

More Islamic ETFs in the Works

Investors are increasingly turning to Shariah compliant instruments, thanks in part to the recent gush in oil prices

By Dalila Abu Bakar



Michihito Higuchi

The prospects for Islamic exchange traded funds (I-ETFs) are bright as there is a shortage of good Islamic investment instruments to cater for the rising global demand for such products. Increasing crude oil revenues have further triggered interest from companies, particularly those in Asia, to issue I-ETFs. The Islamic capital market can expect more issuance of I-ETFs from Asian countries like Japan, Taiwan and Malaysia within the next two years.

Japan's Daiwa Asset Management, which listed its first I-ETF (the Daiwa FTSE Shariah Japan 100) on the Singapore Exchange in May, is eyeing other markets including Hong Kong and London to list its I-ETF.

"We are thinking about listing our Islamic ETF on the London Stock Exchange (LSE) later this year. We started

in Asia because we see growth in this area, that's why we started an I-ETF. Of course, Daiwa aims to attract a worldwide market," Michihito Higuchi, president and CEO of Daiwa Asset Management, said in an interview in Kuala Lumpur.

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Taiwan also plans to list an I-ETF on the Abu Dhabi Securities Exchange this year. "These are non-Islamic countries and they want to offer Shariah compliant products because they realize there is demand for such products," said Zainal Izlan Zainal Abidin, CEO of i-VCAP Management. i-VCAP is a subsidiary of fund management firm and Malaysian government-linked Valuecap.

In January, i-VCAP launched the MyETF Dow Jones Islamic Market Malaysia Titans 25 (MyETF-DJIM25), Asia's first Shariah compliant ETF on Bursa Malaysia. It uses the Dow Jones Islamic Market Malaysia Titans 25 Index (Titans 25 Index) as the underlying benchmark, and covers 25 leading Shariah compliant stocks on Bursa Malaysia. i-VCAP plans to list the product using the same index on a foreign exchange, either in Europe or the Middle East, by December.



Paul Hoff

Since its launch on the 21st January 2008 until the 30th May 2008, the fund's net asset value had fallen 8.3% while the benchmark Titans 25 Index lost 9.2%. In comparison with other indices over the same period, the Kuala Lumpur Composite Index fell 9.4% and the FTSE-Bursa Malaysia Emas Shariah lost 11.9%. The initial issue price of MyETF-DJIM25 was RM1 (US\$0.31) per uni.

I-ETFs gaining ground

Apart from that, four I-ETFs are listed on the exchanges in Europe — two on the LSE, and one each on SWX Zurich and the Istanbul Stock Exchange. Although still in the embryonic stage, I-ETFs are gaining overwhelming response, particularly from Muslim investors.

"There is strong interest for Islamic ETFs... this means there is a large number of Islamic investors around the world," said Paul Hoff, FTSE managing director, Asia-Pacific.

An I-ETF tracks a benchmark index comprising securities that are Shariah compliant whereas a conventional ETF may track any benchmark index, regardless of the Shariah status of its stock components. An I-ETF provides returns that closely correspond to the performance of a benchmark index.

As an I-ETF is managed under Shariah principles, it is necessary to appoint a Shariah adviser and for the ETF to adhere to the Shariah investment policies and guidelines.

The Shariah adviser will conduct regular reviews and audits on the Islamic ETF to ensure strict compliance with Shariah precepts.

The securities that make up the indices are screened, usually on a quarterly basis, to ensure Shariah compliance at all times. There is prohibition on investing in non-Shariah compliant sectors such as alcohol, tobacco, pork-related products and non-halal food production; entertainment such as gambling, casinos and pornography; as well as conventional financial sectors. The screening goes further into the financial health of these companies.

What constitutes Shariah compliance

For FTSE, the Shariah screening of which is outsourced to Yasaar, companies desiring Shariah compliant status must have debt less than 33% of total assets, cash and interest-bearing items less than 33% of total assets, accounts receivable and cash less than 50% of total assets, total interest and non-compliant activities income should not exceed 5% of total revenue, and appropriate purification of dividends at 5%. Yasaar screens the Shariah compliant companies on a quarterly basis and if one does not meet the criteria, it will be replaced immediately.

