Islamic ETFs: The real deal?

Market makers are enthusiastic about more sophisticated investment options. However, NAZNEEN HALIM questions if investors themselves are ready to break from convention.

The world becomes a much less complex place when one realizes that everything can be reduced to buying and selling. With some exceptions of course, where Islamic finance is involved. The proverbial "15 minutes" has trickled into almost every aspect of our lives, including business and investment trends. These days, faster is always better.

However, how does this concept of faster and better relate to Islamic finance — which is famous for its relatively long-tenure finance structures and is therefore anything but quick?

The secondary Islamic market has also suffered from blasé trading habits and a lack of volume and movement, which many blame on a dearth of investment products and educated investors. And if such is the case, perhaps Islamic exchange-traded funds could be the answer.

ET-What?

The concept is simple: Market makers bunch together "clean" stocks, and market players buy up those stocks for trade. For those who enjoy the thrill of buying and selling stocks (to each his own, now), Islamic exchange-traded funds (ETFs) is the filtered alternative.

According to Kevin Chan, investment specialist for Structured, Indexed & Asset Allocation Asia, BNP Paribas Investment Partners: "An ETF is basically a fund which behaves like an equity. The difference between mutual funds and an ETF is that it is transparent, cheap and readily available on the secondary market and bid-offer quotes are available throughout the day, as opposed to mutual funds where there are no intra-day quotes, and subscriptions can only be made at the end of day calculated net asset value (NAV).

"Also, an ETF is passively managed, compared to a mutual fund which is actively managed. This is naturally a better investment option as the management fee for ETFs is reduced by 1.5% to 0.5% compared to that of mutual funds which is at 2%.

Zainal Izlan: Islamic ETFs are very similar to conventional ones

"ETFs also allow investors to gain exposure to various markets which are otherwise difficult to get into. This is especially attractive to portfolio managers that want to include less accessible markets in their portfolios," Chan added.

Zainal Izlan, CEO of i-VCAP which had launched Malaysia's first publicly listed Islamic ETF in January 2008, elucidated that Islamic ETFs are similar to conventional ETFs with few differences. "In terms of features, Islamic ETFs are very much similar to conventional ones. What is different is all that the component stocks of an Islamic ETF are Shariah compliant. The stock screening methodology is heavily dependent on the index provider linked to the ETF." And in i-VCAP's case it is Dow Jones, as it is benchmarked against the Dow Jones Islamic Market Malaysia Titans 25 Index.

"Dow Jones has its own Shariah advisory board, and i-VCAP as fund managers also has to comply with the Malaysian Securities Commission's (SC) Shariah approved list to ensure that all the counters on the index are on the SC's list before it can invest in the index constituents. So far there have been no exceptions, but in the event where any of the components on the index are not on the SC list, we have to take some measures to address the issue, bearing in mind that we have to track the index — which is the objective of the ETF," Izlan added.

Shariah issues

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, Izlan admits, there are stocks on the benchmark index which do not comply with the differing Shariah requirements of different jurisdictions.

Should this occur, he 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 SC, what we can do is re-balance the remaining 24 stocks so that the index will proportionately take on the percentage of the non-approved stock.

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

The 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 channeled for education or charitable purposes.

However, how does one ascertain the exact amount which is not compliant in the whole basket of stocks? Izlan explained: "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." According to Aznan Hassan, Shariah scholar at Bursa Malaysia, there are two main concerns when it comes to Islamic ETFs. One is the use of a binding promise, and the other 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.

Hassan added however that it is 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 it 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 and this, according to Chan of BNP Paribas Investment Partners, is part of the bank's strategy to attract Middle Eastern and unconvinced investors.

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Lackadaisical response

The largest Islamic ETF in the world currently has a NAV of US$195.41 million — pocket change compared to the largest conventional ETF, which is the Spider S&P500 with a NAV of US$80 billion and a daily average trading volume of US$15 billion.

According to those within the industry, this is partly due to low investor awareness and education of the product. Izlan from i-VCAP however assured that this is top priority among most international bourses, with Hong Kong and Malaysia revving up their trading of Islamic ETFs. "Bursa Malaysia has come up with a few initiatives to encourage the liquidity of ETFs, one of them being the reduction of the tick size of ETFs in August 2009.

Previously, the tick size or price change was set at one cent (Malaysian), and NAV prices were quoted to four decimal points. And to strike a better trading balance between buyers and sellers, Bursa Malaysia changed the tick size to three decimal points." The SC and Hong Kong Financial Services Center recently signed an MoU to enable the listing of more Islamic products, including ETFs. However, industry experts do not expect to see this being emulated too swiftly by the Middle Eastern bourses due to their infancy.

Is the future now?

According to Chan, whose company BNP Paribas Investment also acts as advisors to i-Vcap, the market is seeing a gradual shift from mutual fund investments to Islamic ETFs due to accessibility and low management fee. "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, he also stressed on the need for more education about the product.

The ETF industry as a whole, be it conventional or Islamic, is still relatively new in most parts of Asia, including Malaysia, despite being hugely popular in Europe and the US. "Until we have more ETFs available across Asia, the level of interest will still remain relatively low. In the future, if we have 10 to 15 ETFs listed on Bursa Malaysia and other bourses, then the investing public will take interest," said Izlan.

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This, industry experts contend, is also dependent on the underlying benchmark of what the ETF is tracking. The recent global financial crisis has no doubt generated a bleak outlook for equity investments this year, most experts say.

However, the creation of Islamic ETFs has enticed unlikely markets such as the US, which is home to the JETS Dow Jones Islamic Market International Index Fund and Florentez Investment Fund which tracks the FTSE Shariah US Index. Markets such as Japan have also treaded the waters, with Daiwa Asset Management listing its first Islamic ETF — the Daiwa FTSE Shariah Japan 100 — on the Singapore Exchange in May last year and eyeing other markets including Hong Kong and London to list.

Taiwan has also revealed plans to list an Islamic ETF on the Abu Dhabi Securities Exchange. 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.