



# ISLAMIC EXCHANGE TRADED FUNDS

By i-VCAP Management

## INTRODUCTION

An exchange traded fund (ETF), is a unit trust/mutual fund that is listed and traded on a stock exchange. The fund invests in underlying securities of a benchmark index with the objective of replicating the performance of that index. On Bursa Securities, investors transact in units of an ETF in board lot of 100 units via any of the participating organizations (stock broking companies).

The expected return of an ETF closely mirrors the expected return of its benchmark index which in turn is the expected weighted average return of the components of the benchmark index.

A Shariah ETF has similar features to a conventional ETF. The main difference is that a Shariah ETF tracks a benchmark index comprised wholly of component securities which are Shariah compliant whereas a conventional ETF may track any benchmark index regardless of the Shariah status of its component securities.

In Malaysia, MyETF Dow Jones Islamic Market Malaysia Titans 25 (MyETF-DJIM25) is the country's first and currently the only Shariah ETF listed on Bursa Securities. MyETF-DJIM25, launched in January 2008 and managed by i-VCAP Management (i-VCAP), is also the first Shariah ETF listed in Asia and the largest Shariah ETF in the world to date (NAV: RM626 million/US\$203 million as at 31<sup>st</sup> December 2010).

MyETF-DJIM25 tracks the Dow Jones Islamic Market Malaysia Titans 25 (DJIM25) Index, which consists of 25 leading Shariah compliant stocks listed on Bursa Securities. The sector with the highest weighting in the DJIM25 Index currently is plantation, followed by telecommunication, transportation, infrastructure and oil and gas.

In addition to the management of MyETF-DJIM25 pursuant to the Shariah stock screening process, i-VCAP also undertakes an income purification process. This involves segregating the non-Shariah compliant income from the income (mainly dividends) received from the component stocks, and distributing it to charities and/or utilizing it for educational programs for the public.

## REVIEW OF 2010

The global ETF industry's YTD net asset value (NAV) as at end of December 2010 stood at US\$1,311.3 billion, an increase of 26.5% from US\$1,036.1 billion in December 2009, according to Blackrock's "ETF Landscape: Industry Highlights Year End 2010" report.

The NAV of the largest ETF market, i.e. the US, stood at US\$891 billion as at the end of December 2010, an increase of 26.2% from US\$705.5 billion in December 2009. A total of US\$119.2 billion of nett new assets went into US listed ETFs in 2010. The major contributions to net new assets include US\$74.8 billion from equity ETFs (Emerging market US\$29.8 billion and North American market US\$37 billion), US\$29.4 billion from fixed income ETFs and US\$13.3 billion from commodity ETFs.

Shariah compliant ETFs on the other hand are still at the infancy stage with an estimated NAV of approximately US\$1 billion as at end December 2010. Equity based ETFs continue to dominate the Shariah ETFs space but there has been progress in terms of products and new markets for Shariah ETFs.

In Turkey, Kuveyt Turk Participation Bank launched and listed GoldPlus ETF on the Istanbul Stock Exchange. The GoldPlus ETF provides investors access to gold via the exchange and complements



Illustration 1: Expected return of ETF



existing gold ETF by Dubai Gold Securities which is listed on Nasdaq Dubai.

In Saudi Arabia, the Capital Markets Authority approved the first ETF listed in the Kingdom. The Falcom Saudi Equity ETF tracks the performance of the top-30 (by free float market capitalization) Shariah compliant Saudi Equities listed on the Tadawul Stock Exchange, the largest bourse in terms of market capitalization in the MENA countries.

In India, the Bombay Stock Exchange launched its first Shariah compliant stock index in December that could potentially enhance the offering of ETFs and mutual funds in the country. Presently there is one existing Shariah ETF in the country, Shariah BeES, listed in April 2009 on the National Stock Exchange that tracks the S&P CNX Nifty Shariah Index.

In Malaysia, plans are also underway for Bursa Securities to further promote ETFs among investors. Among the possible initiative is to list UCITS III (Undertaking for Collective Investment in Transferable Securities) compliant ETF on Bursa Securities for it to be marketable and accessible for investors in Europe and Asia that require conformance to such investment regulations.

Meanwhile, on the regulation front, the Mutual Recognition Agreement signed between the Securities Commission of Malaysia and the Securities and Futures Commission of Hong Kong in 2009 could potentially spur secondary listings of ETFs (Shariah and conventional) between the two countries.

**"Investors now are increasingly using ETFs as a tactical asset allocation tool"**

## APPLICATIONS OF ETF

The use of ETFs has been more prevalent in Europe and the US, among both retail and institutional investors. Traditionally ETFs are utilized by investors seeking for passive portfolio diversification at a lower cost compared to investments in actively managed unit trust funds.

Investors now are increasingly using ETFs as a tactical asset allocation tool. Investors can gain immediate exposure to an asset class, sector or geographical region which they expect to perform positively while they conduct detailed research on specific securities within that asset class, sector or region. Once these investors have identified specific securities to invest in, they switch out of the ETF and into the securities.

On the other hand, investors who are indifferent to security selection may utilize ETFs to gain exposure to a particular asset class, sector or region which they expect to perform as a group without any preference for specific securities. One such example is investors may purchase MyETF-DJIM25 for exposure to a portfolio of leading Malaysian Shariah equities.

ETFs can also be used as a cash equitization tool where the cash holding is temporarily invested into selected ETFs for potentially higher yield or return than bank deposit rates before employing the cash for a pre-identified investment or purpose at a later date. For instance, an investor who has a pool of cash that has been earmarked for a specific project that commences in six months can

## Islamic Exchange Traded Funds

take a temporary position in an equity ETF during a potential market 'bull run' in expectation of getting a more favorable return than the bank deposit rate over the six month period.

