

Getting to grips with
ISLAMIC EXCHANGE TRADED FUNDS
(ETFs)

ISLAMIC FINANCIAL MARKETS

GRAND HYATT, JAKARTA

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What are Islamic ETFs?

- An Investment Vehicle traded on Stock Exchange much like Stocks
- Holds assets like Stocks, Bonds, Commodities or Funds
- Trades at same price as NAV of underlying assets over course of trading day
- Most ETFs track Indices like DJIM, FTSE Islamic etc.
- Open-ended Funds with unique in-kind creation & redemption mechanism supported by a system of participating dealers & liquidity providers
- Must have a Prospectus like other Investment Companies
- Beta product; Index tracking & Passively-managed
- Low cost; Tax-efficient but with Stock-like features
- Holistic benefits without the need for trading in underlying stocks

What are the benefits of Islamic ETFs?

- Diversification of portfolio with low cost and tax efficiency while maintaining all features of ordinary stock
- Individual shareholder purchase & redemption do not involve buying or selling of underlying securities because these are not actively managed, thus lowering marketing, distribution & operations costs
- ETFs can be bought & sold at market price any time during the day, unlike mutual funds or Unit Investment Trusts which are traded at the end of the day
- Lower tax due to relatively low capital gains because portfolio turnover is low & redemptions do not require selling shares
- Broader market diversification & exposure providing economical way of balancing portfolio quickly
- Complete transparency because the portfolio details are public knowledge & are priced frequently throughout the day



Islamic ETFs – Types which exist or can be promoted

- **Islamic Index ETFs** – currently almost all Islamic ETFs are linked to one Stock Market Islamic Index or another.
- **Islamic Commodity ETFs** – currently non-existent, though physical ETCs based on precious metals are traded on 5 Exchanges in Europe . World Gold Council is targeting 4th Q launch of Islamic Gold ETF in Dubai.
- **Actively Managed Islamic ETFs** – currently non-existent but meant to overcome the Arbitrage & Front-running risks associated with normal ETFs
- **Islamic Exchange-traded Grantor Trusts** – currently non-existent but meant to provide measured exposure to a basket of stocks in a specific sector/industry

Why are Islamic ETFs different from Conventional ETFs?

- Index tracked by Islamic ETFs are made up of companies that have passed filters specified by strictures of Shariah Law
- These filters eliminate companies operating in industries such as Tobacco, Alcohol, Gambling, Conventional Banks & Insurance Companies
- Also companies which do not satisfy financial ratios like Cash & Receivables to Total Assets; Conventional Debt to Market Cap; Haram income to Total Income etc.
- Islamic ETFs avoid Securities Lending, Futures & Options as part of their operations to achieve their investment objectives
- Conventional ETFs provide greater diversification than Islamic ETFs because fewer companies in the broader index qualify through Shariah filters
- Islamic ETFs are a nascent phenomenon in the industry with fewer number of issues and very low trading volumes



Islamic ETFs – where are we today?

- Conventional ETFs Market Size estimated between \$ 650b forecast to touch 1 trillion by 2010
- Islamic ETFs managed under DJ Islamic Indices approx \$ 7 b; overall size estimated at \$ 10 b
- Most Islamic ETFs listed on London, KL, Singapore, Istanbul & Gulf exchanges
- Major players include BNP Paribas (Easy ETF); Bizim Menkul Degerler Turkey (DJIM Turkey ETF); iShares of Barclays Global Investors; iVCAP Management of Malaysia; Daiwa (FTSE Japan 100 Index); Deutsche Bank (DB x-trackers)
- Nascent market but offering growth potential
- More multinational conventional financial institutions offering Islamic ETFs than Islamic Financial Institutions



Islamic ETFs – Going Forward

- **Scope for growth?** 1.2 billion Muslims globally; 57 Islamic countries; \$ 3+ trillion of Wealth; High Oil prices; Booming economies in GCC countries
- **Educating Investors** – Like most other Islamic Finance products, ETFs are not well-understood (only 20% of Muslims surveyed are aware of Islamic Finance products)
- **Good Omen** – Deep-pocket conventional FI's are promoting Islamic ETFs backed by transparency, research & regulatory compliance; just like most other Islamic Finance products brought to the market successfully in the past
- **Energy & Commodity Index-linked ETFs** – most likely to appeal to GCC investors at large and draw large trading volumes from institutional investors. Hence most likely to grow in numbers in coming years
- **ETFs of Funds?** Theoretically possible to accumulate Unit Trusts, Mutual Funds and other listed funds under a basket to address specific needs of retail and similar investors to maximize tax and other benefits

Islamic ETFs – Going Forward

- **Retail Investment Opportunity?** – Structuring appropriate lot size coupled with low costs could enamor retail investors as alternative to Mutual Funds
- **Exchange-led Incentives** – Lower trading costs, start-up & redemption costs incentives from exchanges in major trading centers will help promote the launch & trading of Islamic ETFs
- **Sub-Prime Credit Crisis?** – Islamic ETF would have excluded conventional Financials (which are suffering the most in current crisis) hence would have performed better than their conventional counterparts. Also in high interest rate environment, Islamic ETFs would tend to do better than conventional counterparts due to low debt leveraging and shunning riba-based funding

