

# Behind the Screen of ETF

By Shabnam Mokhtar, Associate Researcher ISRA

The SC's Guidelines on ETFs defines ETF as "a listed index-tracking fund, **structured as a unit trust scheme whose primary objective is to achieve the same return as a particular market index....**"

Simply put, ETFs are listed index fund. That still sounds complex doesn't it? Let's take one step back and understand what an index fund is. Index fund are mutual funds (i.e. unit trusts) that tracks the performance of an index (S&P 500, DJIM, FTSE, KLCI etc). Unlike unit trust that involves active management (fund managers have to choose which stock to buy), an index fund only involves passive management (fund managers don't have to choose what to buy – they buy the index constituent).

Therefore, is ETF just another name for index fund? Not quite. As index fund is a type of unit trust, it is not listed and traded. ETFs, however, are listed on an exchange and traded. That means we can obtain the price of the ETF at any time of the day (just like a stock). That leads to another question? How is ETF different from a stock then? If you

buy a single stock, your portfolio is not diversified. However, if you buy an ETF unit, it allows you to own a pool of stocks via a purchase of a single security. So, ETF gives the diversification of an index fund plus the tradability of a stock. That's the rationale of the name - a listed index fund. It gives you diversification (because it's a unit trust) and tradability (because it's listed).

The equity market started off with stock trading. However, as retail investors did not have the time and skill to pick and trade stocks, this gave rise to mutual funds (introduced in 1975) - a fund manager managing stock trading for a pool of investors. As mutual funds were usually unable to beat the market return (market as measured by indices), the index fund was created. Nonetheless, as mutual and index funds are not listed and traded, the market players came up with ETF - a listed index fund. That's why ETFs represent the evolution in the equity market. This is illustrated in Diagram 1.

## Shari'ah compliant ETF

The conventional space has seen the growth of hundreds of ETFs that cover various sectors, countries and markets whereas Shari'ah compliant ETFs made its entry into the market only in February 2006, when Bizim Menkul launched the first Islamic ETF-the DJIM Turkey ETF-listed on the Istanbul Stock Exchange that tracks the performance of the DJIM Turkey Index. Recall that since ETFs are listed index fund, it will always be listed on an exchange and it will track an index. Table 1 highlights the Shari'ah compliant ETF that are in the market currently together with the index they track and the exchange that they were listed on.

ETF need not be limited only to shares. It could be on any underlying assets, be it shares, bonds (Sukuk) or even physical commodities. The year 2008 has witnessed at least two Exchange Traded Commodities (ETC) that obtained Shari'ah compliant status. Table 2 summarizes the ETCs.

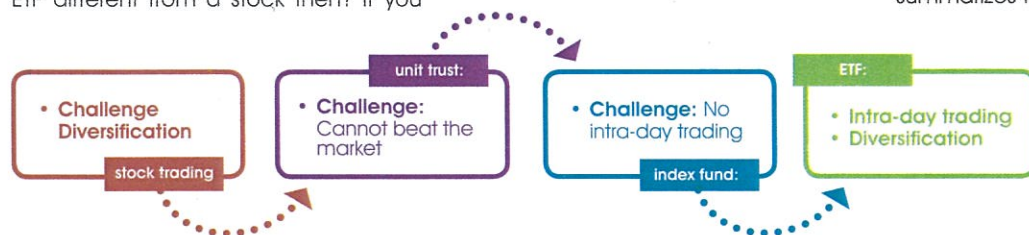


Diagram 1: How ETF was born

Name	Index	Manager	Launch/ Listing
DJIM Turkey ETF	DJIM Turkey	Bizim Menkul	Feb 2006/ Istanbul
EasyETF DJIM Titan 100	DJIM Titan 100	BNP Paribas	Feb 2007/ Swiss
iShares:	MSCI Islamic	Barclays (iShares)	December 2007/ London
• MSCI World Islamic			
• Emerging Market Islamic			
• USA Islamic			
MyETF DJIM 25	DJIM Titan 25	i-VCAP Management	January 2008/ Malaysia
Daiwa FTSE Shariah Japan	FTSE Japan Shariah	Daiwa Asset Management	April 2008/ Singapore
Db x-trackers:	100	Deutsche Bank	August 2008/ London
• S&P 500 Shariah	S&P		
• S&P Europe 350 Shariah			
• S&P Japan 500 Shariah			

