

The First Islamic ETF: Turkey's Experience

OIC Member States' Stock Exchanges Forum
5th Meeting with Capital Market Linkages & Technology Seminar
Istanbul, September 17th-18th, 2011



Organisation of Islamic Cooperation



**ISTANBUL
STOCK
EXCHANGE**
www.ise.org



Issuer: BMD Securities

- Brokerage company with integrated investment banking services
- Has agency agreements with all of four participation banks, unique in Turkey
- Particularly specialized on compliant investment products and services
- Issuer and manager of mutual funds



The First Islamic ETF

 DJIM TURKEY
EXCHANGE TRADED FUND

- Tracks DJ Islamic Market Turkey index
- Launched in February 2006
- Quoted in Istanbul Stock Exchange
- Currently has 30 stocks in portfolio
- Only fund delivering dividends at once
- High correlation; low tracking error
- Lower management fee than other funds



Fund Information

| | |
|---------------------------|----------------------------|
| ETF Name | BMD Dow Jones DJIM Turkiye |
| Issuer | Bizim Menkul Degerler A.S. |
| Manager | Bizim Menkul Degerler A.S. |
| Index Provider | Dow Jones Indexes |
| Total Number of Shares | 3,000,000 |
| Bloomberg ETF Ticker | DJIMTR TI |
| Bloomberg Index Ticker | DJIMTR |
| Reuters ETF Ticker | DJIMTf.IS |
| Reuters Index Ticker | .DJIMTR |
| Foreks NAV Ticker | DJIMTR |
| ISIN Code | TRYBZIM00042 |
| Number of Stocks in ETF | 30 |
| Number of Stocks in Index | 30 |
| Annual TER (bps) | 112 |
| Annual MER (bps) | 108 |

