Shariah ETFs: Catching the next wave of growth in Islamic finance

The surge in volume of ETFs has been an industry wellspring, with increasing investment demand and new technology frontiers contributing to its explosive growth. According to research by ETFGI, assets invested in ETFs listed globally hit a new milestone this year, reaching over US$4 trillion in assets. AKMAL HASSAN delves further.

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Although the US and Europe accounted for most of the growth, the Asia Pac (ex-Japan) region is emerging as a notable player as well, posting its own record inflows and collective asset size of over US$151 billion at the end of July 2017, according to ETFGI.

While, the Islamic finance space has yet to catch on with this passive wave of investing, we think the sector is poised to eventually. And, together with the availability of other index-linked investments and passive products, the Islamic finance sector could see renewed growth driven by large inflows from investors who are inclined toward Shariah compliant solutions or are ethical investors.

With only just eight ETFs listed on Bursa Malaysia, split evenly between Shariah and conventional ones, Malaysia stands at the epicenter of the industry as the Islamic financial hub to capture the lion's share of this growth.

Performance of Shariah versus conventional indices

Despite rising affluence among Muslim communities worldwide, the market remains largely underpenetrated when it comes to investments. Some attribute this to a lack of awareness, while some also add that is due to the stringent securities-selection process demanded by Shariah principles which could hold back investors due to its time-consuming nature.

Enter Shariah ETFs which offer a credible alternative for investors to invest in a basket of securities benchmarked against a Shariah compliant index.

Table 1: Comparative price returns (YTD as of the 28th June 2017)

	Shariah	Conventional	Variance
S&P Global BMI	13.3%	11%	2.4%
DJIM World	13.6%	11.1%	2.6%
S&P 500	10.4%	9%	1.4%
DJIM Asia Pacific	17.6%	14.4%	3.2%
DJIM Europe	19.5%	15%	4.4%
DJIM Emerging Markets	19.8%	15.6%	4.2%
S&P Pan Arab Composite	1%	1%	0%

SOURCE: S&P Dow Jones Indices. Calculations are based on price return index levels in the US dollar. Charts are provided for illustrative purposes. Past performance is no guarantee of future results.

Offering all the distinct advantages of a conventional ETF which provides low-cost exposure and transparency, the only difference is that a Shariah ETF employs an additional filtering process to sieve through non-compliant securities.

How does this additional filtering stage impact returns and performance? Interestingly, it augurs well against a benign economic backdrop of moderate inflation, dramatic headlines stemming from escalating tensions in North Korea, more missteps in President Donald Trump's administration and China's deleveraging exercise. Both the S&P 500 and Dow Jones Shariah compliant benchmarks outperformed their conventional peers year-to-date (YTD) as of the 28th June 2017 (see Table 1).

The broader Dow Jones Islamic Market World and S&P Global BMI Shariah indices also returned 13.6% and 13.3% respectively, eking out higher returns compared to their conventional counterparts by considerable margins, according to data from S&P Dow Jones Indices.

The results underscore yet again the overall defensiveness of Shariah compliant funds and its less volatile nature. By excluding firms with high leverage and including securities with certain financial prerequisites and better credits, the resulting portfolio is one that is more resilient especially in a heightened period of market volatility.

Carving out institutional demand

Following the decision by Malaysia's Employees Provident Fund (EPF) to introduce its Simpanan Shariah scheme in 2017, the statutory fund reported that a total of RM59 billion (US$14.05 billion) of the initial RM100 billion (US$23.81 billion) allocation was taken up by investors. A further RM50 billion (US$11.9 billion) injection has been allocated by EPF for the scheme next year.

Other global pension funds are expected to follow suit and introduce multi-pillar pension systems and Shariah compliant savings options, according to Securities Commission Malaysia (SC). Doing so will increase institutional demand for Shariah assets and bolster growth.

According to PwC, pension fund assets in Muslim-majority countries are expected to surpass US$1 trillion by 2020, and pension funds in the Middle East and Africa are forecast to grow 8.8% annually, outpacing the global growth forecast of 6.6%.

Global trends in sustainable and responsible investing (SRI) also point to continued demand for Shariah

Continued

assets, as we see an increasing number of institutional investors especially pension and sovereign wealth funds worldwide subscribing to more sustainable or ethical forms of investing.

Leveraging on the strength of its Islamic funds industry, Malaysia is once again leading its peers, holding the largest SRI market in Asia with assets under management (AuM) of US$15 billion, or 34% of the total Asian AuM, according to SC.

More importantly though, the industry must be ready to cater to this increased demand when it comes, and low-cost solutions such as ETFs and index funds are possible options that could spur growth, drive inflows and broaden choices for Shariah assets.

Putting in the next key step for growth

Recent initiatives by the SC, including the unveiling of its Islamic Fund and Wealth Management Blueprint and the establishment of an ETF taskforce which made recommendations to lower the minimum capital requirement for issuers and widen distribution channels, are definitely positive moves for the industry.

A framework is in the pipeline to introduce more innovative types of ETFs, including futures-based, leveraged, and inverse ETFs, that will further provide investors with cost-efficient entry points to access more sophisticated and traditionally difficult-to-access investments, according to the SC.

The global convergence of Shariah standards and principles, including the development of a Shariah gold standard by AAOIFI in 2016, could also prop demand for physically-backed gold ETFs and reignite interest in the safe haven asset.

Ultimately, the sector needs to view such moves toward digital distribution channels, the growing preferences for SRI and the popularity of low-cost and passive investment solutions as imperative to put into place the next key step for growth for the Islamic finance sector.