Table 1: Shari'ah compliant ETF in the market

Name	Commodity	Manager	Shari'ah compliant status
NewGold	Gold	Absa Investment	March 2008/ South Africa (JSE)
ETF Securities:			
• ETFS Physical Platinum	Platinum	ETF Securities	August 2008/ Europe
• ETFS Physical Palladium	Palladium		
• ETFS Physical Silver	Silver		
• ETFS Physical Gold	Gold		
• ETFS Physical Precious Metal Basket	Mixture		

Table 2: Shari'ah compliant ETC in the market

EXTRACTED FROM: VOL 02 / APRIL 2009  
 WRITER: SHABNAM MOKHTAR (EDITOR)



## Behind the Screen of ETF

Since Malaysia has one Shari'ah compliant ETF listed on Bursa Malaysia, ISRA Bulletin approached i-VCap's CEO, Zainal Izan Zainal Abidin, to discuss the mechanics of ETF and understand how it is priced. The following are excerpts from the interview:

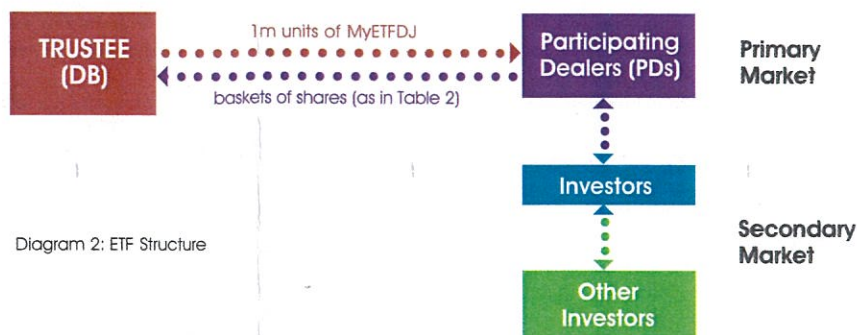


Diagram 2: ETF Structure

### Would you explain how ETFs are created?

One unique feature of ETF is that it involves in-kind creation and redemption. Let me give some background first. MyETF tracks the DJIM 25 i.e. top 25 Shari'ah compliant counters on Bursa according to Dow Jones' screening criteria. i-VCap publishes the daily fund value (refer to Table 3) that lists what stocks are on MyETF. This list is also known as the perfect basket and it represents the number of shares that make up one million unit of MyETF. Creation and redemption in the primary market must be done in multiples of the perfect basket. You can create or redeem one, two or three million units for example. This list is to facilitate the participating dealers (CIMB and OSK in our case).

If someone wants to create one million unit of MyETF for example, they will need to have 15,500 Sime Darby Shares, 22,000 IOI Corp Shares etc plus a balancing amount known as the cash component (refer to Table 2 for the exact composition). The investors effectively don't pay with cash, they pay with the perfect basket. That's why it is called in-kind. The participating dealers (PD) would have to deliver this perfect basket to the trustee in order to create one million unit of MyETF. When the PDs deliver the perfect basket, the trustee will issue the ETF units. That's why I said the ETF represent the underlying shares. In the secondary market, the investors who own the ETF unit can sell it to other investors, and of course this is done using cash. Not in-kind anymore. (Refer to Diagram 2 for the illustration).

### What if the investors do not have the shares?

This is the challenge. In the conventional space, they could use Securities Borrowing and Lending (SBL). So they could borrow the stocks and deliver the perfect basket. However this would not be Shari'ah compliant. Until there

