Islamic ETFs: Here to Stay?

Market makers are looking for alternative forms of investments. NAZNEEN HALIM questions if Islamic ETFs are the way to go.

The concept is simple: Market makers bunch together "clean" stocks, and market players buy those stocks up for trade. For those who enjoy the thrill of buying and selling stocks, Islamic exchange traded funds (ETFs) are the filtered alternative. An ETF is basically a fund which behaves like equity. The difference between mutual funds and an ETF is that it is readily available on the secondary market and stock quotes are available throughout the day, as opposed to mutual funds whose net asset value (NAV) is calculated at the end of the day.

There are two ways an ETF is managed: Actively, or by tracking an index. ETFs that use an index tracking approach generally follow a pre-selected index; with the returns on the ETF correlating with the underlying index. When actively managed, ETFs behave more like a mutual fund; often with the objective of outperforming rather than tracking a set benchmark index, but generally with a lower fee to traditional mutual funds. This enhances the commercial viability of ETFs, with a 1.5% discount on management fee compared to the 2% that comes with mutual funds.

Zainal Izlan, CEO of i-VCAP, which had launched Malaysia's first listed Islamic ETF in January 2008, elucidated that Islamic ETFs are very much like conventional ETFs with few differences. "In terms of features, Islamic ETFs are very much similar to a conventional ETF. What is different is all the component stocks of an Islamic ETF would be

Picture source: Shutterstock

Shariah compliant. In terms of Shariah screening, the methodology is heavily dependent on the index provider linked to the ETF." The index provider in i-VCAP's case is Dow Jones, as its ETF is benchmarked against the Dow Jones Islamic Market Malaysia Titans 25 Index.

According to Arif Sultan, business development director at Dow Jones Indexes, Islamic ETFs are bound for success due to its first mover advantage, issuer credibility, the success of its underlying index and associated branding, investors' ability to track the underlying index, and the sustainable liquidity of its underlying shares for efficient creation and redemption.

Shariah issues

The largest Islamic ETF in the world currently has a net asset value (NAV) of US$660 million— pocket change compared to the largest conventional ETF, which is the Spider S&P 500 with an NAV of US$80 billion and a daily average trading volume of US$15 billion.

The diversity provided by an Islamic ETF is perhaps its most attractive feature, which on the flip side can also provide room for uncertainty. What provides diversity to an Islamic ETF is the fact that an investor buys into a basket of underlying equities — and in some cases, Zainal admits, there are stocks which do not comply with the binding Islamic requirements.

Should this occur, Zainal says, an Islamic ETF fund manager has three options: "In *i*-VCAP's case, our index is based on 25 stock components; therefore, if one is not approved by the SCM, what we can do is rebalance the remaining 24 stocks so that it will proportionately take on the percentage of the non-approved stock."

"The second option is to look for an approved stock with similar characteristics and correlation as the one which is not approved, and include that into the portfolio as a replacement stock; while the third option is to maintain that portion of the non-approved counter in cash," Zainal said.

Another defining feature that separates an Islamic from a conventional ETF is the income purification process. A component stock held in an ETF will receive dividends from its stocks, and it is recognized by Shariah scholars that not 100% of the income will actually be generated from Shariah compliant activities, with an estimated 5% room for non-compliance. What an Islamic ETF does is extract the non-compliant portion from the fund and place it in a separate holding account which will then be channelled for education or charitable purposes.

However, how does one ascertain the exact amount which is not compliant in the whole basket of stocks? Zainal explained: "In our case, the index provider, on a quarterly basis, will look at the index component stocks and determine the ratio which is not compliant by reviewing the company's financials and advise us, the fund managers. It is normal for every component stock to have a non-compliant portion."

