ETF issuers pushing for greater depth

Investors can widen their portfolios with more exchange-traded funds

by Farah Saad

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Mahdzir says without the introduction of new ETFs in the market, the growth will come mainly through creation activity

EXCHANGE-TRADED fund (ETF) issuers are hoping 2014 will see the ETF market increase in depth and liquidity, which will in turn attract larger institutional investors and retail investors alike.

Bursa Malaysia has only five ETFs, and this number has remained unchanged since 2010, i-VCAP Management Sdn Bhd CEO Mahdzir Othman says. More ETFs are needed to create depth and increase liquidity in the market, something institutional investors are pushing for before they are ready to participate, he adds.

"The main issue institutional investors raise is liquidity. They would like to see more of it in the open market. This is where the role of the market makers comes into play. If you do not enter the market, you can't get the size, [and] if you don't get the size, you don't want to enter. This is the chicken and egg situation," Mahdzir tells ***FocusM*** in a recent interview.

i-VCAP has two ETFs awaiting approval from the Securities Commission (SC), which it hopes will enter the market in 2014. According to industry sources, CIMB Securities is also awaiting SC's approval for a new ETF.

i-VCAP is a wholly-owned subsidiary of Valuecap Sdn Bhd which in turn is equally owned by Khazanah Nasional Bhd, Permodalan Nasional Bhd and Kumpulan Wang Persaraan (Diperbadankan).

Mahdzir points out that the net asset value (NAV) of the local ETF market has grown 12%, to RM1.04 bil as at November, from RM923 mil the previous year. He says the growth needs to be spread outwards, and diversity is the key to pulling in investors.

Having more ETFs available is the key to generating volume, says Mahdzir. When more ETFs are on the market, investors will have the chance to widen their portfolios. The five ETFs listed on Bursa are the FBMKLCI ETF, i-VCAP's MyETF-Dow Jones Islamic Market Malaysia Titans 25, CIMB's FTSE Asean 40 Malaysia and FTSE Xinhua China 25, and the fixed income ABF Malaysia Bond Index Fund from AmInvestment Services Bhd.

Mahdzir cites the Singaporean market as an example. There are around 80 ETFs listed on the Singapore Exchange (SGX), around 10 of which regularly see large volumes shifted. The SGX is also looking to improve liquidity, but the market is ahead in the sense that there is depth.

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> – Mahdzir

Is the SC concerned that there will be a large number of ETFs, but still not enough activity?

"Five ETFs are still not sufficient to develop the product. The more ETFs you have, the better it is for investors to create their portfolios. There will be more depth. It is a matter of creating the diversity, and for investors to have the choice available to them," he adds.

More ETFs, more volume

Given there are only five ETFs in the local market, there is obviously plenty of room for improvement in terms of volume and participation. Other than sporadic bursts of activity, the ETF market is relatively quiet.

"Trading volume has not been particularly exciting, which is one of the issues we need to address. You do have spurts of more than 500,000 units, but on average it is 50,000–100,000 per day, which is something which investors highlight. They want volume," says Mahdzir.

The bigger volume pushers are institutional investors which are mainly in the market-maker role. The Employees Provident Fund (EPF), when contacted, declined to comment on whether it included ETFs in its portfolio or not.

"It is our policy not to reveal our business strategy in public," said an EPF spokesperson in an email response to ***FocusM***.

Mahdzir says some institutional investors and fund managers promise returns in excess of the market, so ETF, which tracks the index, may not appeal to these parties.

"Some funds have an absolute returns objective, with 'excess returns'. ETFs track the index, so there will not be the excess returns. It is very much a portfolio management perspective," he says.

ETFs are also not an approved asset class for investment for many institutional investors.

"When it comes to creation/redemption activities, it isn't in the approved mandate [of allowable investments] either, so it is tough to get them involved. The mandate was likely drafted before ETFs appeared on the market, so we are hoping to get this updated to include ETFs," says Mahdzir.

From an ETF issuer's perspective, the costs of creating a new ETF can be extensive for smaller issuers, which could put off those potential issuers.

"The cost of establishing an ETF can be more accommodative. Newer issuers may not be able to bear the costs. You have to appoint an investment bank as an adviser until you have managed ETFs for at least five years," he says.

Retail investors shun ETFs

The general investment outlook of the average Asian investor also determines the odds of picking up an ETF.

"Asians in general are stock pickers. They prefer stocks to slower moving tools like ETFs or unit trusts. But in other countries like the US, ETFs are a part of most portfolios," explains Mahdzir.

A common conception is that ETFs do not provide attractive returns. ETFs trade like shares, so investors expect quick returns or volatile price movements, which do not occur for ETFs.

