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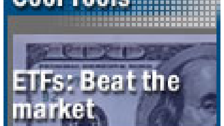


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## Fund Spy

# A new ETF player worth watching

Upstart PowerShares has just four funds so far, but big plans -- and its ETFs don't just aim for the usual benchmark indexes, but to beat them.



By Morningstar

The exchange-traded fund world is filled with cute sobriquets: iShares and PowerShares, SPDRs and Vipers, StreetTracks and Qubes. Smart investors know there's more to an investment than a catchy name, though. There are investment advisors of varying sizes and expertise behind those monikers.

To help put these firms and their places in the industry into context, this column will offer periodic reviews of ETF purveyors. We'll start at the bottom -- size- and age-wise -- with industry upstart, PowerShares Capital Management of Wheaton, Ill.

PowerShares was founded by former Nuveen Investments sales and marketing executive H. Bruce Bond in August 2002. Its offices are in a single-story professional building next to a suburban Chicago children's zoo -- a location that belies the splash the firm is trying to make in the ETF industry. With more than $500 million in assets at the end of January 2005, PowerShares is still minuscule compared with industry-leader Barclays Global Investors and its $114 billion iShares ETF family. However, it has attracted attention with its unorthodox offerings: Whereas all other ETFs track traditional indexes, PowerShares' strategy is to offer ETFs that track specialized indexes designed specifically to beat the usual benchmarks.



### Overpowering the indexes

PowerShares' first two funds, **PowerShares Dynamic Market** (PWC, news, msgs) and **PowerShares Dynamic OTC** (PWO, news, msgs), track the American Stock Exchange's Intellidex indexes. These benchmarks are reconstructed by Amex once a quarter based on a quantitative stock-picking model that trolls for the most promising securities in the broad U.S. stock market and the Nasdaq Composite, respectively. So far, the funds have been able to beat their respective benchmarks. The funds' trailing one-year gains through Feb. 4 -- 17.2% for the Dynamic Market fund and 9.3% for the Dynamic OTC portfolio -- are far ahead of the **S&P 500** ($INX), which rose 8.5%, and the **Nasdaq Composite** ($COMPX), which advanced 3.6%. Both funds are below the median size for ETFs, but the

Dynamic Market ETF's strong absolute performance has helped it gather $254 million in less than two years.

The firm has since launched two additional ETFs: **PowerShares Golden Dragon Halter USX China** (PGJ, news, msgs) and **PowerShares HighYield Dividend Achievers** (PEY, news, msgs). However, founder Bond's ambitions go beyond the four ETFs in its current lineup. PowerShares currently has 24 offerings awaiting approval from the Securities and Exchange Commission. In terms of the number of ETFs offered, that would make it the second-largest ETF provider behind industry-behemoth Barclays. The ETFs in registration include some tracking style-based bogies that use the Intellidex methodology and one following a clean energy index. Those are set to launch March 3. Other sector ETFs as well as ETFs aping benchmarks built by Zacks and ValueLine also are in the works.

Clearly, Bond is focused on growth. He hopes to have $2 billion to $3 billion under management by year end. In part, the firm will use its unique focus on nontraditional benchmarks to drive expansion, but it also has chased hot money. PowerShares launched its dividend-focused and China ETFs last year (after iShares rolled out its own versions) as strong recent performance and other trends, such as favorable dividend tax law changes and rapid Chinese economic growth, increased interest in such strategies.

### An unproven player

PowerShares has turned some heads. The firm still has a lot to prove, though. Its oldest funds, the Dynamic Market and Dynamic OTC ETFs, have fared well and have avoided costly capital-gains distributions even though their portfolio turnover rates resemble those of actively managed funds. Nevertheless, their records remain short, and it's unknown whether Intellidex indexes will be able to thrive in all market environments. Indeed, the market has a way of catching up with quantitative models, lessening their effectiveness over time.

The biggest hurdle facing PowerShares, however, is distribution. It's hard for new ETFs to grab assets from established players, but the firm has sought approval from the SEC for a novel and controversial remedy. It wants to charge a 2% load on ETF shares sold during their initial subscription period. The loads, which would include break points for larger investors, are designed to induce brokers and financial advisors to sell PowerShares ETFs and increase their economies of scale, Bond argues.

No ETF has charged a load before, not even PowerShares, as the SEC has yet to give its blessing. If it does, it would be cheaper for many investors, especially those who use discount brokers, to avoid the sales charge by buying the ETFs in the secondary market after their initial public offerings. Bond says his firm many not need or use the loads, and we hope they don't.

PowerShares' expense ratios already are above average for ETFs. The loads would add a layer of cost and complexity and detract from one of the central appeals of ETFs: The affordability and transparency of their fee structures.

### David among Goliaths

Finally, PowerShares is thinly staffed and faces competition from above and below. The company currently consists of four partners and about eight employees. It has just one portfolio manager, John W. Southard. He is a former senior analyst of Chicago Investment Analytics, a quantitative research firm bought by Charles Schwab SCH in 2000. He also worked as an analyst and portfolio manager at a unit investment trust firm, First Trust Portfolios of Lisle, Ill. But he has a short track record as a retail mutual fund or ETF manager.

The firm still lacks the resources of established ETF players such as Barclays or SSgA, as well as other recent entries into the ETF market, such as Vanguard, Fidelity Investments, and Rydex. Although, PowerShares is sure to add people and capabilities as it grows. In fact, San Francisco venture capital firm FTVentures is expected to make a $10 million commitment to the shop. There also is at least one other start-up ETF firm backed by deep-pocketed investors. Index Development Partners was founded last year by former American Express chairman and CEO James D. Robinson III and counts Wharton professor and Stocks for the Long Run author Jeremy Siegel as a board member.

So far PowerShares has proved that it is worth keeping an eye on. It's not clear if it will succeed at playing David to the ETF industry's Goliaths, though. Investors should consider its relative inexperience and lack of scale before making any decisions.

*-- By Dan Culloton*

*Barclays Global Investors (BGI), which is owned by Barclays, currently licenses Morningstar's 16 style-based indexes for use in BGI's iShares exchange-traded funds. iShares are not sponsored, issued or sold by Morningstar. Morningstar does not make any representation regarding the advisability of investing in iShares.*

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