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PowerShares To Launch Juiced Up ETFs

PowerShares, a privately held firm in Wheaton, Ill., is seeking to launch a stable of 26 exchange-traded funds, some of which will attempt to beat a variety of market indexes.

Most ETFs resemble index-tracking mutual funds, but trade on an exchange like a stock. Actively managed ETFs, which are still being developed, would reflect the choices of a professional asset manager, rather than the relatively static holdings within an index. Though some firms are reportedly close to launching active ETFs, they have taken years to develop because their structure is quite complex.

However, PowerShares Capital Management, has come up with something in the middle of the two. It launched two such ETFs in May 2003, and is now seeking approval for 21 more, according to a July filing with the Securities and Exchange Commission. The remaining five to be launched will track various other indexes.

PowerShares' inaugural ETFs track "enhanced" or "intelligent" indexes—called Intellidex Indexes, which were created by the American Stock Exchange—that attempt to outperform their respective market-segment benchmarks. Each index evaluates companies across a variety of categories, including fundamentals, valuation and risk. The indexes rebalance quarterly and can be most easily compared to a quantitative mutual fund.

"What the indexes are designed to do is to have representation of a market sector, but then what they attempt to do is give you that exposure by owning the highest-quality stocks or those with the greatest investment merit," said Bruce Bond, president of PowerShares. Essentially, it attempts to achieve "outperformance with less risk."

"Most indexes were developed to track different segments of the market, not to outperform the market," added Christopher Traulsen, a senior analyst at Morningstar. "These indexes are designed to outperform the market."

While the costs of the new ETFs have yet to be disclosed, PowerShares' existing two products are pricier than most: PowerShares Dynamic Market

Portfolio (PWC) and PowerShares Dynamic OTC Portfolio (PWO) both carry expense ratios of 60 basis points, or 0.60%. That's much higher than the average domestic equity ETF, which charges 36 basis points, according to Morningstar. The cheapest ETF, the iShares S&P 500 (IVV), charges nine basis points and the popular Nasdaq-100 Index Tracking Stock, known by its trading symbol QQQ, charges 18 basis points.

Meanwhile, the new ETFs also will carry a sales charge of 2%, something ETF investors aren't accustomed to. In fact, one of ETFs' biggest draws is the fact that they are so inexpensive. So why the sales charge?

"In short, our goal is to provide ETFs to the retail marketplace," Bond said. "By having the 2% load on there, it allows us to introduce the product using the syndication process, which will introduce it quickly, more like a closed-end fund or an initial public offering of a company."

By incorporating the sales charge, it provides a distribution platform on which the ETFs can be introduced, as well as an incentive for financial advisers and brokers to sell the product through their distribution networks. The charge applies to buyers during the initial subscription offering only. After that period is up, investors only will have to pay the applicable brokerage commissions and expenses that all ETF investors are subject to.

So wouldn't it be worth it to just wait to avoid the charge? Bond says the SEC requires that initial investors must receive some sort of benefit. In this case, he says small investors might spend less paying the 2% rather than paying full-service brokerage commissions. However, with the low cost of trades at many discount brokers, Morningstar's Traulsen isn't so sure.

The question becomes "one, 'Do you want to invest in a family that is brand new?' and I'd say the answer is no, and second, 'Do you want to pay 2% upfront for the privilege?' and again I'd say the answer is no," Traulsen said. (His firm has licensed its style-based indexes to Barclays Global Investors, which offers ETFs that track them.)

It's hard to judge a fund with less than a three-year history, never mind one that's just a year old. However, PowerShares' existing ETFs have done quite well since their inception: PowerShares Dynamic Market Portfolio is up 18.02% over the past 12 months through Wednesday, compared with 7.34% for the Standard & Poor's 500 Index, while the PowerShares Dynamic OTC Portfolio has risen 11.96% over 52 weeks, compared with a 3% gain for the Nasdaq Composite.

Twenty-one of the new ETFs will track the Intellidex indexes, including the PowerShares Dynamic Large Cap Growth and PowerShares Dynamic Large Cap Value Portfolios, as well as ETFs dedicated to midcap growth, midcap value, small-cap growth and small-cap value. Several others will track sectors ranging from biotechnology and genomes to pharmaceuticals, telecommunications, media and semiconductors.

The ETFs also will mimic indexes created by other parties as well, the SEC filing said, including:

• The PowerShares Halter Golden Dragon China Portfolio, which will seek to track the USX China Index, comprised of U.S. exchange-listed stocks of companies that derive a majority of their revenue from mainland China.

• The PowerShares High Yield Equity Dividend Achievers Portfolio, which follows the Dividend Achievers 50 Index, tracking the performance of the 50 companies with the highest dividend yields.

• The PowerShares Value Line #1 Timelines and Safety Portfolio, which will track the index of the same name that will include a group of U.S. stocks that have the potential to outperform the market in the next six to 12 months.

• The PowerShares Wilder Alternative Power Technologies Portfolio, which will track the WilderHill Clean Energy Index that will include companies that focus on technologies for things such as energy conversion and pollution prevention and that utilize greener, more renewable energy sources, the filing said.

• The PowerShares Zacks Rank Large Cap Portfolio, which will try to match the Zacks Rank Large Cap Index, designed to pick companies with superior risk-return profiles that have the potential to outperform both the S&P 500 Index and professional large-cap asset managers.

PowerShares declined to provide further details on the new ETFs because they are in a quiet period given the SEC filing.