crude in the past two years has nearly doubled, from about $30 a barrel to above $55, the Wilderhill index is up by just a third.

Clearly, there are problems with using the price of crude, or companies processing crude, as an indicator for renewable energy companies such as those held in PBW. One problem is that renewable energy companies primarily target electricity generation. According to the Department of Energy, oil provides only 3% of electricity production. Compare this number to that of coal (53%), nuclear (21%), natural gas (15%) and hydropower (7%). Although electricity prices have moved higher in the last two years as commodities from coal to uranium have soared, the prices have not moved as quickly as oil.

The second problem with comparing oil prices, or the price of oil service companies, with that of alternative power, is a difference in business culture . Oil companies are among the largest and most highly capitalized companies in the world. The alternative and renewable energy universe, however, is populated mostly by much smaller organizations, reminiscent of early-stage biotech companies or, as some hope, the internet companies in the early days of the Web. Some alternative energy technologies are just coming online, others are advancing at a snails pace, and many remain mostly theoretical. A number of alternative energy technologies remain dependent on some form of government or legislative subsidy to be viable.

Renewable energy, however, is becoming increasingly important, faster than many people realize. In Denmark, for example, over 20% of power usage today comes from wind power alone. In Germany, over 6% of total usage comes from wind. Currently US wind energy capacity, at about 6,500 megawatts (an amount equivalent to the usage of about 1.5 million average American households) lags Germany's 15,000 MW of wind power. In comparison to the US the EU as a whole has over five times the US capacity, about 30,000 MW. But the US Department of Energy has recently announced a plan that will require 5% of US energy consumption to come from wind by 2020. While government initiatives, especially in the energy sector, have a reputation for derailing, renewable domestic power production is conservatively expected to grow at least 1.5% per year, a higher growth rate than any other domestic energy source. Political will or technological innovation may triple this rate.

Investors have begun to take note of the opportunity. Goldman Sachs, not exactly known for its socially conscious investment focus, recently acquired Houston-based Zilkha Renewable Energy, one of the largest wind-energy development companies in the US, to add to its portfolio of 30 wind energy development plants. Another big player, General Electric (NYSE:

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GE - News), after acquisitions in a variety of alternative energy technologies, including Enron Wind and solar photovoltaic cell producer Astro Power, now has a 20 billion dollar renewable energy portfolio. Specific components of PBW, such as Energy Conversion Devices (Nasdaq: ENER - News) and Evergreen Solar (Nasdaq:ESLR - News), have as much as quadrupled on a two-year basis.

It's been pretty easy for ETF investors to make money in the energy sector over the last couple of years, simply by buying traditional oil sector ETFs like XLE. With demand for energy surging higher, and crude consistently trading at or near all-time highs, investors in XLE and other traditional energy ETFs have enjoyed a steady run with relatively low volatility. With oil trading late Monday at over $55 a barrel, there seem to be few arguments for any change in strategy for these investors. However, as oil is depleted, and as environmental concerns related to burning fossil fuels grow, alternative energy investments will likely become increasingly important to any energy portfolio.

The problem with investing in the new PBW is that, even if some of the speculative technology companies it holds succeed, it is not clear whether it will be a winner; GE or private wind farms owned by the likes of Goldman Sachs may be the ones who come out ahead. Although PBW has its critics and its problems, the Wilderhill Index which it tracks has had strong returns over a two-year period and it, like the companies that it tracks, deserves a serious look from investors.

Jonathan Bernstein has specialized in short-term trading of equities and equity options since 1998.

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