"On the Shariah aspect, I think we are getting more and more clarity as more people get involved in Shariah investment and exchange traded products. Companies are able to provide a high level of transparency and when there are issues relating to Islamic products to investors," said FTSE's Hoff.

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For Dow Jones Indexes, there are three financial ratios that must be administered for companies deemed Shariah compliant. These are debt to market capitalization (one-third), cash and interest bearing to securities (one-third) and account receivables to market capitalization (one-third). Dow Jones also reviews the Shariah compliant companies on a quarterly basis.

Rushdi Siddiqui, global director of the Dow Jones Islamic Market Index Group, said the Dow Jones financial ratios have been accepted by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).

"We are happy with AAOIFI for accepting our standard because it recognizes the work that we have done in 10 years," he told *Islamic Finance Asia* in an interview.

However, he added, these ratios are just the beginning as scholars have said that ideally, companies that are Shariah compliant, especially in Muslim countries, should have zero conventional debt and zero account receivables.

"But, we are not there yet, so we have to go through the stage called the 'tolerance parameters' which have a pre-condition for listed companies on the exchange," he said.

Islamic investors just as sophisticated

Rushdi also emphasized that the I-ETFs are based on market demand and that Islamic investors are just as sophisticated as conventional ones. However, he said, these investors do not have access to the variety of investment vehicles because of the restriction and lack of product sponsors as the ETF market is still in the embryonic stage.

"Islamic finance is 40 years old but in reality, it is only five years old because in the last five years, we have seen the rise of Islamic mega banks, we have seen the rise of Sukuk, we have seen Western jurisdictions issuing Sukuk.

"This will probably see demand and interest level going up. If you talk about a learning curve, we could be at a learning stage. A lot needs to be done to help investors"

So, at this stage, you can't expect to have the efficiencies of the conventional Western system that have been gained over decades, if not centuries.

"The first Islamic ETF in Malaysia is just the beginning and we expect a variety of ETFs such as sector ETFs over Islamic indices and we are looking at other asset classes. This is just the tip of the iceberg," Rushdi explained.

To ensure growth, Rushdi thinks there should be a level playing field for I-ETFs compared to conventional.

"I think more than anything else, we need to provide a level playing field of I-ETFs compared to conventional ETFs. It is an issue of certain peculiarities of having something that is Shariah compliant. Basically, if there are tax deficiencies, they should be removed and also if there are certain regulatory impediments.

"The Securities Commission (SC) has done a remarkable job on the products and the records speak for themselves. The market has a high level of confidence in the SC of Malaysia



Zainal Izlan

in doing their job in providing a level playing field for Islamic products like I-ETFs," Rushdi said.

Education and understanding of the ETF market are also needed, not only for the man in the street but also financial institutions on how the products work and their benefits.

Hoff said the I-ETF market in Asia is developing slowly due to several issues, including regulation and trading practices.

"Most equity markets need to revive their laws, regulations and trading practices. A lot of these revolve around tax because this is the normal transaction. There is a need for creation of redemption to create liquidity in ETFs.

"I think the market needs those regulatory changes and needs to educate retail investors and fund managers on ETFs such as Shariah investment proposition. This will probably see demand and interest level going up. If you talk about a learning curve, we could be at a learning stage. A lot needs to be done to help investors," Hoff added.

Zainal said I-ETF is a new asset class that needs investor education to fuel growth. According to him, Bursa Malaysia and the SC are playing a vital role in promoting the product and have featured Islamic ETFs as an asset class in some of their road shows.

Zainal added that the Malaysian regulators and authorities are working on the Shariah compliant Securities Borrowing and Lending issues to facilitate trading and ensure liquidity of Islamic ETFs on the market.⁽²⁾