

Follow the Money

In the world of investment, the efficiency of even the most elaborate models is often based on surprisingly simple truths. Harnessing the idea of making money where it is to be found, David O'Leary has organized his investment strategy around a proprietary money flow measure to generate alpha for the PowerShares Active AlphaQ (PQY) and the PowerShares Active Alpha Multi Cap (PQZ) ETF portfolios.

How do you define your investment philosophy?

The core of our philosophy is that if you are investing in a portfolio of companies where the volume is consistently on the offer side of the market and there are earnings growth and valuation reasons to justify that, the portfolio will usually produce excess returns to the market, generally known as alpha.

What is your research process?

We think that you are more likely to make money as you follow the money, and our research process is based on deciphering where the money is flowing, which sectors and which stocks. Having been in the investment business for 35 years, I believe that the best indication of the future of a company is the movement of the stock price. It tends to have leading information on an individual company.

The research process that we use is a combination of a proprietary money flow measure that we call the Alpha Score. We cover about 3,000 companies with all stocks over \$400 million market cap. On a weekly basis, we assign each stock an Alpha Score. The Alpha Score attempts to measure the amount of volume in each individual company stock executed on the offer side versus the bid side of the market.

Many times, as a securities analyst and as a portfolio manager, I may have

the correct view of the company. But, I may actually end up losing money in the stock because the market moved away from that particular industry or there was something else going on that impacted the stock price. That is how the stock price leads fundamentals. Essentially, most of the research done in the investment business is backward looking. Most of the forecasts are nothing more than an extrapolation of what is currently happening. Nobody could forecast that oil would go up to \$147 dollars in 2008. The major factors that influence markets are not possible to forecast.

How do you construct the Alpha Score?

The Alpha Score, a money flow measurement, attempts to measure whether there are net buyers or net sellers for a specific security. We attempt to keep a portfolio invested in companies that have a strong money flow. When there is a change in money flow, or when a major sector of the market starts to under-perform, you are likely to see money flow changes occur with a very significant volume on the bid side of the market. Conversely, when a sector starts to outperform the underlying stocks that are driving that sector are the ones that are actually generating money flow, or Alpha. Since Alpha Equity Research was founded, The Alpha Score has been updated every week.

The second step is to run every stock on a weekly basis through five filters in a pass or fail mode. The first question that we ask



DAVID O'LEARY, Chief Investment Officer of AER Advisors, has primary responsibility for managing the Funds' portfolio. The investment process utilized by the Funds has been in existence since 1998 when it was developed by O'Leary, who has over 35 years of experience in the financial services industry.

O'Leary is also Founder of Alpha Equity Research, an independent research firm created in 1994. Prior to Alpha Equity Research, he served as Vice President of the Specialized Asset Management Group of Fidelity Investments Institutional Services Company where he developed the Alpha Select System for FAS 115.

O'Leary was vice president of Kemper Securities where he rebuilt institutional sales research and investment banking for Bateman Eichler. He holds a Bachelor's degree in Economics from Harvard and is a Chartered Financial Analyst.

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Product Name	Ticker Symbol	Inception Date	Market Price Returns Since Inception
PowerShares Active ETFs			
Listed November 20, 2008			
PowerShares Active U.S. Real Estate Fund	PSR	11/20/08	N/A
Listed April 11, 2008			
PowerShares Active AlphaQ Fund	PQY	04/11/08	-15.22%
PowerShares Active Alpha Multi Cap Fund	PQZ	04/11/08	-19.90%
PowerShares Active Mega Cap Fund	PMA	04/11/08	-11.68%
PowerShares Active Low Duration Fund	PLK	04/11/08	1.05%

DATA THROUGH: 11/30/2008

ourselves is, "Is the company in a positive sector?" To put sectors in perspective, we first assign individual companies an Alpha Score. We are then able to gross that up and assign an Alpha Score to individual sectors. We follow 36 sectors with each representing about 3% of the S&P 500 index, therefore, based on our own research, we find out if a company is positioned in a positive sector. We then ask, "Does the company have a positive money flow?" and that is represented by an Alpha Score of at least 60. We next look at earnings. We are not attempting to forecast earnings but we use certain information to ascertain if the Street and the consensus earnings estimates show strong earnings growth. Instead of trying to figure out if a company is going to exceed or miss its earnings estimates, we would rather ask, "Does it have attractive earnings growth?"

The fourth variable is found in the question, "Does the company have a low PE relative to growth?" This is the PE to growth ratio known as PEG ratio. We want to produce portfolios that are able to have strong earnings growth relative to the value that you have to pay for that.

The fifth variable is a combination of a number of factors. One is the average daily volume, which has to meet a certain minimum. Most of the time, the level required is at least 100,000 average daily

shares. Then, the stock has to trade in the United States and we also look at institutional ownership. Another variable that we take into account is called "The Earnings Index", which looks at the fundamentals of the company such as sales growth and profit margins relative to the price earnings multiple.