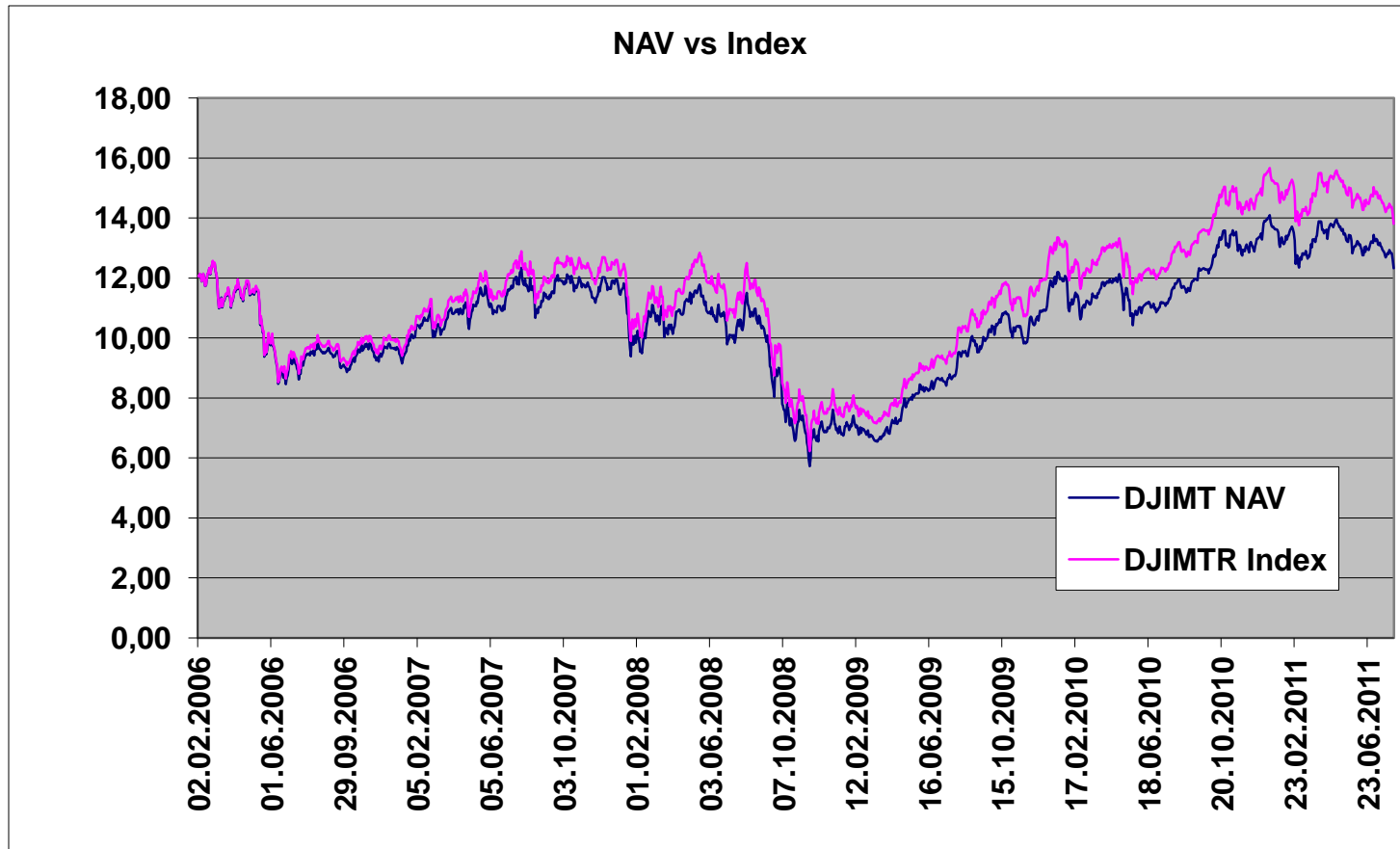


Fund Information

| | |
|-----------------------------------|---|
| Dividend Frequency | Immediate |
| Currency | TL |
| Fund Structure | Turkish Type A |
| UCITS | III |
| Registrations | Turkiye |
| Exchange | Istanbul Stock Exchange |
| Launch Date | 2/2/2006 |
| Round Lot | 1 |
| Stock Delivery | T+2 |
| Unit Return | T+2 |
| Creation and Redemption Size | 10,000 |
| Creation and Redemption Fee | TL215 |
| Cut off Time to Create and Redeem | 4:30pm local |
| Custodian | Takasbank A.S. |
| Website | http://www.djimtr.com |

