INVESTING STRATEGY

ETFS — ROOM FOR MORE

ETFs, which are in a nascent stage of growth in Malaysia, have performed well in recent years. Are there enough of them around and are they a good investment option? ***By Elaine Boey***

The first exchange-traded fund (ETF) in Malaysia was launched nine years ago. Since then, only five other ETFs have been introduced — a lethargic pace, compared with the ETF market in neighbouring countries.

An ETF is an investment fund that is traded on the stock exchange. Singapore's first locally created ETF, the SPDR Straits Times Index ETF, listed in 2002. Twelve years later, 96 ETFs have listed on the Singapore Exchange, of which 11 originated from the island-state. The rest are cross-listed ETFs (an ETF that initially listed in a foreign market, such as the US, then also listed in Singapore).

Thailand's first ETF was introduced in September 2007 and there are currently 17 ETFs trading on its stock market (see Table 1, page 7). Thai asset managers issue all of the country's ETFs.

The low-cost and instant diversification offered by an ETF has obvious advantages. So, why aren't there more ETFs on Bursa Malaysia?

Industry observers cite a chicken-and-egg problem: With only nascent demand, issuers are not motivated to issue new ETFs. Without new ETFs and the accompanying educational and awareness activities by an issuer, demand from retail investors stays weak.

This situation can change if an ETF issuer decides to buck the trend and issues new ETFs based on the long-term premise that savvy investors will increasingly appreciate and ask for low-cost passive investments. i-VCAP Management Sdn Bhd is attempting to be the game changer.

In April, the asset manager launched MyETF MSCI Malaysia Islamic Dividend ETF, the first ETF to list after a four-year hiatus. Back in 2010, CIMB-Principal Asset Management Bhd launched two offshore ETFs (see Table 2).

When you begin to invest so that you will have enough for your own retirement many decades hence, do so in a way that minimises the extraction by the financial community of the returns generated by business... Doing so is the only way to guarantee your fair share of whatever returns our financial markets are generous enough to provide, says John Bogle, founder and former CEO of the Vanguard Mutual Fund Group.

i-VCAP CEO and director Mahdzir Othman says the company is working on "making ETFs interesting to the retail market" and is planning to launch another syariah-compliant ETF later this year.

"ETFs have proven themselves as a workable product in developed markets outside Malaysia. The low-cost structure really benefits investors. An ETF market needs variety so that investors can implement their own asset allocation strategy with ETFs in their portfolio," says Mahdzir.

He points out that although Singapore has a large number of listed ETFs, trading volumes have been low and about half are usually inactive. "Perhaps the biggest misconception among investors is that a low trading volume means that the ETF is illiquid and thus a risky investment. This shows a need for more education. An ETF has appointed 'market-makers'. These are the guys who will make or redeem units in an ETF based on demand. So, if you want to evaluate the liquidity of an ETF, you have to look at the liquidity of its underlying assets. In other words, what is the ETF holding and are those assets frequently traded?"

Education on the benefits of and how an ETF works is a long-term process that requires commitment from all the stakeholders in the market. Investors often treat ETFs as they do stocks and expect quick returns. This does not work. It is more accurate to benchmark ETFs against unit trust funds that invest in the same category of underlying assets. Fund tables such as Lipper include ETFs in their ranking of collective investment schemes.

"If you look at Lipper's fund

Kenny Yap

PERHAPS THE BIGGEST MISCONCEPTION AMONG INVESTORS IS THAT A LOW TRADING VOLUME MEANS THAT THE ETF IS ILLIQUID AND THUS A RISKY INVESTMENT. THIS SHOWS A NEED FOR MORE EDUCATION

| ***MAHDZIR OTHMAN***

tables, you will see that ETFs are not the worst performers. This says that passive investments are outperforming some actively managed funds. Those who are invested in such funds are paying a higher fee for a fund manager as well as a high upfront fee, only to have their fund underperform a low-cost ETF which just follows an index. In this case, which is the better investment? "Of course, I'm not saying that unit trust funds are bad investments. These are the choices available and an investor needs to know the pros and cons of each type in order to make an informed decision about what is best for them," says Mahdzir (see How local ETFs stack up against unit trust funds).