For i-VCAP's MyETF, which was listed in 2008, the fund made gains of 8.62% as at November 2013. On a three-year basis, the fund made cumulative gains of 26% to 28%, and over five years close to 100%. MyETF has been tracking the index with a tracking error of 1.78%.

"ETFs function and behave like unit trusts, so those into higher-risk strategies, like short-selling, which are applicable to share trading will find the same does not apply. You need to have more of a medium- to long-term horizon and how much you can make depends on your timing," explains Mahdzir.

Unit trusts have been gaining ground over the past 10 years or so, mainly because of the agents employed to push the product. Investing in unit trusts is relatively safe compared with investing in equities, but there are fees involved that could eat into the investor's profit margin. Every transaction involves a fee, and there is an annual management fee which can be up to 1.5%.

ETFs, on the other hand, are traded like shares in the open market. The only fees involved are brokerage fees, which are negotiable.

Where a unit trust fund is a basket of stocks, an ETF is a basket of stocks put together to track the movement of its underlying index. How "good" an ETF is depends on how closely it can mimic the movements of its underlying index. The tracking error measures the deviation of the movement of the fund from the benchmark index. The lower the tracking error, the better it is for the fund. Ideally, the tracking error should be less than 3%.

One of the main reasons why unit trusts, although more costly, have gained more traction is the misconception that the second account of the EPF can be withdrawn only for this particular type of investment.

"What a lot of investors do not know is you can take out money from your EPF account 2 and invest in ETFs through an approved asset manager," says Mahdzir.

Outlook for 2014

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When an ETF wants to create new shares of its fund, it works together with an authorised participant, likely an institutional investor with buying power. The investor will take up stocks in the underlying index and sell them to the ETF provider in exchange for blocks of 50,000 or even 100,000 ETF shares.

"Units can be created without going through the open market, and it is more applicable to institutional investors or market makers. So the fund will grow in size [this way]," he says.

Malaysia also has the potential to become the global centre for Shariah-compliant ETFs, as there are fewer than 20 Islamic ETFs globally, says Mahdzir.

Malaysia is the largest Islamic ETF issuer, with US$95 mil worth of assets under management. FocusM

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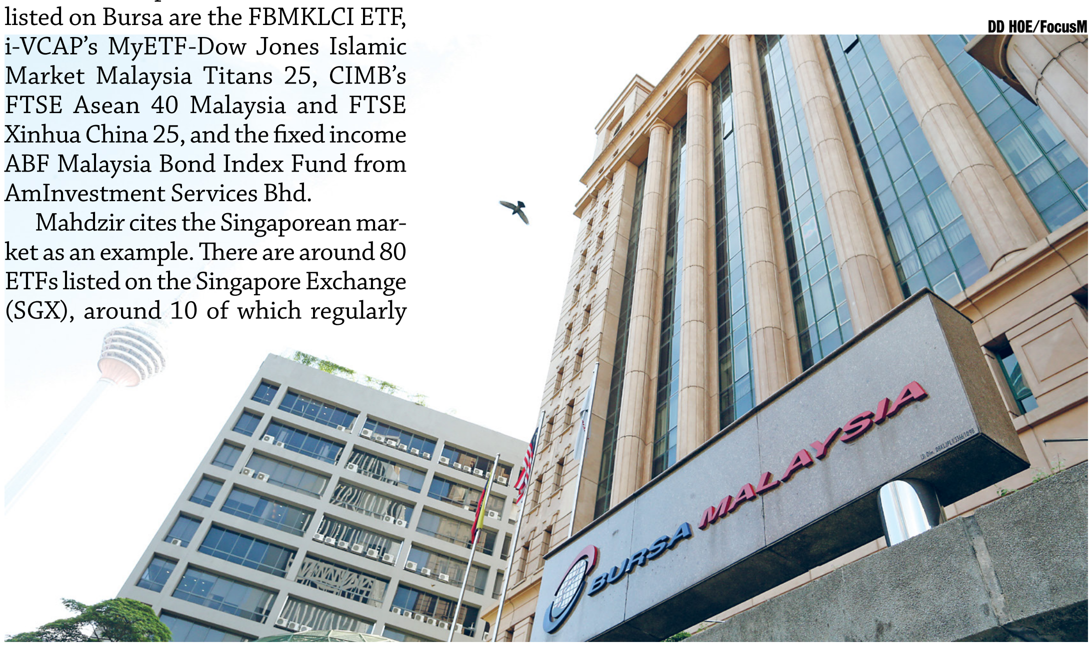

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