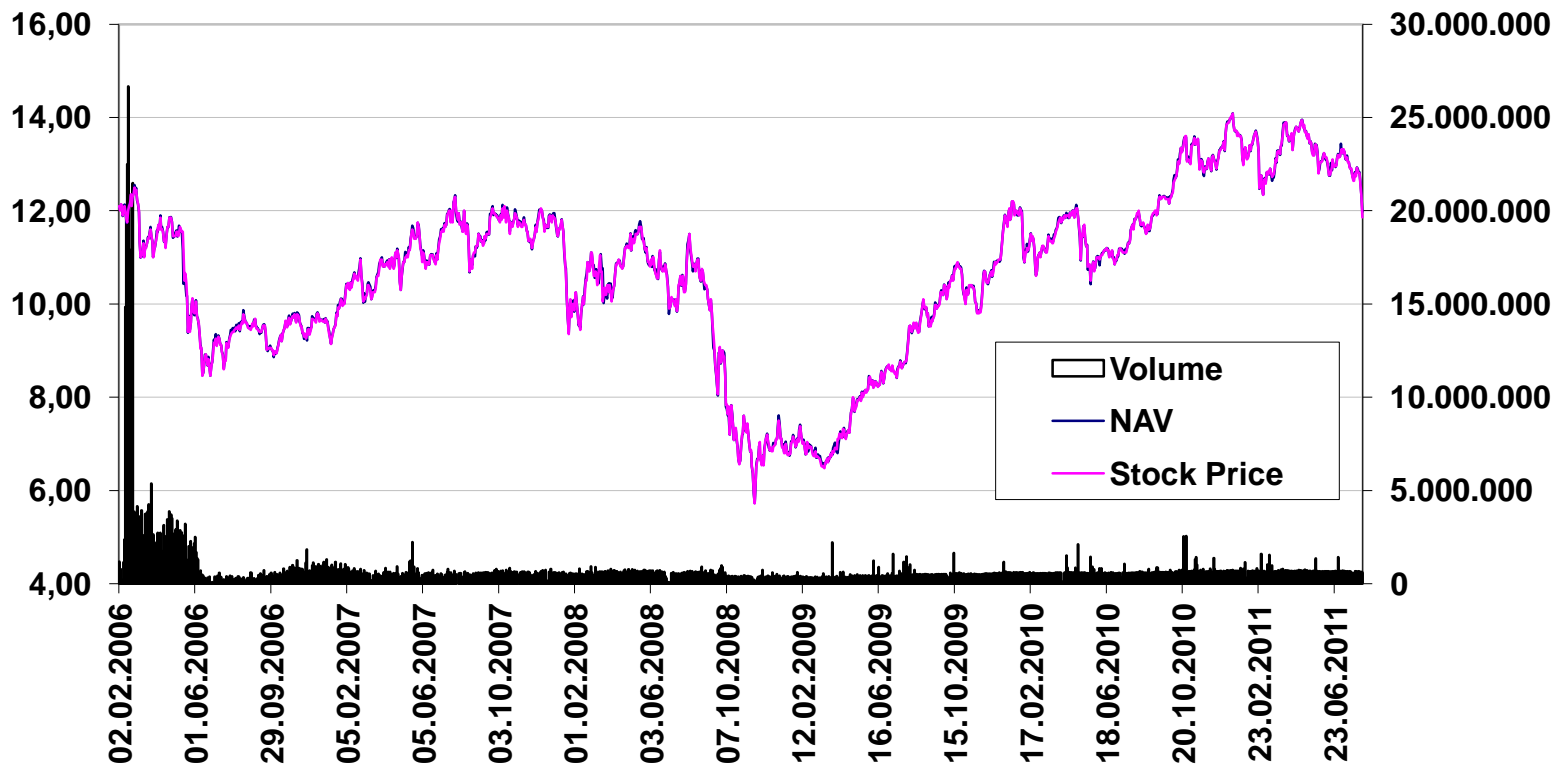


Tracking Graph