The maximum Alpha Score for a stock is 109 and with five variables the maximum score can go as high as 545. The NOW rank is the percentage that serves as a diffusion index. The NOW rank of 100 would mean a stock has a maximum Alpha Score and it passes all five tests. If it passes five tests and the Alpha Score drops below 63, the NOW rank moves to HOLD from BUY. Currently, we have so many companies that appear positive in our work that we have an abundance of buy ideas. We believe the U.S. equity market is extremely undervalued. It is about twice as undervalued as it was at the bottom in 2002.

How many stocks do you have in your portfolios? What kind of companies does it consist of?

We have tended to maintain the number of holdings around 50, equally weighted. Whenever a position gets up to 3%, we automatically cut it back to 2% and, over time, we end up getting the benefits of equal weighting in the portfolio.

When we go through the process, we can now create a portfolio that has in excess of 30% earnings growth and is currently selling at about 12 times the next 12-month earnings. That produces a PEG ratio of 0.4, which tends to produce very high alphas over time. Therefore, the goal is to expose the portfolio to companies with very high earnings growth, low PE, and buy pressure.

You could say that part of what we do is a quantitative approach to the market, but the only companies that end up in the portfolios we manage are the ones that have extremely positive earnings and that sell at a low value.

As an independent money manager, why would you put faith in the money flow, which is nothing but an approximation of other people's expectations? Does that mean that you are reluctant to apply a contrarian approach?

We are not a contrarian investor. If a company has a negative money flow, we will avoid it. If a large mutual fund family is liquidating their positions in a company, we do not get in the way of that. We do not say, "It is almost exhausted," or "It is about to turn." Alpha is produced by exposing a portfolio to companies where people are paying up for the stock, so you will never see a company where the price is declining over some period of time and the volume is consistently on the bid side of the market. Those stocks literally fall out of our work.

Ultimately, it is important to stress that we do not do anything that involves forecasting. We are measuring day in and day out, taking whatever the market will give us. We are not making any extraneous judgments about the economy and about the value of the dollar or other external factors. In order to produce Alpha, you need to invest in things that are producing Alpha and we stay with it until it changes.

How and when do you decide that things are changing?

Over time, we have tested that the perfect timing for the smoothing that we do is four weeks. We look at the latest week's data as the most important, but we average results over the past four weeks. A company may undergo a price decline of 15% or 25% that will still, when you smooth it out, have an Alpha Score over 60.

Many times, you will get a spike that will involve futures activity or options expiration. It might involve a huge trade in one of the Exchange Traded Funds that filters down into the individual companies. However, over time, in the ETFs that we manage we can change up to three stocks a week.

We are not trying to sell out at the top and buy at the bottom. In fact, we are trying to buy companies as they come up with the Alpha going from 50 above 60 or as high as above 80. In addition, we are looking for companies that have tremendous earnings where the valuation is reasonable. As long as the candidates meet those criteria, you can see how we create the master list every week as we literally sort out the companies at the top of the ranking.


What do you do to avoid liquidity traps?

Since the average market cap in our portfolios is fairly high, the average daily volume for 50 stocks that we select runs about four million shares a day, presenting us with a lot of liquidity. The risk of an individual company shows up originally in the money flow. We will start to see the money flow, the Alpha score will start to peak out and then decline and it reaches a certain level when it raises a yellow light. Once the NOW rank that we produce, which is a combination of the Alpha Score and five variables that I highlighted earlier, drops below 60 it is a candidate for a replacement.

How do you improve your model with newly acquired knowledge in order to make your system more refined and sensitive to the signals that you get as you go along?

About five years ago, we were doing more work with the smoothing techniques because there was an expansion on the use of ETFs by the proprietary traders. There was more systematic risk in terms of companies and sectors. With the five financial groups that we have, instead of one or two of the financial groups going negative and the other ones being positive, we would have all five going negative. We did a little bit of shifting with the smoothing at the time and, in the last couple of years we have not made any changes at all. The question remains the same – where is the highest degree of confidence and where can we get the most earnings growth for the lowest PE?

We believe portfolio management is not really about trying to hit grand slams. It is exposing the portfolio to those companies that are growing in real terms with high profit margins in a way that cash comes down and ends up being part of shareholder value. The most amazing fact is the amount of human effort that goes into analyzing companies that are already in trouble, or are so big that they have no potential for growing.

Whenever a company reports earnings, I get a report that shows the number of analysts that are following the stock. Those followed by only a few analysts are the ones that have the most potential for producing Alpha because they are going from under-ownership and, at some point down the road, they may become over-owned. So, I consider that a positive. The less coverage they have now and the fact that they are not in an index or they are not a significant part of an index gives those stocks the potential for producing Alpha. 

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