

PowerShares FTSE RAFI US 1000 PRF

Morningstar's Take | 07-13-10 | by Michael Rawson, CFA

By using a fundamental approach, this fund offers an enhancement to pure indexing.

PowerShares FTSE RAFI US 1000 PRF may be a suitable core holding for investors who want the low cost¹ diversification benefits² of indexing but believe that imperfect market psychology can lead to exploitable pricing errors. The efficient market hypothesis asserts that stock prices reflect all currently available information and that therefore the market portfolio is optimal. Proponents of this view, such as Eugene Fama or Jack Bogle, would suggest that on average, active management cannot beat a passive, index-based approach after fees. But even the index-based approach is not immune to stock market crashes. To the extent that stocks can become overpriced, as we saw during the tech bubble, market-cap-weighted indexes will be overweight in the most overpriced stocks. To avoid these pricing errors, this fund grounds its stock weightings based on tangible measures of economic worth, rather than market capitalization, which is no more than the market's opinion.

Enhanced or fundamentally weighted indexes seek to outperform the market, but to do this requires risk taking and the possibility of underperforming. So, it should come as no surprise that at 26%, this fund had a volatility of return nearly 5 percentage points greater than the Russell 1000 or the S&P 500 over the past three years. However, it outperformed both of those indexes by more than 3% over that time period. Based on correlation, the PRF actually behaved more like a mid-cap value index, which indicates that the fund has a smaller-cap and value tilt. The return premium from small cap and value stocks is volatile and can be negative for extended periods of time.

Fundamental View

Traditional indexes use a firm's market value as the basis for its weight in the index, while this fund uses economic measures. Weighting based on market values can have results that at times seem detached from fundamentals. After all, does Apple AAPL, a firm with \$43 billion in sales in 2009 that paid no dividends, deserve to be ranked as the second most important company in the U.S. ahead of companies such as GE, with \$157 billion in sales that paid \$9 billion in dividends? While this approach has appeal, it is backward-looking while the market is forward-looking and willing to pay a premium for expected growth. Apple has nearly doubled its sales in three years while GE sales have shrunk by 9%. The fund has a tilt toward slower growing segments of the market, such as utilities and financials, and away from faster growing segments of the market, such as technology and health care.

Morningstar Rating

★★★★

PowerShares FTSE RAFI US 1000 PRF

Stock Quality

Wide Moat	Narrow Moat	No Moat
30.1%	44.7%	21.1%

Morningstar Coverage

96.34% of assets, 838 of 1003 Holdings

Pros

- This fund is ideal for investors who want the diversification² and low cost¹ of an index fund but are skeptical that the market correctly prices stocks in relation to their fundamentals.
- With an expense ratio of 0.39%,³ it is inexpensive in absolute terms and compared with the typical actively managed mutual fund and competitive with enhanced index ETFs.

Cons

- The higher returns for smaller stocks and value stocks are highly volatile and typically take decades to appear.
- Despite holding essentially the same stocks, the fund has been more volatile than passive indexes such as the S&P 500 or the Russell 1000.

Morningstar analysts currently see the stocks in this fund as trading at a price/fair value of about 0.82, slightly more attractive than the 0.83 on the stocks in the S&P 500. However, they see the stocks in PRF as being of slightly lower quality, as just 30% of the stocks have a wide economic moat compared with 42% for the S&P 500. Economic moat is Morningstar's measure of a firm's sustainable competitive advantage. The U.S. equity markets rallied sharply off the March 2009 lows on the back of improving economic data and strong corporate earnings. But just when deficit and housing-market worries had been put on the back burner, sovereign debt and sustained high unemployment have given the market pause. Those investors who cashed out during the market decline and were disappointed that they did not reinvest fast enough as the market rebounded might want to use this as a buying opportunity. This fund is an appropriate choice for investors who want to maintain the diversification² and low costs¹ of an index fund yet want a slightly active tilt to their portfolio or believe that the market is not always right.

Portfolio Construction

This fund tracks the FTSE RAFI US 1000 Index, which weights stocks based on book value, dividends, sales, and cash flow rather than market cap. This fundamental indexation approach was patented by Robert Arnott. The holdings are very similar to those in the Russell 1000, but the weights are slightly altered resulting in a smaller-cap and valuation tilt. The index is rebalanced annually and because five-year averages are used for several of the variables, turnover is low. Despite its value tilt, it actually has a lower dividend yield than the S&P 500. This may result from the use of five-year averages, which would be slow to react to the reduction in dividend payouts by financial firms.

Fees

PowerShares FTSE RAFI US 1000 charges an expense ratio of 0.39%.³ While this is very low compared with mutual funds and lower than many enhanced index ETF strategies, it is higher than purely passive index ETFs.

