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Cleaning Up with Clean Energy ETFs

The regulatory backlash against Big Oil may benefit alternative energy providers

The April 20 Deepwater Horizon explosion in the Gulf of Mexico and the seemingly unstoppable flow of oil from the ocean floor is turning into one of the greatest environmental catastrophes of modern times. The full implications of the disaster will not be known for years, but there is little doubt that there will be far-reaching economic consequences as outrage over the environmental damage will demand political action. A regulatory backlash against offshore drilling has already begun, with US President Barack Obama placing a six-month moratorium on offshore permits and Norway halting new deepwater drilling in the North Sea.

…. With the increased difficulty of accessing hydrocarbon fuels like oil and gas, 'clean' energy like wind, solar or even nuclear power becomes even more viable. However, we are still in the early stages of commercialising most of these alternative energy sources. Without the foresight to pick winners among these alternative technologies, a diversified ETF is a good way to invest in the trend towards clean energy.

Since the accident, BP's stock price has been hammered, falling well over 40% compared to about a 10% decline in the FTSE 100 index. Over that same timespan, the returns on the seven clean energy ETFs available in Europe have been between -4.5% and -16.6%, all of them bettering the returns on the STOXX 600 Oil and Gas Index. While the evidence so far suggests that Big Oil's loss is alternative energy's gain, the real investment opportunity is over the long-haul as societies transition to reduced carbon emissions and more sustainable energy sources.

Choosing an ETF

In addition to the usual considerations in choosing between similar ETFs such as the method of replication (physical or swap-based), the treatment of dividends (capitalising or distributing), as well as the size, trading volume and expense ratio, choosing an alternative energy ETF requires a deeper dive into the specifics of each portfolio. Unlike a straightforward country- or sector-specific index, the alternative energy indices have more leeway in terms of how they choose the number and weighting of stocks in their holdings. Does one consider nuclear power to be 'alternative energy'? How about a company like General Electric that has a large wind energy group, but most of its revenues comes from other industrial lines of business? Of these seven alternative energy ETFs, none share the same index. There is no one standard for the 'clean' or 'alternative' energy sector, unlike indices for technology or oil and gas.

With the number of holdings in these ETFs ranging from a low of 15 to a high of 100, investors have a great choice in terms of diversification versus concentration. The range of ETFs also feature different weighting schemes, from traditional market capitalisation to equal-weighting to a mixed weighting. Also, some indices strictly include companies involved in energy production, while others include services, efficiency, and other related sub-sectors. Let's take a closer look at each ETF in turn.

Name	Weighting	# of Stocks	Currency	Exchange Countries
EasyETF Global Renewable Energy	Mixed	27	Euro	FRA
ETFX DAXglobal Alternative Energy	Mixed	15	Euro	UK NLD
ETFX WNA Global Nuclear Energy	Mixed	65	USD	UK GER ITA NLD
iShares S&P Global Clean Energy	Market-Cap	30	USD	UK SWI
Lyxor ETF New Energy	Market-Cap	20	Euro	FRA ITA GER SWI SPA
Osmosis Climate Solutions ETF	Equal	100	USD	UK
PowerShares Global Clean Energy	Equal	85	Euro	UK GER
Morningstar Data as of 8/6/2010				

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PowerShares Global Clean Energy This ETF is based on another equal-weighted index, the WilderHill New Energy Global Innovation Index. Sector and size caps ensure additional diversification. As well as the usual alternative energy production, this index includes companies involved in pollution control, energy efficiency and cleaner waste storage. 20 different countries are represented in the index.

Our petroleum-based economy won't disappear overnight. No one questions the importance of oil and coal to meeting our energy needs. It will take years if not decades for ‘clean’ alternatives to compete with the efficiency of ‘dirty’ energy sources. But as the costs of exploration and production of new sources of oil continue to soar, the rising price of oil will make non-fossil-fuel energy sources a more compelling alternative. The replacement of ‘dirty’ energy with ‘clean’ energy may be a slow process, but that won’t stop it from being a potentially profitable change for long-term investors.