Besides education, there is another growth driver that can spur an ETF market. This is the financial advisory industry. The assumption is this: When the financial product distribution model moves from commission-based to fee-based, advisors will start recommending cheaper ETFs to their clients. According to news reports, this was the US experience after 2008. There, fee-based assets drove the uptake of ETFs among retail investors who currently contribute to about half the trades in the ETF market in the US. The rest of the trades are by institutional investors.

Singapore's ETF market is also expected to see more liquidity if a fee-based financial product distribution model gains critical mass. In Malaysia, the financial product distribution model is still largely commission-based. This means that agents are not incentivised to educate their clients on passive investments such as ETFs and their benefits.

i-VCAP does not manage unit trust funds although it can manage private mandates. Neither does it have a sister company that distributes unit trust funds. This does away with any possible conflict of interest. As collective investment schemes, an ETF and a unit trust fund have similarities (as well as differences). The former can be seen as a threat to the livelihood of unit trust agents who charge a sales fee of up to 6.5% for equity unit trust funds. In contrast, an investor will pay the much lower brokerage fee, stamp duty and clearing fee to trade an ETF. This is similar to the fees incurred when buying or selling a share.

An ETF asset manager survives solely on the management fee of an ETF that averages around 0.4% per annum for ETFs with local underlying assets and 0.6% per annum for ETFs with foreign underlying assets. In contrast, unit trust management companies can charge up to 1.8% per annum to manage equity funds. This means that an ETF needs to be sizeable before its manager can reap cost efficiencies.

The uncertainty of when ETFs will gain enough traction to be financially viable is probably why the biggest ETF issuers in the world, such as BlackRock and iShares, have not entered the local market although they are already present in Singapore. Mahdzir adds that the local market may be more regulated than other countries, a move that deters foreign issuers but protects the local investors.

"ETFs are not the most exciting investment. They are passive investments and some can be riskier than others, such as those with small to mid-cap stock exposure, or those with foreign asset exposure. It is typically a long-term investment, much like a unit trust fund, but it does not levy a high upfront fee. So there is much to like and I hope more investors will warm up to the idea of using ETFs in their portfolio," says Mahdzir.

HOW LOCAL ETFS STACK UP AGAINST UNIT TRUST FUNDS

FUND ranking tables display the return made by a collective investment scheme on a net asset value (NAV)-to-NAV basis. The cost to invest paid by an investor is not included in this figure. This means that an investor's personal returns are lower than displayed in the table. So if an investor had paid an upfront fee of 6% to invest in a unit trust fund that made a return of 6% over a year, he actually made a loss after paying the fund's annual management fee of 1.5% per annum.

The unit trust fund industry strives to make returns that surpass the fees imposed on investors. Only then does it make financial sense to invest in a fund. On this basis, unit trust funds should outperform low-cost passively managed investments such as exchange-traded funds (ETFs).

But ETFs in the country have actually outperformed a large number of their peers, which are actively managed unit trust funds. Their historical performance can be found in the Lipper's unit trust performance table, that shows the return or loss made by collective investment schemes (unit trust funds, ETFs, real estate investment trusts). The newest ETF in the country, i-VCAP Management Sdn Bhd's shariah-compliant MyETF MSCI Malaysia Islamic Dividend ETF, is not included as it has yet to acquire a one-year performance.

Two ETFs, which fall under the popular syariah-compliant and conventional equity Malaysia fund categories, have performed very well against their actively managed peers. I-VCAP's first ETF had a return of 119.04% in the five years ending March 31. The average return made by its syariah-compliant category is 105.38%, which means this passive investment outperformed the average return made by its actively managed peers. It is ranked 15 out of 49 collective investment schemes.

The FMB KLCI ETF made a return of 133.25% during this five-year period. It also outperformed the average return of 131.56% made by its category. It is ranked 28 out of 66 collective investment schemes. In the shorter duration of one year and three years, the performance of both ETFs is closer to the average returns made by their respective categories.