Alternatives

ETF investors looking for alternative weighting schemes have a number of options. Rydex S&P Equal Weight RSP holds the same securities as the S&P 500 but weights them equally, resulting in a smaller average market cap. Similar to PRF, this approach will also underweight the most overvalued stocks. The fund charges 0.40% and compared with RSP, it has a larger average market cap and a distinctly value tilt. WisdomTree Earnings 500 EPS charges 0.28% and weights firms based on earnings. Consequently, firms with a high price/earnings ratio receive a lower weight than they would in a cap-weighted index.

There are a variety of dividend-focused funds with different weighting schemes. iShares Dow Jones Select Dividend Index DVY charges 0.40% and selects stocks based on dividend yield subject to screens for dividend payout and growth. The remaining stocks are weighted by total dividend. SPDR S&P Dividend SDY is based on the S&P High Yield Dividend Aristocrats Index and charges 0.35%. Weighting stocks by yield results in a small-cap and value tilt. To avoid a value trap, a stringent screen requires a 25-year history of raising dividends, but this results in just 50 holdings. Vanguard Dividend Appreciation ETF VIG charges a mere 0.23% and tracks stocks with a 10-year history of raising dividends. The modified market-cap weighting results in less of a small-cap value tilt compared with other dividend-themed ETFs.

NOT FDIC INSURED | MAY LOSE VALUE | NO BANK GUARANTEE

1 Since ordinary brokerage commissions apply for each buy and sell transaction, frequent trading activity may increase the cost of ETFs.

2 Certain funds and portfolios, particularly the PowerShares ETFs, in and of themselves do not qualify as diversified investment strategies.

3 As stated in the Fund’s prospectus, the gross annual fund operating expense ratio is 0.46%.

**PowerShares FTSE RAFI US 1000
Average Annual Total Returns (%), as of June 30, 2010**

	1 Year	3 Year	5 Year	10 Year	Fund Inception
NAV	23.65	-8.16	--	--	-0.34
After Tax Held	23.08	-8.74	--	--	-0.90
After Tax Sold	15.39	-7.17	--	--	-0.60
Market Price	23.60	-8.06	--	--	-0.28

Fund returns are based on the inception date of the Fund. Performance data quoted represents past performance. Past performance is not a guarantee of future results; current performance may be higher or lower than performance quoted. An investor cannot invest directly in an index. Investment returns and principal value will fluctuate and Shares, when redeemed, may be worth more or less than their original cost. The Shares’ performance reflects fee waivers, absent which performance would have been lower. See invescopowershares.com to find the most recent month-end performance numbers. Market returns are based on the midpoint of the bid/ask spread at 4 p.m. ET and do not represent the returns an investor would receive if shares were traded at other times. After Tax held represents total return after taxes on distributions and assumes Shares have not been sold. After Tax Sold represents total return after taxes on distributions and the sale of Fund Shares. After-tax returns reflect the highest federal income tax rate but exclude state and local taxes.

****** Overall Morningstar Rating**

Among 1, 135 large value funds. Ratings are based on a risk-adjusted return measure that accounts for variation in a fund’s monthly performance (including the effect of sales charges, loads and redemption fees), placing more emphasis on downward variations and rewarding consistent performance. The overall rating is derived from a weighted average of three-, five- and 10-year rating metrics, as applicable. © 2010 Morningstar, Inc. All rights reserved. The information contained herein: is proprietary to Morningstar and/or its content providers; may not be copied or distributed; and is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information. Past performance is not guarantee of future results. PowerShares FTSE RAFI US 1000 (PRF) received four stars for three years among 1,135 large value funds. Rating is as of June 30, 2010 and is subject to change every month. A fund is eligible for a Morningstar Rating™ three years after inception. The top 10% of funds in a category receive five stars, the next 22.5% four stars, the next 35% three stars, the next 22.5% two stars and the bottom 10% one star.

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About risk: The Fund may contain securities in the consumer discretionary and financial sectors. Companies engaged in these sectors are subject to greater risks, and are more greatly impacted by market volatility, than more diversified investments.

Investing in securities of small and medium-sized companies may involve greater risk than is customarily associated with investing in large companies.

Investments focused in a particular industry are subject to greater risk, and are more greatly impacted by market volatility, than more diversified investments.

Shares are not individually redeemable and owners of the shares may acquire those shares from the Fund and tender those shares for redemption to the Fund in Creation Unit aggregations only, typically consisting of 50,000 shares.

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Note: Not all products available through all firms.

An investor should consider the Fund's investment objective, risks, charges and expenses carefully before investing. For this and more complete information about the Fund call 800 983 0903 or visit invescopowershares.com for a prospectus. Please read the prospectus carefully before investing.

Sources: Invesco PowerShares; ©2010 Morningstar Inc.

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