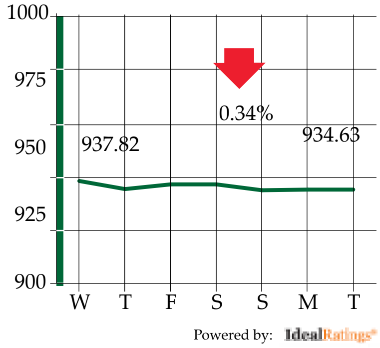
Islamic Finance *news*

The World's Leading Islamic Finance News Provider

REDmoney publication

4th September 2013

REDmoney Indexes (All Cap)



Volume 10 Issue 35

www.islamicfinancenews.com

Islamic ETFs: Ready to fly

The ETF universe is vast and growing, with global assets topping US$2 trillion at the end of July fuelled by a stellar global equity performance in the second quarter and an increased appetite for passive investing. Yet the Islamic ETF market has been slow to take off compared to the unit trust and mutual fund industries. This week we explore the ETF universe, and take a look at why Islamic investors remain shy of one of the fastest-growing stars in global asset management firmament.

There is nothing complex or intimidating about exchange-traded funds (ETFs), which are simply a basket of securities, funds, indexes or commodities that are traded on an exchange and are usually linked to or track a benchmark index.

The market is both big and booming. According to a recent report from ETFGI, net inflows of US$44.08 billion in July pushed year-to-date inflows to a record US$148.53 billion. Coupled with an impressively strong market performance this helped to push global exchange-traded product assets to a record US$2.16 trillion at the end of July 2013. A new report by Cerulli Associates entitled 'ETF and Retail Alternative Products and Strategies 2012' estimates that assets could reach US$3.8 trillion by 2016, and around 63% of investment managers surveyed in the Cerulli report expect ETF growth to accelerate this year as the high flow of funds encourage mutual fund managers to get involved.

A tempting prospect

Passive funds have surged in popularity over the last few years, as investors rebel against the high costs and poor returns perceived to be generated by active managers. In the past four years in the US, investment in passive funds has more than doubled and the sector now — accounts for US$1.3 trillion-worth of assets. In fact, a report by Ignites released in June found that 66% of the 1,000 fund management professionals surveyed actually have an investment in passive products. Another recent survey by Nerdwallet of over 24,000 mutual funds in the US concluded that only 24% of professional investors beat the market over a 10-year period, while index funds outperformed actively managed funds by 0.8%.

As interest grows, the asset class is expanding into new markets. Vanguard, the third-largest ETF provider in the world, held over US$280 billion in assets as of June this year and has expanded into a range of new countries including Hong Kong. "Investors worldwide have become more focused on broad diversification, low investment costs and transparency" said Jim Norris, the managing director for Vanguard International, in an April interview with ETF Strategy.

Islamic interest

While these characteristics have not always been a priority for Islamic investors, ETFs offer an array of advantages which are becoming increasingly pertinent in today's expanding cross-border markets. Shariah compliant ETFs offer convenient access to the relevant sectors of the wider global equity market without requiring time consuming specific scholar approvals as can be the case for actively managed mutual funds.

Chin-Sharpe

This makes for a much lower total expense ratio. Conventional ETFs are currently offered at a total expense ratio of usually less

continued on page 3

Islamic ETFs: Ready to fly

Continued from page 1

than 10bps, and while Shariah compliant ETFs cannot necessarily match this, they can often be considerably better value than competing mutual funds, while also being more transparent as their holdings are revealed on a daily basis due. "You can just go to an exchange and buy an ETF. They give you easy access to a particular market or region and are very cheap, about 80 to 100 bps," says Angelia Chin-Sharpe, the CEO of BNP Paribas Investment Partners. "If you want exposure to a market where you don't have the resources to research, then this one instrument could be ideal. Other than that you can use it as a technical allocation by weighting other sectors which you are more bullish about without having to buy a whole list of stocks."

Index growth

A key factor for Islamic ETF growth is of course the availability of Shariah compliant indexes for these funds to track; most ETFs are based on an underlying benchmark index. While in the past these were less readily available, over the past decade almost every major index provider has created a Shariah compliant offering, covering almost every major class and region with more coming onto the market all the time.