Manager's Fee* (% p.a)	Trustee Fee* (% p.a)	License Fee* (% p.a)	NAV per Unit (RM)	Dow Jones Islamic Market Malaysia Titans 25 Index
0.40%	0.05%	0.04%	0.5962	550.05
Stock Code	Issuer	Qty of Shares	Price As At 24 FEB 2009	In-Kind Creation/Redemption 1,000,000 units
4197	SIME DARBY BERHAD	15,500	5.650	RM87,575.00
1961	IOI CORPORATION BERHAD	22,000	3.650	RM80,960.00
6947	DIGI.COM BERHAD	1,900	21.200	RM40,280.00
2445	KUALA LUMPUR KEPONG BERHAD	3,500	9.900	RM34,650.00
3816	MISC BERHAD	7,200	8.550	RM61,560.00
5398	GAMUDA BERHAD	10,500	1.930	RM20,265.00
4065	PPB GROUP BERHAD	3,900	9.750	RM38,025.00
7164	KNM GROUP BERHAD	19,900	0.400	RM7,960.00
5052	PLUS EXPRESSWAYS BERHAD	8,400	2.880	RM24,192.00
8664	SP SETIA BERHAD	5,400	3.340	RM18,036.00
4588	UMW HOLDINGS BERHAD	3,600	5.400	RM19,440.00
6033	PETRONAS GAS BERHAD	1,700	9.750	RM16,575.00
1899	BATU KAWAN BERHAD	1,400	7.950	RM11,130.00
6888	TM INTERNATIONAL BHD	10,100	3.220	RM32,522.00
2291	ASIATIC DEVELOPMENT BERHAD	1,800	4.100	RM7,380.00
3794	LAFARGE MALAYAN CEMENT BHD	1,900	3.820	RM7,258.00
7277	DIALOG GROUP BHD	5,800	0.845	RM4,901.00
5077	MALAYSIAN BULK CARRIERS BHD	2,100	2.780	RM5,838.00
2283	ZELAN BHD	1,800	0.775	RM1,395.00
6084	STAR PUBLICATIONS (MALAYSIA)	2,100	3.060	RM6,426.00
5122	KENCANA PETROLEUM BHD	2,900	1.210	RM3,509.00
2356	SARAWAK ENERGY BHD	3,800	1.640	RM6,232.00
3867	MALAYSIAN PACIFIC INDUSTRIES	400	5.550	RM2,220.00
2887	LION DIVERSIFIED HOLDINGS	2,400	0.290	RM696.00
4863	TELEKOM MALAYSIA BHD	9,700	3.340	RM32,398.00
Cash issue/ Redemption Component Aggregate Creation/ Redemption Value				RM24,777.00 RM596,200.00

Table 3: MyETF Perfect Basket composition

is a Shari'ah compliant mechanism (which Bursa Malaysia is working on), the investors would need to go and acquire the shares in the open market. (Note: The participating dealers can help to put together the perfect basket for the investors).

### When MyETF was first issued, how was this problem tackled?

In our case the Government Linked Investment Companies (GLICs) played a role as seeders and investors. We created 840 million units. The seven GLICs that were involved (Khazanah Nasional, Employees Provident Fund, Kumpulan Wang Persaraan (Pension Fund), Lembaga Tabung Haji, Lembaga Tabung Angkatan Tentera, Permodalan

Nasional Bhd (PNB) and Valuecap Sdn Bhd) seeded the 840 million units. They subscribed to some of the 840 million but also made some available to the public during the initial subscription period. In a normal ETF you don't usually have the seeders. If a pool of investors let's say want to buy 10 million units of ETF, then the PD would have to go and buy the perfect basket in the open market if it had not been seeded. In this respect, the role of GLICs in MyETF was two folds; first to facilitate the creation and second to reduce the market disturbance during the subscription. In addition, the primary reason for the GLICs' participation was the government's effort to reduce part of GLICs' holding in some of these shares. Sime Darby's shares for example, which



makes up a big portion of the MyETF, were held in a quite large portion by the GLICs. So when the GLIC seeded the stock, the free float of these shares improved.

#### When the underlying share pay dividends, are these distributed to the ETF holders?

In Malaysia, ETF is quite new. There is a set of guidelines on ETF issued by SC but at the same time in certain areas the guidelines are silent, including on dividends. If we refer to the unit trust guidelines, a fund can only pay dividends out of net realized profit or income. In MyETF's case, even though the underlying shares pay dividend, because we do rebalancing on a quarterly basis, when we rebalance there are stocks that we sell and due to market conditions, these were sold at losses. As a result, the net realized position of the fund was a net loss last year. Nevertheless, we are seeking further clarification on this issue with the relevant parties.