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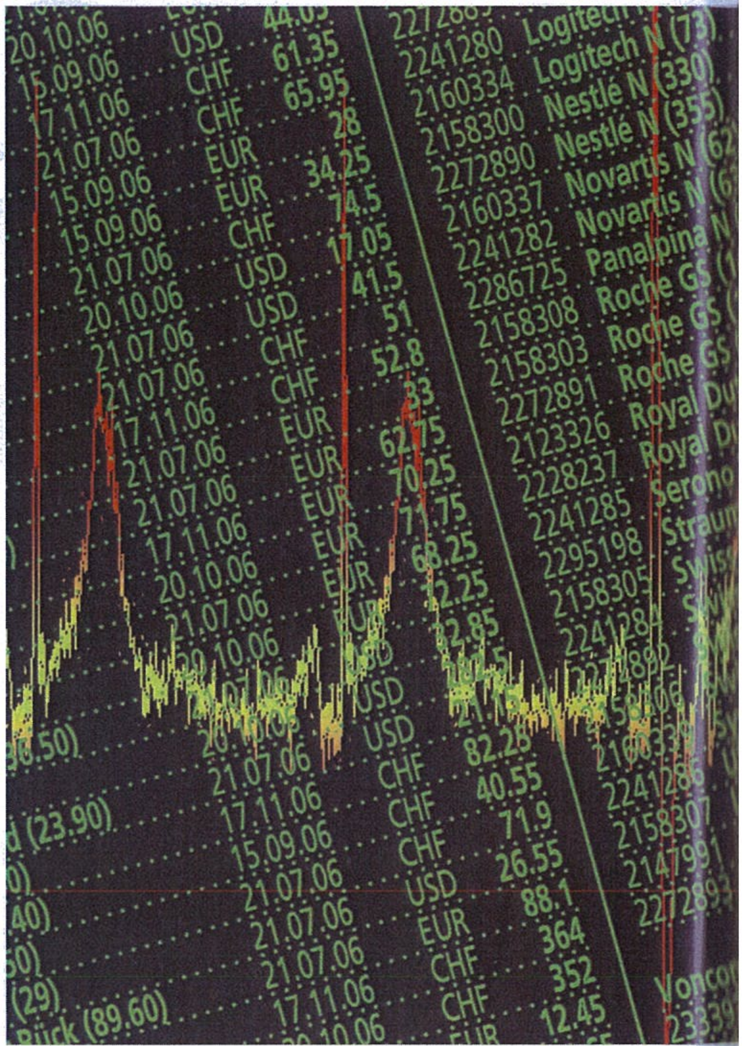

According to Aznan Hassan, Shariah scholar at Bursa Malaysia, there are two main concerns when it comes to Islamic ETFs. The first being the use of a binding promise, and the second is Jahalah, or the ignorance of price at the time of promising. However, the latter only occurs during the time of promise and not after the sale contract has been concluded.

According to Aznan, it is, however, acceptable for a promise of sale or purchase to be given and to be binding, despite not knowing the price at the moment of promise, but is imperative that the price is known at the time of the sale contract. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) had also recently taken an active stand in screening Islamic finance products in order to ascertain compliance.

Warming up

The market is seeing a gradual shift from mutual fund investors to Islamic ETFs due to its accessibility and low management fee. According to an industry practitioner: "People want diversification but they do not want to pay so much, and due to the liquid nature of Islamic ETFs, investors can buy and sell almost immediately." However, there is also the underlying need to provide more education on this product. Bourses such as Bursa Malaysia have also begun to recognize the need for this, providing a range of educational series on ETFs to enhance public knowledge and investor interest in the product. The SCM and Hong Kong's Securities and Futures Commission had also recently signed an MoU to facilitate the listing of more Islamic products, including ETFs. However, industry experts do not expect to see this phenomenon taken up too swiftly by the Middle Eastern bourses due to their infancy, compared to European bourses such as EURONEXT and the London Stock Exchange.

The creation of Islamic ETFs has also enticed unassuming markets such as Japan, with Daiwa Asset Management listing its first Islamic ETF (the Daiwa FTSE Shariah Japan 100) on the Singapore Exchange in May last year, and is eyeing other markets including Hong Kong and London to be listed. Taiwan has also revealed plans to list an Islamic ETF on the Abu Dhabi Securities Exchange.

Ultimately, market makers anticipate a surge of interest in this arena once Asian investors embrace Islamic ETFs as a cheap, transparent and liquid tool for beta exposure.