The S&P and Dow Jones family are well known, and these families continue to expand to provide even wider access for Islamic asset managers. In India, S&P recently launched a new index with the Bombay exchange, while in June last year it also announced the launch of the S&P/OIC COMCEC 50 Shariah index designed to track the performance of the top 50 Shariah compliant firms across OIC member states. Alka Banerjee, the vice-president of global equity and strategy indices at S&P, commented on the launch that: "Demand for Shariah compliant investing solutions and interest in the equity markets of Islamic countries has increased over the past several years. The S&P/OIC COMCEC 50 Shariah is unique in that it encapsulates in one index the performance of Shariah compliant stocks from Islamic countries located throughout the world."

Index providers are innovating as well as expanding geographically, and in

continued...

Fund focus: MyETF-DJIM25

Malaysia is home to one of the world's largest ETFs, the government-owned MyETF-DJIM25, which was launched in January 2008 and tracks the performance of the benchmark Dow Jones Islamic Market Malaysia Titan 25 Index.

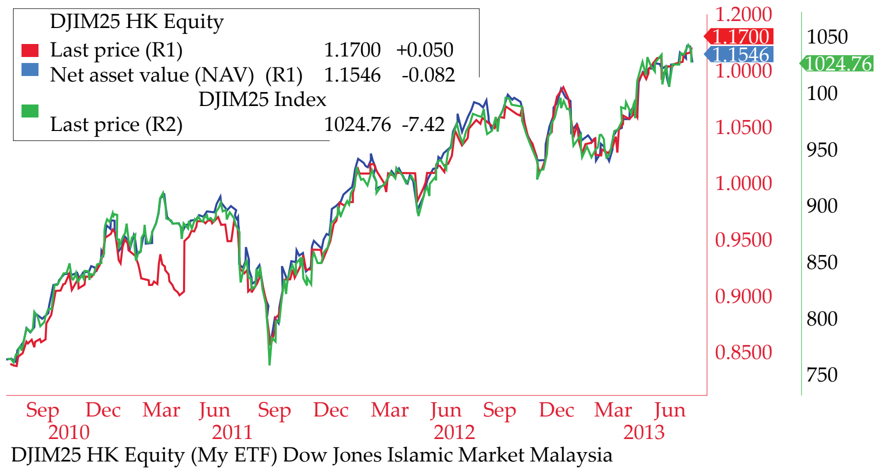
Fund

As at the 31st July 2013 the fund had a total net asset value (NAV) of RM296.34 million (US$90.27 million) and accounted for 30% of Malaysia's total ETF industry despite a ratio of just one Islamic ETF to five conventional (in comparison, Islamic unit trust funds in Malaysia make up just 12% of the total industry). The fund is managed by i-VCAP (advised by BNP Paribas) and its Shariah advisor is CIMB Islamic Bank while its trustee is Deutsche Trustees Malaysia.

Performance

Since inception the fund has seen a cumulative performance of 17%, compared to 6.28% for its benchmark. Year-to-date it has also outperformed, bringing in 4.46% over 3.08%. In June this year the fund's NAV per unit rose to an all-time high of RM1.16 (US$ 0.35) before easing off to end the quarter at RM1.15 (US$0.35), representing a 7.17% underlying quarterly gain. In comparison, the underlying benchmark index gained 6.29%. Meanwhile, the fund's unit price traded on Bursa Securities closed at RM1.15/unit, up 6.48% for the same period.

Figure 1: Fund movement



Outlook

Emerging market equities in 2013 have seen an outflow of liquidity and underperformed developed markets, and the Malaysian bourse was not spared, with net foreign outflows in June leading the ringgit to weaken significantly to RM3.20 against the US dollar from RM2.95 in early May. Nonetheless, given its defensiveness, Malaysia remains one of the top performing markets in the region; boosted by a strong equity performance and a favorable investor reaction to the general election.