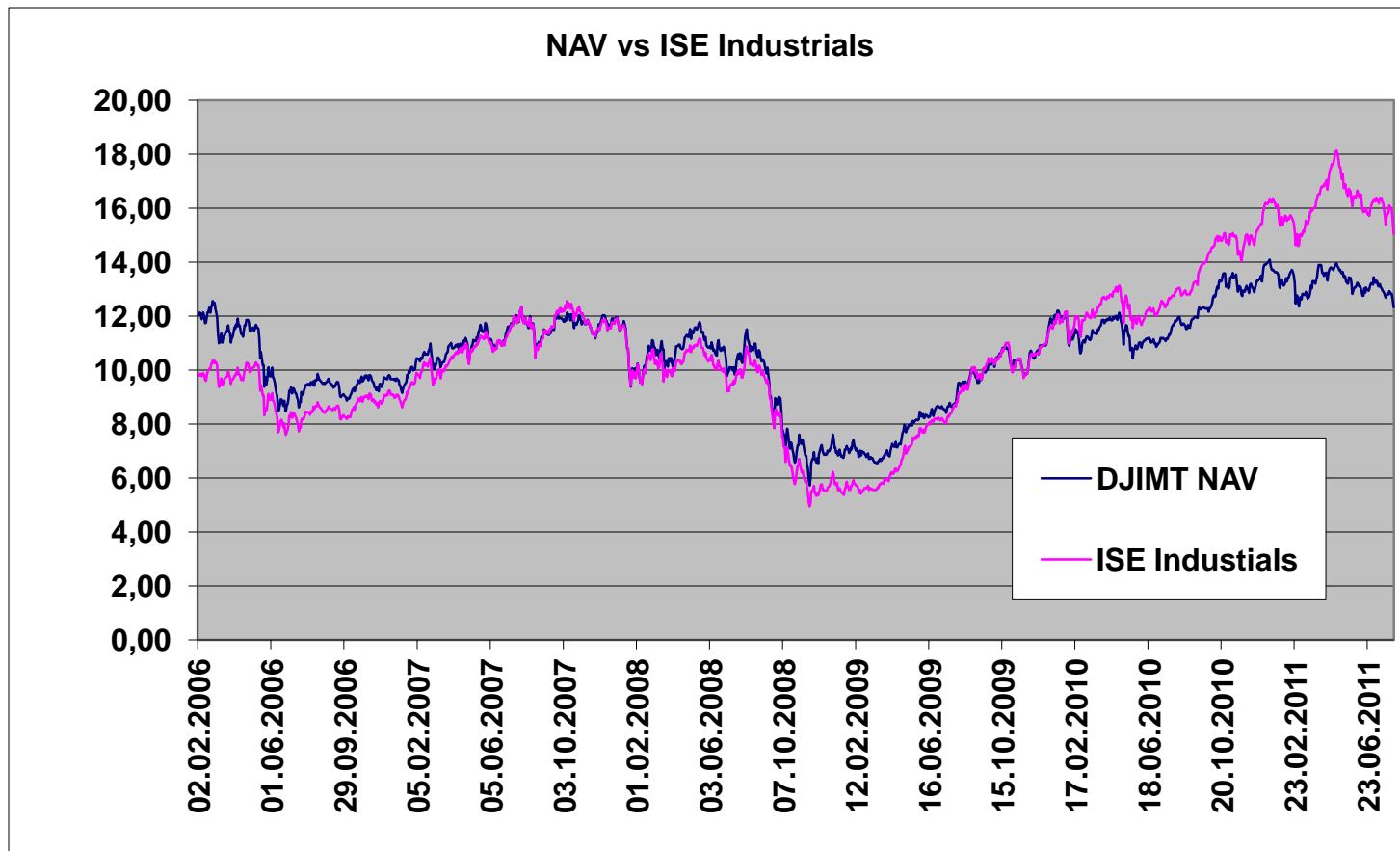


Tracking Graph

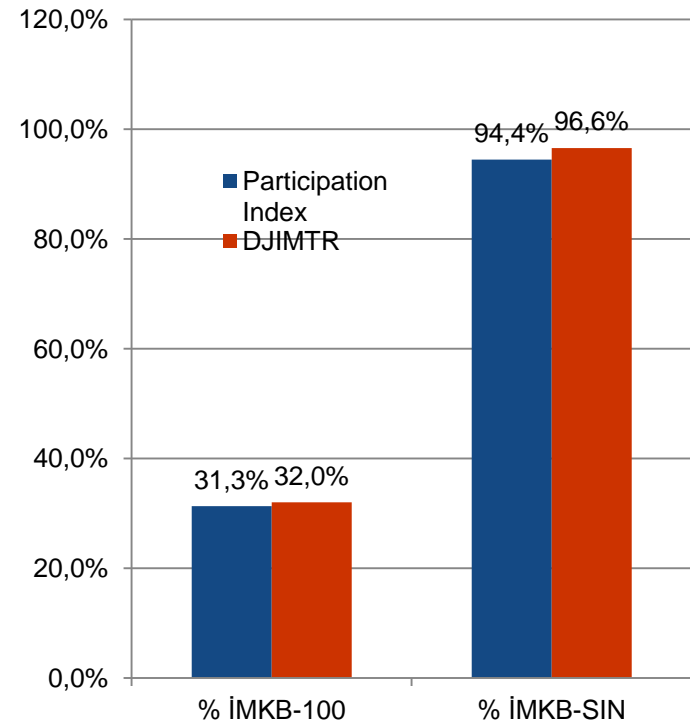
