



Investing in Shariah ETFs

The concept of Shariah ETF investing began to come onto the radar of investors around 2007. Although the growth was not as aggressive compared to its conventional counterpart, the market saw continued momentum of issuances of Shariah ETFs in early 2008. MAHDZIR OTHMAN, CEO of i-Vcap, looks at the growth of this new asset class.

Following the subprime crisis that hit the global capital markets, demand for Shariah ETFs has tapered off and many ETF issuers have not been aggressive with new issuances. To date, there are only 12 Shariah equity ETFs issued worldwide with total assets under management of around US\$300 million, a meager number compared to over US\$1.5 trillion of 3,160 issuances for conventional ETFs.

Structures and permissible assets

Shariah ETFs can be structured in a similar fashion to any other physical-backed ETFs that exist within the conventional space. This encompasses the traditional securities such as stocks and fixed income instruments as well as alternative investments into real assets to the like of real estates and commodities. The Shariah ETF structure adheres to the overall principle in Shariah investing where there is high transparency of the assets that underlie the fund, no separation of profit and risk between the fund and its assets, fair profit distribution to investors and no element of Riba (interest) as far as the structure is concerned. The structure of synthetic or swap-based ETFs which are most common in Europe, however, defies these principles of Shariah investing. The benefits enjoyed by investors in terms of endless possibilities of innovation are at the expense of additional risks which will be explained in the later part of this article. Many would have also realized that Shariah investing in a way is a subset of ethical investing, a popular strategy in developed countries. However, the latter has additional business screening criteria, reducing the investable universe and thus its correlation with the broad market further.

The two asset categories that dominate the ETF offerings

worldwide are debt and equity. Debt financing is indispensable for any company or economy, an avenue allowed by Shariah through issuances of Sukuk and Ijarah bonds. For equity, the equity benchmark indices tracked by passively-managed ETFs comprises stocks of companies whose business are in alignment with that of Shariah law as well as fulfilling certain financial ratios as guided by Fatwas issued by Shariah supervisory boards of index providers. While the Shariah business screenings helps to disqualify non-permissible stocks from the sectoral perspective, financial screenings are used to analyze the degree of involvement of stocks in forbidden financial practices: namely Riba and extensive leveraging. Having a Shariah overlay on top of other standard investability filters reduces one's universe by 30-40%. Nonetheless, correlation may remain high to the overall equity universe. The broad-based S&P 500 Index and the S&P 500 Shariah Index, for example, shows a correlation of 0.99 for a period of three years ending August 2012.

Excellent investment tool for investors

Like traditional ETFs, Shariah ETFs feature benefits derived from both listed equity and mutual fund investments. Among others, an ETF boasts high transparency, tradeability and liquidity, diversification, precise market exposure and low total expense ratio that it lends to investors.

Strategically, ETFs in general serve as an excellent investment tool for asset allocation, allowing a blend of active and passive investments. Various core-satellite combinations can be generated to cater for investors' strategic and tactical asset allocation objectives, depending on the asset-liability profile

of an investor. For instance, dividend-based equity ETFs can be positioned as the core portfolio alongside fixed-income instruments for the purpose of meeting fixed liabilities while sector-based or country-specific ETFs could be used as the active satellite portfolios for potential alpha.

Feedback on the marketing and promotion of Shariah ETFs to institutions and high net worth investors detect interest and need for this product are dependent on a high trading liquidity and transparent instruments in order to conduct a wholesome shariah-compliant asset allocation. At present the options are limited mainly to collective investment schemes and investment-linked Takaful products. Shariah ETFs could potentially be the new vehicle for private clients, particularly when ETFs could potentially overcome certain allocation hurdles such as Sukuk/ fixed-income allocations.

Compared to the US where there is evidence of passively-managed portfolios providing similar returns to actively-managed portfolios, the same cannot be observed in Asia. In Malaysia for instance, unit trusts have been the main investment vehicle for investors to gain outperformance relative to the broad-based benchmarks such as FBM KLCI Index and FBM Hijrah Shariah Index. The existence of ETFs in the local market will provide an alternative investment avenue for investors to obtain outperformance at a relatively lower cost.

Another important advantage of Shariah ETFs is that they provide investors with convenience and access to the transparent and robust methodology from leading global index provider in terms of investment process and Shariah filtering and monitoring. Index methodologies established by index providers are based on rigorous research and proven to reflect the specific exposure that the indices are supposed to represent. The extent of research would require large resources and is costly for investors to undertake.

Lower risk

The financial ratios used to filter for Shariah compliant stocks look at the level of debt, interest bearing securities and account receivables against the value of equity or total assets of the company. This is akin to quality filters adopted by market practitioners, way before the idea of Shariah investing emerges in the capital market. Hence, the investable universe will by default consist of stocks of strong fundamental and low debt-to-equity ratio, a natural avoidance of riskier assets especially during bear periods. This is reflected by the outperformance of almost 5% by the MSCI World Islamic Index against the MSCI World Index during the period of the subprime crisis of between mid-2008 through to March 2009.

Another low risk element feature of a Shariah ETF is the fact that it allows only physical assets to back the fund. Hence, investors are not exposed to counter-party and funding liquidity risks which are the by-products of swap-based ETFs.

Shariah ETFs in Asia

In Asia, the prospect of Shariah ETFs is expected to be promising given that the pool of rising Muslim wealth in Asia is enormous. Investors with Shariah mandate objectives that

look for low risk and cost-efficient products may find Shariah ETFs to be a valid option.

More than 40% of the world's Muslim population lives in the five main Muslim countries within Asia – Indonesia, Pakistan, India, Bangladesh and Iran. Savings rates in these countries are approximately 33% amounting to an estimated US\$983 billion fund uninvested. The amount is substantial compared to approximately US\$13.4 billion of Shariah funds available and issued within the Asian domiciles. There are also substantial and rising Muslim populations in China and other emerging countries in Asia such as India, Malaysia, the Philippines and Russia which are expected to be among the key economic growth drivers due to their rising wealth and affluence.

Being the host to more than 60% of the global Muslim population, Asia should naturally be the base for the take-off of investment in Shariah ETFs. To achieve this, it is vital to see more launches of Shariah ETFs of various underlying assets, regional exposures and 'smart beta' so that the region can offer variety to meet investors' needs.

Challenges

The role of regulators in establishing clear and comprehensive guidelines on the issuance of Shariah ETFs, or ETFs in general, is crucial to ensure the growth traction in the Shariah ETF industry continues. A well thought-out regulatory framework ensures efficient execution of new products into the market and provides clarity to investors that are new to this new form of investment instrument. The Securities Commission of Malaysia for example, has been the front-runner in this aspect pursuant to the issuance of ETF Guidelines in 2009. Work is currently being done to refine and make the guideline more comprehensive in terms of asset coverage and efficiency of the ETF market.

Limitations in terms of the underlying securities and portfolio strategy may limit the width and depth of Shariah ETF product offerings. With reduced investable stock universe and restrictions on derivative exposure in the portfolio, investors are left with less optimal options to undertake sophisticated investment strategies. Structure-wise, the inability to apply swap-based structures within the Shariah space means Shariah ETFs are not able to enjoy the lean cost structure of synthetic ETFs. However, more pressing issues for the issuers currently are to continue educating and encouraging retail and institutional investors to embrace and use ETFs as an investment tool that can meet their investment objectives. (3)



i-VCAP Management
Level 9, Block B, HP Tower,
12, Jalan Gelenggang
Bukit Damansara, 50490 Kuala Lumpur
Malaysia

Tel: +603 2093 7119
Web: www.myetf.com.my