In the equity China category, CIMB FTSE China 25 ETF made a loss of 9.02% in the three-year period ending March 31, 2014 and outperformed two peer unit trust funds. This category of four collective investment schemes (three funds and CIMB FTSE China 25 ETF) made an average loss of 17.60% for this period.

CIMB FTSE Asean 40 Malaysia ETF is the second lowest performer in the equity Asean category for the three-year duration ending March 31, with a five-year return of 14.33%. Its category made an average return of 17.97% for this period. This performance is more consistent with the expected return of passive investments against actively managed funds.

The only bond ETF in the market also performed as expected from a passive investment. It made a five-year return ending March 31 of 17.15%, against its category average return of 27.45%. This could be attributed to its portfolio of mostly Malaysian government securities. Bond funds usually invest in higher-yielding corporate papers. But it is not the worst performer in its category, with a rank of 25 out of 28 collective investment schemes.

If the cost to investing is taken into account, local ETFs have outperformed even more of their peers — the actively managed funds. This means investors need to be very selective with the funds that they invest in or seriously consider opting for a low-cost passive ETF. ■

TABLE 1: ETFS BY COUNTRY

COUNTRY	NUMBER OF LOCAL ETFS*	NUMBER OF LISTED ETFS	AUM (US$ MILLION)	MARKET SHARE (AUM, %)
China	82	82	23,235	14.0
Hong Kong	81	134	34,068	20.5
India	39	39	2,376	1.4
Indonesia	5	5	51	0
Japan	124	156	75,720	45.5
Malaysia	6	6	317	0.2
Singapore	11	96	1,741	1
Thailand	17	17	178	0.1

*Data as at April 14, 2014. *Refers to the number of ETFs originating from providers in that particular country*

TABLE 2: ETFS ON BURSA MALAYSIA

ETF	CIMB FTSE CHINA 25 ETF	CIMB FTSE/ASEAN 40 MALAYSIA ETF	MYETF DOW JONES ISLAMIC MARKET MALAYSIA (DJIM) TITANS 25	FTSE BURSA MALAYSIA KLCI ETF	ABF MALAYSIA BOND INDEX FUND	MYETF MSCI MALAYSIA ISLAMIC DIVIDEND
ETF (short name)	CIMBC25	CIMBA40	MyETFDJ	FBMKLCI-EA	ABYMY1	MyETF-MMID
Type of asset class	Equity	Equity	Syariah-compliant equity	Equity	Fixed income	Equity
Description	Consists of the 25 largest and most liquid Chinese stocks traded on the Hong Kong Stock Exchange	Consists of the 40 largest companies listed in Indonesia, Malaysia, Philippines, Singapore and Thailand by market capitalisation	Consists of the 25 largest syariah-compliant companies on Bursa Malaysia by market capitalisation	Consists of the 30 largest listed companies on Bursa Malaysia by market capitalisation	Consists of mainly Malaysian government bonds	Consists of syariah-compliant stocks with a track record of consistent dividends
Underlying index	FTSE China 25 Index	FTSE/Asean 40 Index	Dow Jones Islamic Market Malaysia Titans 25 Index	FTSE Bursa Malaysia KLCI Index	Markit iBoxx ABF Malaysia Bond Index	MSCI Malaysia IMI Islamic High Dividend Yield 10/40
Listing date	July 9, 2010	July 9, 2010	Jan 21, 2008	July 19, 2007	July 13, 2005	Feb 27, 2014
Fund manager	CIMB-Principal Asset Management Bhd	CIMB-Principal Asset Management Bhd	i-VCAP Management Sdn Bhd	AmInvestment Services Bhd	AmInvestment Services Bhd	i-VCAP Management Sdn Bhd
Website	www.cimbetf.com	www.cimbetf.com	www.myetf.com.my	www.fbmklcietf.com.my	www.abfmy1.com.my	www.myetf.com.my