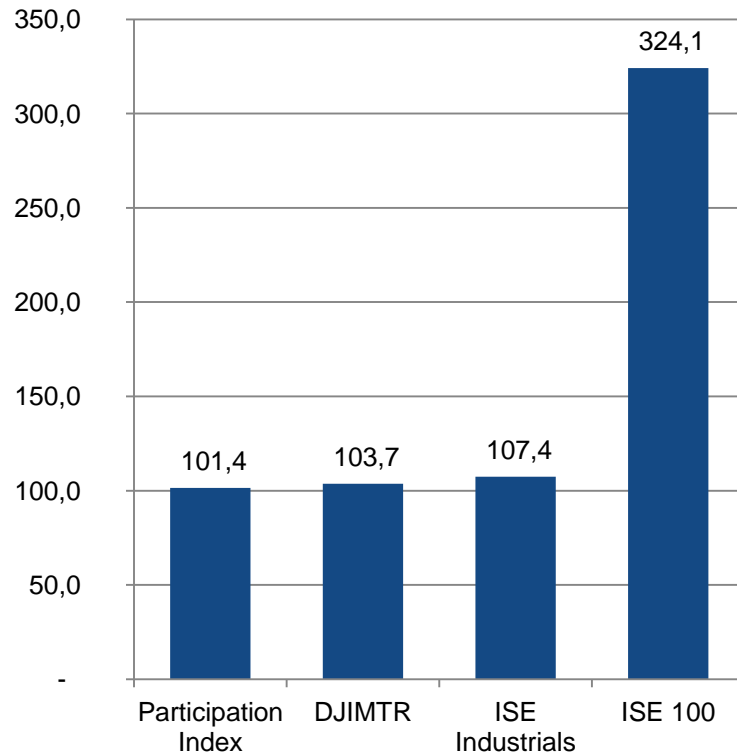
NAV vs Stock Price



