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Boom Time For Indexers?

Written by Murray Coleman

The backlog of filings for new exchange-traded funds is growing at a pace that rivals the number already on the market. With such a booming product pipeline, demand for increasingly exotic indexes is following suit. Does that translate into boom times for indexers? Maybe, maybe not. Several unique challenges face smaller index providers. For one, the path to profitability for a new index provider is a long one: First, you have to develop the index, which can take years; then you have to license it to a product issuer, fighting with other index providers for limited slots; then the product must actually launch and attract assets, which is a big hurdle (currently, more than 100 U.S.-listed ETFs have less than \$10 million in assets). As more active ETFs come onto the scene, indexers face new challenges, as the need for indexes may be outstripped by the high-profile nature of popular managers. Still, against these odds, some upstart index providers have done their homework and say they like what they've found.

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That's similar to the number that PowerShares Capital Management uses to support more than 120 ETFs. "We've got two camps of indexers. One is the more globally well-known providers who aren't very open to changes to their indexes," said Ben Fulton, executive vice president of product development at PowerShares. "Those can be well-established providers like the FTSE, S&P and Dow Jones, which have set models and demonstrated research." On the flip side are smaller index shops such as WilderShares, Dorsey Wright, Lux Research and Mergent. In many cases, PowerShares finds that with less widely known indexers, "we can work with them to turn their theoretical research models into working indexes," Fulton said. For example, Dorsey Wright has been providing technical analysis for decades to Wall Street. "I knew them well and knew they had created rankings for each company in terms of relative strength in the market," Fulton said. Once someone has some sort of ranking system, then it can be fairly straightforward to create an index, he added. "But we also like to see providers with brand-name awareness. If they don't have that

or some sort of ranking system, we might as well go to an established benchmark like S&P or FTSE," Fulton said. "Without some sort of value-add, turning research into an index doesn't make much sense." The indexes used by PowerShares are almost exclusively designed for ETFs. "Most other ETF providers start the other way. They'll put out a request for proposal of all the indexes you have at a specific time," Fulton said. "What you end up getting is all the indexes that haven't been licensed yet to your competitors. We really try to sit in an advisor's seat and consider what they really need." The key is to make sure an idea is investible. An example the firm cites is its recently launched PowerShares India Portfolio (NYSE: PIN). "We looked at the existing indexes, which included the SENSEX, the S&P Nifty Fifty and the MSCI India. But those were all developed for people inside India to track," Fulton said. Once you move outside of the country, he added, there are all sorts of regulatory issues regarding foreign ownership restrictions. "So we were concerned about the tracking error. We want to make sure we can manage a fund in a realistic manner. It's more a matter of common sense than anything," Fulton said. With his 20-plus years of industry contacts, he started talking to smaller research groups focused on India. One that stood out was Indus. "Their specific focus is around India-based indexes for the U.S. marketplace," Fulton said. "And they were willing to devote the time to create a customized index just for an ETF. And then we hooked them up with Standard & Poor's to maintain and calculate the index's performance on a daily basis." But the India ETF's launch was one of the rare times when an idea moves to full fruition. Only about 4 percent of the ideas originally pursued wind up as an index that PowerShares picks for an ETF, he added. His team maintains that many concepts for new products are on the drawing board despite years of research. "The bottom line is that we need to have confidence in an index and index provider," Fulton said. "They've got to go through a gauntlet of criteria we impose. We do heavy due diligence for everything before even considering actually putting it out on the market." He added: "We've had hundreds of research groups and existing index providers come to us and talk about creating ETFs. But we only work with a very select few. The lion's share don't make the cut." In fact, Fulton says, many of PowerShares' competitors' new products came to him first. "I'm sure at least one prospective index provider a day contacts us," he added. "And we get them from all over the world." He says that the index monitoring isn't a one-time gig, either. "We continue to monitor the portfolios and index constituents. We also think it's important to keep track of what the index providers are doing with their businesses."