Figure 2: MyETF top 10 holdings, July 2013

Sime Darby
Axiata Group
Maxis
IOI Corporation
Digi.Com
Petronas Chemicals Group
IHH Healthcare
Kuala Lumpur Kepong
Petronas Gas
UMW Holdings

Islamic ETFs: Ready to fly

Continued from page 3

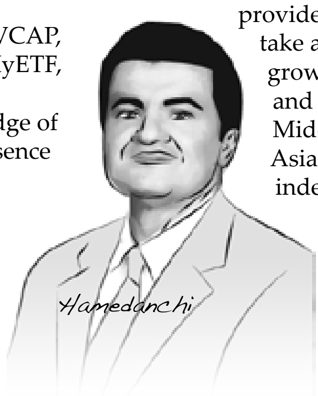
February this year S&P Dow Jones Indices launched its GIVI Shariah indexes based on low volatility combined with an alternative weighting scheme that measures a stock by its intrinsic calculated value rather than on market capitalization. And while S&P Dow Jones remains a dominant player in the index universe, several other heavyweights are also driving it forward: including global Islamic finance information provider and Islamic Finance *news* partner IdealRatings, which recently partnered with Russell Indexes to offer a new Russell-IdealRatings Islamic Index Series based on the Russell Global Index universe of over 10,000 securities. The new family, which includes a global large and small cap index as well as covering developed, emerging, US, BRIC and GCC markets, was specifically designed to provide benchmarks for both active, index-linked and exchange-traded funds.

Slow growth

Shariah compliant ETFs have demonstrated lower volatility than their non-compliant counterparts and in fact have tended to outperform over the past few years, just as the S&P Shariah 500 has outperformed the S&P 500. Islamic asset management is one of the fastest-growing sectors in the global financial services industry with annual growth rates topping 25%. However, the ETF sector remains massively underdeveloped both in terms of products and assets. ETFs are one of the easiest ways for investors to invest in a cost-effective Shariah compliant manner, but growth simply has not lived up to expectations.

Recent data confirms that Islamic ETF assets are failing to increase, with the combined assets of iShares three ETFs currently standing at US$117.32 million – almost 30% lower than the record high of US$164.5 million in September 2011. So what is holding investors back?

Mahdzir Othman, CEO of i-VCAP, the manager of Malaysia's MyETF, suggests that this could be ascribed to a lack of knowledge of the industry, the limited presence of ETF providers in the Gulf region and a preference for property and private equity investments.



Islamic universe

As of the end of last year there were just 12 Shariah compliant ETFs worldwide, with total assets of under US$500 million – compared to over 3,000 funds and around US$2 trillion in assets for the conventional industry.

iShares by BlackRock and the db-X series from Deutsche Bank are the market leaders, and offer exposure to all leading global markets including the US, Europe, Japan and emerging markets on multiple European exchanges including the LSE, Deutsche Borse, NYSE Euronext Amsterdam, NYSE Euronext Paris and the Stuttgart Stock Exchange. Several other players are also active in the market: including Daiwa Securities of Japan which offers an ETF tracking the FTSE Japan Shariah Index, and BNP Paribas which launched its first Islamic ETF in 2007 and a second a few years later to track the Dow Jones Islamic Market (DJIM) China/Hong Kong Titans Index. Malaysia, despite being one of the key players in the Islamic finance universe, has only one domestic ETF, the MyETF-DJIM25 (see sidebar) managed by government investment vehicle i-VALUE CAP; while the Middle East has also seen only a few providers enter the market including HSBC Amanah and Falcom Financial Services.

Several other providers have tried and failed, suggesting that rather than a lack of supply it is a lack of demand that is stifling growth. In October 2010 Javelin Exchange Traded Shares, a US issuer that launched its DJIM International Index Fund in July 2009, announced that the fund would close. President and founder Brint Frith explained that: "We found it difficult to reach target investors through the marketing channels typically used by ETFs."

Emerging markets

However as new markets emerge new providers are also moving in to take advantage of high regional growth. With weak US growth and a Chinese slowdown, the Middle East and Southeast Asia are the new hotpots for index-linked investment and as investors turn to passive strategies over active ones, the sector may finally be looking up.

Saudi Arabia is a key focus for the next year, and according to ING Investment Management the market will open up with an increased flow of IPOs and greater access for foreign investors. Fadi Al Said, the head of strategy at ING Investment Management, told ETF Strategy that: "In 2011 and 2012, the real GDP growth in the MENA region will average out at 3.4%, exceeding that of the G7 which we predict will stand at 2.2%." In Saudi Arabia strong economic growth and massive government spending will drive the markets, with Fadi confirming that: "By identifying the best relationship between growth and value, ING foresees good opportunities for alpha creation in 2012."

Islamic choices in the GCC remain limited, although several conventional funds already exist including the Market Vectors Gulf States Index ETF and PowerShares MENA Frontier Countries ETF. However in 2011 HSBC Amanah launched its first Gulf ETF with the Saudi 20 ETF, tracking the HSBC Amanah Saudi 20 Equity Index of Shariah compliant firms and listed on Tadawul, the Saudi exchange.