Market Correlation



Market Capitalization



(September 9th, approx.)

Gold ETF (GoldPlus)



- Issuer is Kuveyt Turk Participation Bank, provider and manager is BMD Securities.
- Based on 100% physical gold spot market, no leverages, no futures and options.
- The physical standard bullion held by fund portfolio is in the custody of Istanbul Gold Exchange on behalf of the fund.

Gold ETF (GoldPlus)



- Fund shares are traded in Istanbul Stock Exchange and exchange price closely follows the physical gold price.
- The Gold ETF provides a convenient way for investors to buy and sell gold at a good price, without risk of keeping physical gold.
- The first Gold ETF issued by a no-interest bank.

Participation Index ETF



- It is an ETF based on Participation Index (KATLM) and will be issued by a consortium of participation banks.
- The ETF launch is planned in the following months.
- Fund shares will be traded in Istanbul Stock Exchange (ISE).

Participation Index

- Participation Index is a stock index formed of securities traded at ISE and conforming to Participation Banking principles.
- The first compliant local index in Turkey, provided by BMD with sponsorships of the participation banks.
- It is based on international standards; calculated and broadcasted by ISE.



Islamic ETFs, Basics

Islamic ETF

- Islamic Exchange Traded Fund is a special thematic variation of conventional ETF
- That the fund portfolio is completely formed of compliant financial instruments in an index by their proportions in the index
- And fund shares are traded in the stock exchange
- Thus it provides the investors the opportunity to buy and sell the index that the fund represents in compliance with Islamic principles

Islamic ETFs, Basics

- Easiest is tracking equity indices
- Major index providers, DJ, S&P, MSCI
- Local and regional, mostly local
- Custom indices are possible
- Currently stock market oriented
- Gold & FX ETFs are also possible

Islamic ETFs, Guidelines

- Complies with the general principle of sharing return & risk
- Finance companies with interest income, alcohol, pork, weapon, gambling, lottary, etc. related businesses are excluded
- Conglomerates are usually excluded if related to above businesses

Islamic ETFs, Guidelines

- The index is variable to a larger extent, companies may change field of business
- Participation to related businesses are generally limited by 5 to 10%, usually in terms of sales or revenues
- Index makers have their compliance boards, local practice may require additional compliance supervision

Index Families

- Index criteria are similar
- Recognition of index is an advantage for international investors
- Index providers can design custom made indices depending on needs
- Actively managed index is possible, but it may be difficult to sustain a liquid fund

Major Index Providers

| provider | MSCI Barra | DJ Indexes | S&P |
|-----------------------|---------------------|-------------------|-------------|
| family | MSCI Global Islamic | DJ Islamic Market | S&P Shariah |
| screening | | | |
| business activities | yes | yes | yes |
| financial ratios | yes | yes | yes |
| incompliant revenues | yes | yes | yes |
| dividend purification | possible | possible | possible |
| revision | quarterly | quarterly | monthly |