In addition, investors who wish to have positions in markets or asset classes that are rather difficult to access directly may buy into the relevant ETFs to gain exposure to such investments, for instance a regulated market that requires direct investors to be pre-qualified or the commodity asset class.

## ETF STRATEGIES

Investors may also utilize ETFs for portfolio construction by incorporating the following strategies:

### Core Strategy

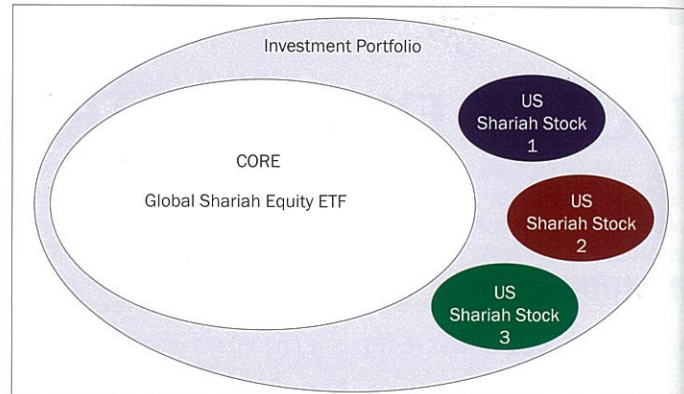


Illustration 2: "ETF as core" Strategy

The ETF becomes the core component of the investment portfolio while single securities are added to gain "overweight" or "secondary" positions. One such example is to purchase a Global Shariah Equity ETF as the core investment and add US Shariah compliant securities to overweight the portfolio in US stocks.

### Satellite Strategy

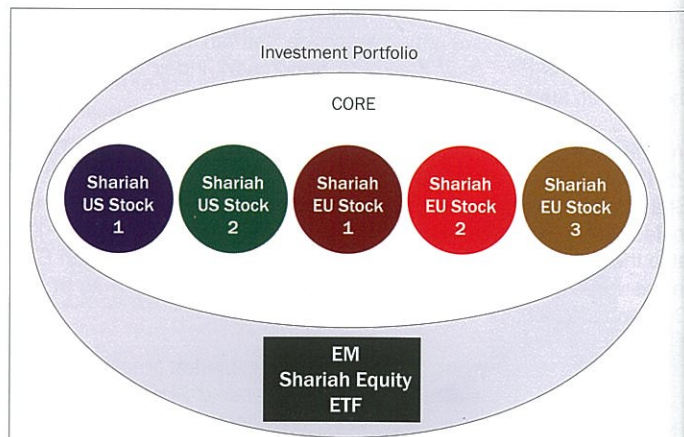



Illustration 3: "ETF as Satellite" Strategy

An ETF or a series of ETFs provide peripheral components of the portfolio where the main portion is invested in single securities. One such example is to purchase US and European Shariah compliant securities for the core portfolio and emerging markets Shariah Equity ETF as the satellite component.

### Fund of Funds Strategy

An investor may invest into a number of ETFs to create a Fund of Funds. A Fund of Funds strategy utilizes the ETFs to represent





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Invest in a basket of leading Shariah-compliant stocks through a single transaction
- **Convenience**  
Enjoy the flexibility of managing your investments at any time during Bursa Securities' trading hours
- **Transparency**  
Get real-time information on the Fund's component stocks and their performance
- **Cost Efficiency**  
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The fund is available in Malaysia only. It is recommended that you read and understand the contents of the Prospectus for MyETF-DJIM25 dated 21 January 2008 which is registered with the Securities Commission and seek independent advice before investing. Please consider the fees, charges and risks involved. Since the unit price and income distribution varies, past performance of a fund is not indicative of future performance. You may view the Prospectus at the Fund's website or obtain a printed copy from i-VCAP Management Sdn. Bhd.'s office.



various asset classes, sectors, regions, etc... in a diversified portfolio without investing in single securities, e.g. an Asian Shariah Equity ETF, a European Shariah Energy ETF and a Global Shariah Sukuk ETF would form the investment portfolio of a Fund of Funds.

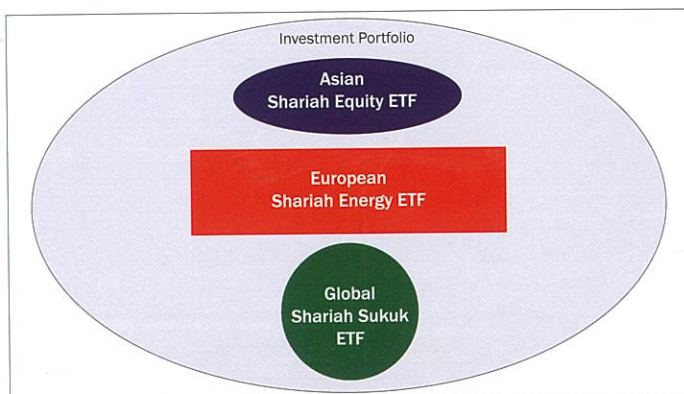


Illustration 4: "ETF as Fund of Funds" Strategy

## Islamic Exchange Traded Funds

### CONCLUSION

Looking ahead, greater awareness and acceptance of the applications and usage for ETFs will spur the demand for Shariah ETFs. We believe when more Shariah ETFs are introduced to provide a broader range of ETFs tracking different asset classes (equities, fixed income, commodities) and geographical regions, then ETFs will become a widely accepted investment tool.

Furthermore ETFs in general, Shariah and conventional, are attractive for their relatively lower investment cost compared to active management which may not necessarily deliver alpha across all asset classes.<sup>(2)</sup>

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