Osama Shaker, the managing director and head of financial markets at HSBC Saudi Arabia, commented on the launch that: "ETFs have enjoyed a phenomenal global success and continue to rise in popularity. We believe there's international demand for Saudi exposure and expect that the Saudi economy will continue to grow, driven by high oil prices and historical government reserves as well as improving private sector spending."

ASEAN advantage

Southeast Asia is unsurprisingly another region to watch, with the leading ASEAN economies of Malaysia, Indonesia, Thailand and the Philippines seeing steady growth and strong returns even as the European debt crisis and weak US growth turn investors towards other opportunities. Simon Smith of ETF Strategy points out that ASEAN nations currently hold 3.1% of total global GDP but account for just 1.9% of the MSCI AC World Index, with this under-representation highlighting the growth potential and investor opportunities

continued...

Islamic ETFs: Ready to fly

Continued from page 4

in the region. Last year PwC released a report entitled 'The Southeast Asian Tigers Roar Again: This Time For Real' which highlighted the growing importance of the Southeast Asian region for investment, predominantly due to its cheap labor pool.

"Long recognized as a low-cost production platform, Southeast Asia will continue to reap the benefits of its competitively priced labor pool, which is expected to endure as the region's greatest asset," said the report. "The average economic growth rate of the fastest five is projected to reach an average of 5.8% annually from 2011–15."

Southeast Asia's largest economies, Indonesia, Malaysia, the Philippines, and Thailand, along with Vietnam and Singapore, had a 2010 combined gross domestic product (GDP) at purchasing power parity of approximately US$3 trillion, equivalent to nearly three-fourths of Japan's and one-third of China's economies.

While there are over 14 ETFs which currently focus on ASEAN, from providers including Deutsche Bank, Amundi, Credit Suisse, HSBC and RBS, there are currently no Islamic ETFs specifically covering the region. The closest investors can currently get is the Malaysian MyETF-DJIM25 and the iShares MSCI Emerging Markets Islamic ETF, which covers some Asian countries – suggesting a clear opportunity in such a booming market.

Narrow asset focus

One of the biggest gaps in the Islamic ETF universe is the continued focus on equities to the exclusion of any other asset class. There is no reason for an exchange-traded fund to limit itself to the equity market, yet many investors seem to believe that equity is the only option available. In fact, an ETF can track any index and cover almost any asset class – so why are Islamic providers not offering funds covering commodities, property or, given the booming Sukuk market, fixed income?

Although equity makes up the lion's share of conventional ETFs it is by no means the only asset class. According to BlackRock, conventional fixed income exchange-traded products saw record-breaking inflows of US$25.5 billion between January and April this year, and reached US$49.9 billion in 2012. For Islamic investors, a key attraction of ETFs should be the opportunity to diversify their portfolios easily, and access investments that have a low correlation with their existing equity investments. Yet despite a number of Shariah compliant indexes that track Sukuk, commodities and other asset classes, ETFs following these themes have yet to reach the market. One bank that has done so is Kuveyt Turk, which in 2010 launched its GoldPlus ETF which trades gold on the Turkish exchange via an index from BMD Securities.

However, according to Tariq Al Rifai, the head of investor relations at Kuwait Finance House and speaking to Reuters this year, investor interest exists but providers have not yet responded to this. "Our Sukuk index is very popular, but products remain manager-driven."

A question of selling

According to market experts, the problem may be in the channels available for selling to Islamic investors. In the US and Europe funds are often sold through independent advisors whose profits are not derived from the cost of the product, and are therefore happy to sell ETFs which have low management fees. In the GCC region however, most funds are sold to institutional investors through placement agents and fund marketers who charge sale-based commissions and thus prefer to market funds with higher margins. While an ETF might have a management fee of 0.5% for example, a mutual fund might charge 2%.

A bright prospect

Nevertheless, the advantages of Shariah compliant ETFs are undeniable and as demand and supply converge, we should expect further growth. "There are tremendous opportunities in Shariah compliant ETF industry," says Saeid Hamedanchi. "The industry is young and underdeveloped globally, but we expect that it will comprise a minimum of 10% of the Islamic funds industry within the next five years. This translates to assets reaching around US$10 billion." *—LM*