Islamic ETFs, DJ Constraints

- Excluded are companies whose total debt divided by trailing 12-month average market capitalization is 33% or more
- Those whose cash plus interest-bearing securities divided by trailing 12-month average market capitalization is 33% or more
- Those whose accounts receivables divided by total assets is 33% or more

Financial Ratios

| provider family | MSCI Barra MSCI Global Islamic | DJ Indexes DJ Islamic Market | S&P S&P Shariah |
|---|-----------------------------------|---------------------------------|--------------------|
| total debt / total assets* | 33% | 33% | 33% |
| cash + interest bearing securities / total assets* | 33% | 33% | 33% |
| account receivables / total assets* | 70% | 33% | 49% |
| incompliant revenues | 5% | 5% | 5%** |

* DJ and S&P utilize market cap instead of assets

** other than interest income

ETF Design

- Index selection is vital for target
- Performance & liquidity analysis may indicate requirement for a custom index
- Sensitivity analysis should be done for ETF market ticker steps
- Fees, dividend policy, tax and local regulations are other important factors

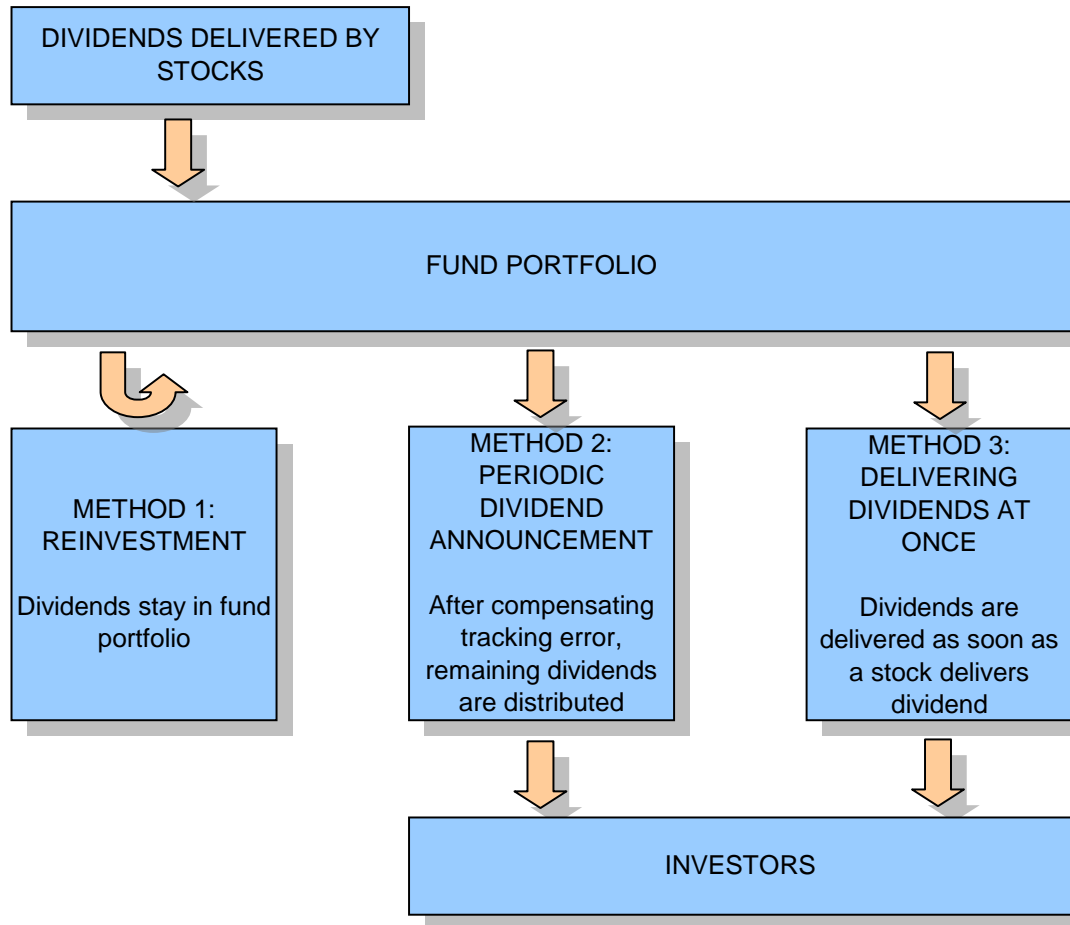
Ticker Sensitivity

- This is the percent change in ETF market price when all of the stocks go up or down one tick
- Affects market liquidity, responsiveness and intraday tracking error
- If regulation allows, ETF unit size and ETF ticker step size should be adjusted accordingly

Local aspects

- Local practices may not allow global standardization
- Additional local compliance auditing
- Tax regulations are also very crucial in terms of costs
- Fixed income ETFs require very liquid bonds exchange, not valid for everywhere

Dividend Policy





Islamic ETFs, Major Issues

Islamic ETFs, Benefits & Costs

- Many conventional ETF advantages apply
- Provides an alternative portfolio, mostly industrial stocks, risk management
- More financially sound and stable companies since measuring debt ratios
- Absence of financial stocks may decrease liquidity

Major Factors, Issues

- Liquidity may be lower based on liquidity of compliant sectors
- Number of shares are variable and usually higher than comparable ETFs
- Can be more volatile due to more frequent changes in the index
- There is “Compliance Effect”

Compliance Effect



Compliance Effect

- This effect is observed occasionally during our ETF experience
- As Debts/MCap is among index criteria, stocks enter the index at high MCap, and exit at low MCap
- Does not need to be always negative, but assuming other variables constant, it may have a negative effect on performance

Typical Index Revision

Conventional

| | Weight |
|----------------|--------|
| 1 Company A | 17% |
| 2 Company B | 16% |
| 3 Company C | 13% |
| 4 Company D | 11% |
| 5 Company E | 11% |
| 6 Company F | 9% |
| 7 Company G | 7% |
| 8 Company H | 6% |
| 9 Company I | 6% |
| 10 Company J | 4% |
| Total | 100% |
| Revision Ratio | 16% |