#### What is i-VCap's role in MyETF?

We have two main roles as the Manager; rebalancing the portfolio and managing the tracking error. Dow Jones reviews the benchmark index on a quarterly basis. So when they review, we will also rebalance our portfolio so we are in-line with the revised index weightings. Rebalancing is a cash neutral strategy meaning that we will buy some stock and sell some other stock. This is our role with regards to trading. Other than that our role is to manage the tracking error. That is how our performance is measured. How closely we track the benchmark index. For us, managing the tracking error supersedes the usual investment consideration like realizing gain. Even if we expect the market is going to come down, we would not sell and hold cash because it would enlarge the tracking error. So what we do is, we just make sure that our fund's portfolio (the shares) is as close as possible to the composition of the benchmark index.

Managing tracking error means we try to match the return on a daily basis. Sometimes some people think that in between we can do something differently, however a daily basis tracking error does not allow this. We manage our tracking error not only periodically but on a continuous basis.

#### How is the ETF unit priced?

There are two prices that we need to differentiate; first the market price of the ETF units and second the net asset value (NAV). The market price would be driven by supply and demand, but typically it would hover around the NAV of the fund. NAV is the actual value of the fund. It is derived from the prices of the underlying shares. However like any shares, the market price of the ETF is affected by supply and demand. So you may have a situation where the NAV is RM0.60

but the ETF unit price could be RM0.62 or RM0.63, which is 5% higher, because there are more buyers than sellers in the market. In our case the trading volume is still illiquid. Thus investors may be taking a view. Let's say they feel that in six months time, the market will go up. Thus they don't mind paying more than the actual value of the fund. Because they think in six months the value would be RM0.75 for example.

#### How do you calculate the NAV?

The NAV is made up of the actual closing prices of the component stocks. At the end of the day, we will price it according to the closing price of each stock. If we take the number of shares in the portfolio and multiply it with the respective closing price we will arrive at the market value of the stocks. If we add the cash component (received and receivable) to this market value then we'll arrive at the portfolio value. Of course we will have our management expenses (manager fee, trustee fee and license fee to name a few). These expenses will be accrued on a daily basis. If we deduct the daily expenses from the portfolio value, we will arrive at the total NAV. Then we take the NAV and divide it by the number of units in circulation. That's how you arrive at the NAV per unit. (Refer to Box 1 for summary).

• Number of shares * Closing price	=	Market Value of Shares (MV)
• MV + cash component	=	Portfolio value
• Portfolio Value – Expenses (accrued daily)	=	Net Asset Value
• NAV/unit in circulation	=	NAV per unit

During the day, this information is available on the broker's trading system. This is what we call the indicative optimized portfolio value (IOPV). In Europe it is known as indicative NAV (INAV). The brokers can actually see what the indicative live value of the fund is. We provide this to Bursa every evening which Bursa will upload to their trading system. Then it would be linked to the live prices on the next day. So brokers can actually see when live prices change, the IOPV will also change. The only thing that they don't capture is the accrual of the expenses or the cash portion. But it is good enough for the brokers to get an indication. Especially if market is volatile, this would be an indication of how the fund value changes.

#### What do you do if one of the underlying shares changes status from Shari'ah compliant to non-compliant?

DJ screens firstly by industry (pork related, gaming, alcohol, entertainment, banks, weapon etc). Then they do a financial screen. They have three different ratios – accounts receivable, debt ratio and interest income. These components cannot exceed certain ratio. On a quarterly basis, they will rebalance the weighting of the component stocks. On an annual basis they will review the component stocks themselves. They will use the latest financial statement of these companies to see if they meet the financial ratio screen. But this is only on annual basis. The idea is not to make the composition of the index too volatile.

From the fund's perspective, which is listed in Malaysia, it is also subject to SC's criteria. Theoretically if one of the DJIM 25 components is not compliant according to SC's criteria, then we have to abide by SC's screen because the fund is based in Malaysia. So we can't put the stock in our fund, even if it is in the index. In this case we would have three options:

1. Rebalance the remaining stocks (24) so they make up the 100%.
2. Find another stock that has a close correlation with the excluded stock (substituting).
3. Keep the excluded stock portion in cash form.