What are the risk?

Among the risks that investors should carefully consider before investing in ETFs are:

- Market risk – ETF prices are exposed to the economic, political, currency, legal, and other risks related to the index that the ETF tracks.

- Tracking error – Although the main objective of an ETF is to track the performance of its benchmark index, the ETF’s performance may deviate from the performance of the benchmark index.

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Who should invest in ETFs?

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**What is an ETF?**

An exchange-traded fund (ETF) is a unit trust fund that is listed and traded on a stock exchange. ETFs are open-ended, with a unique in-kind creation and redemption mechanism supported by a system of participating dealers and liquidity providers. The difference between ETFs and unit trust funds is in the manner in which their units are bought and sold.

An ETF is listed and therefore its units can be bought and sold anytime during stock exchange trading hours. Investors buy and sell ETF units through stockbrokers rather than unit trust agents.

An ETF is an index tracking fund. Most ETFs are passively managed index funds although there is ongoing work to create enhanced and actively managed ETFs. In managing index funds passively, managers do not pick stocks based on fundamental analysis. Instead, managers track the performance of a benchmark index.

**What is an Islamic ETF?**

An Islamic ETF and a conventional ETF share common characteristics. The main difference between a conventional ETF and Islamic ETF is the benchmark index that the Islamic ETF tracks. An Islamic ETF only tracks an Islamic benchmark index where the index constituents comprise companies which are Shariah compliant.

An Islamic ETF is also required to appoint a Shariah adviser/committee to provide expertise and guidance to ensure that its structure, investments and all matters related to the funds’ activities comply with the Shariah.

**Diagram 1: Basic Structure of an Islamic ETF**

**Diagram 2: Concept and Regulation of Islamic ETFs in Malaysia**

**What are the benefits of investing in ETFs?**

The following are benefits of investing in ETFs:

(a) **Diversification**

Similar to index funds, ETFs provide investors with similar diversification benefits derived from holding the benchmark index’s constituent stocks without having to invest in each of the stocks directly.

(b) **Lower expense ratio**

As a passively managed fund, ETF incurs lower management fee and lower transaction costs as compared to an actively manage fund.

(c) **Lower transaction cost**

ETF units are bought and sold at the same transaction cost as those charged for trading shares on the stock exchange. Buying and selling of normal unit trusts are subjected to transaction costs which are generally higher.

(d) **Tradeability**

ETF units can be bought and sold at anytime during trading hours of the stock exchange.

(e) **Transparency**

ETF prices are disseminated throughout trading hours on the stock exchange. The constituent stocks of the index which the ETF tracks are normally published on the fund or index provider’s websites.

(f) **Shariah-compliant investment**

As for Islamic ETFs, an additional benefit is its conformity to the Shariah principles and practices, which is important to Muslims. Non-Muslims may also wish to invest in such funds based on Shariah principles.
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**How Does Islamic ETF work?**

**Diagram 1: Basic Structure of an Islamic ETF**

SECONDARY MARKET

- **Investors**
  - Buy ETF units
  - Sell ETF units

- **Shariah Adviser/Committee**
  - Advisory on Shariah matters

- **Manager**
  - Sell ETF units
  - Buy ETF units

- **Trustee**
  - Sell ETF units
  - Buy ETF units

PRIMARY MARKET

- **Islamic ETF**
  - sell ETF units
  - Buy ETF units

- **Participating Dealers**
  - Sell ETF units
  - Buy ETF units

- **Liquidity Providers**
  - Sell ETF units
  - Buy ETF units

Note: In ETF, a basket of securities (index’s constituents) can be converted into an ETF unit via “in-kind” creation process while “in-kind” redemption converts the ETF unit back to securities.

**Diagram 2: Concept and Regulation of Islamic ETFs in Malaysia**

- **Securities Law and Regulations**
  - Capital Market and Services Act, 2007 (CMSA)
  - Regulations issued under the CMSA
  - Guidelines on Exchange-Traded Funds
  - Guidelines on Unit Trust Funds
  - Prospectus Guidelines for Collective Investment Schemes
  - Rules of Bursa Malaysia Securities
  - Listing Requirements
  - Rules of Bursa Malaysia Depository

- **Securities Commission (SC)**

- **Trustee**
  - (obtains approval from the SC to act as trustee of the fund)

- **Manager**
  - (obtains approval from the SC to act as a manager of the fund)

- **Trustee**
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