Islamic

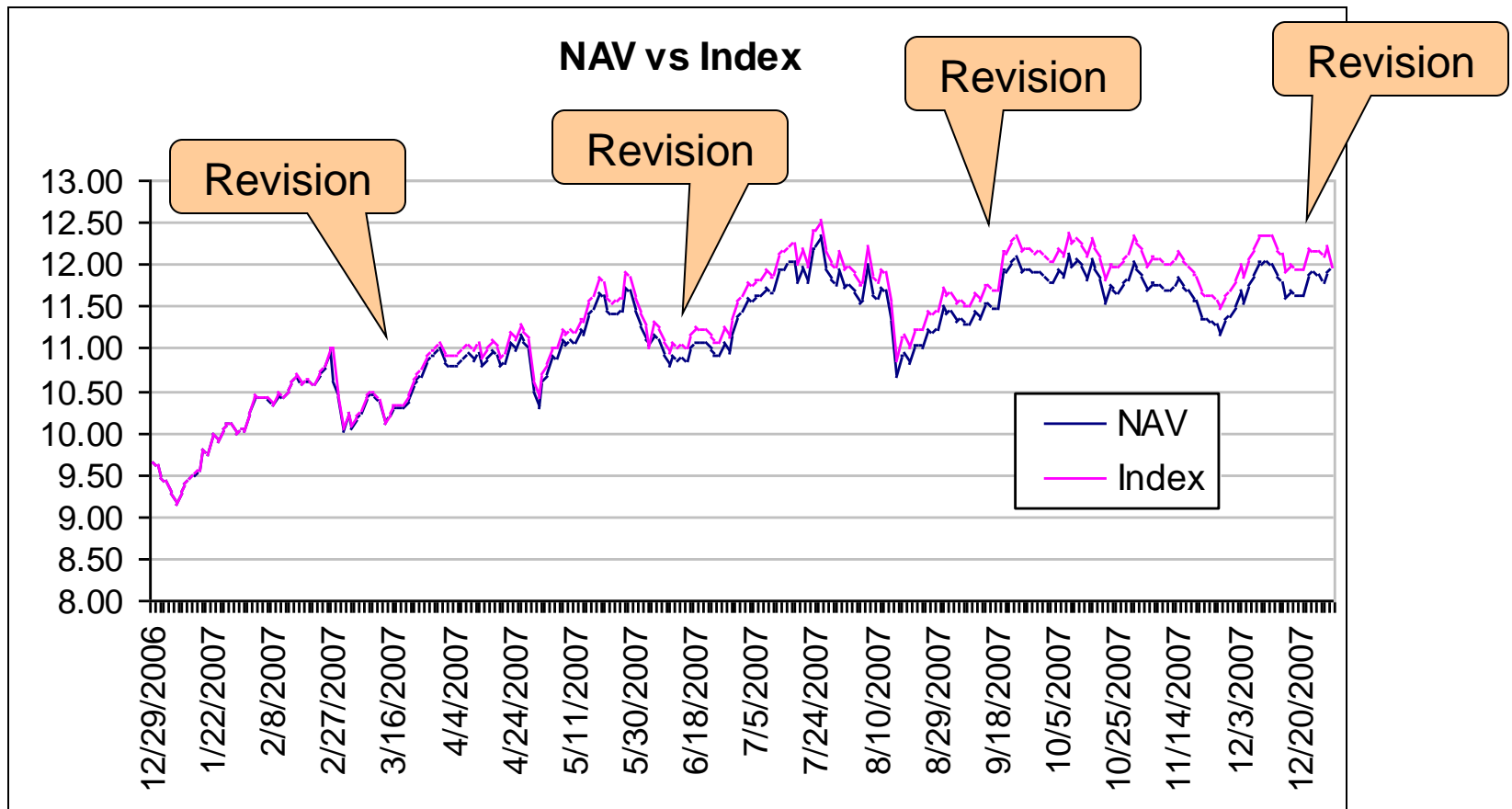
| | Weight |
|----------------|--------|
| 1 Company A | 23% |
| 2 Company B | 19% |
| 3 Company C | 13% |
| 4 Company D | 13% |
| 5 Company E | 9% |
| 6 Company F | 8% |
| 7 Company G | 7% |
| 8 Company H | 4% |
| 9 Company I | 2% |
| 10 Company J | 2% |
| Total | 100% |
| Revision Ratio | 40% |

- Higher transaction fees
- Higher spread costs for Islamic ETFs

Major Factors, Issues

- Market maker is crucial for liquidity and responsiveness
- Frequent and larger changes in the index lead to higher costs and tracking error
- Cross-listing may not be always possible due to different regulations and also technical infrastructure among custodians

Tracking Errors



Dividends

- Dividend policy may differ based on local practices, purification method is important
- Reinvesting dividends may be a problem such as in our case
- Conventional policy is periodic dividends
- What we do is distributing and reporting dividends immediately, which is unique

Technical Issues

- ETF requires intense technical infrastructure and regulations for exchange, custodian or settlement bank, manager and market maker
- Regulations and technical systems are usually established for conventional ETFs
- Infrastructure may be incompatible with Islamic ETFs for some instances and may require adjustments

Compliance Limitations

- Short-selling of Islamic ETF may conflict with Islamic principles
- Asset-lending may be limited according to some schools
- Futures & options are also controversial, so it is hard to establish Islamic commodity ETFs (ETCs) based on futures contracts

Asset Allocation Issues

- Since asset classes are limited, equity and bond ETFs will be major types
- Compliant bonds are best for allocation purposes if their market is liquid
- Gold and FX are compliant as long as they are traded in spot market
- Conventional hedging strategies using futures & options on ETF may not be available

Islamic ETF in Brief

- Most of conventional ETF advantages apply, convenient investment with low cost
- Compliant product for index tracking
- Have some disadvantages particularly on costs and liquidity side
- Requires additional precautions during design compared to conventional ETFs

Thank you.



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