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Do Islamic Equity Funds Measure Up?

The View from Al-Tawfeek

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ABSTRACT

The recent growth of Islamic investment funds can be attributed to not only their simplicity and profitability, but also to the growing expertise of *sharīʿa* boards and to the availability of Islamic indices. Holdings in these funds—which concentrate on asset classes such as trade finance and commodities, leasing, equities, real estate, and venture capital—undergo a screening process that assesses a company's business line, debt/equity ratio, and fraction of income derived from interest, in order to determine whether the investment is *sharīʿa*-compliant. Although this process reduces the potential stock universe by up to 95% and makes diversification more difficult, a case study of Al-Tawfeek reveals that the application of Islamic principles does not necessarily imply a lower return on investment.

I. INTRODUCTION

In the last three decades, the scope of financial services has widened considerably, and new types of financial institutions have emerged to provide new products and services. A major trend has been "disintermediation," wherein the traditional intermediary role of banks has been bypassed by investment management institutions. These offer investors direct participation in primary and secondary markets by pooling their investable funds, enabling them to choose their desired level of risk and earn a commensurate return. The investment vehicle through which this is accomplished is the mutual fund, also known as the investment fund or the unit trust.

Islamic finance has developed in the same period as the growth of mutual funds, and certainly Islamic finance has not gone untouched by it. The Islamic investment fund, defined in the current Islamic banking practice as a joint pool (*mu∞āraba*) wherein investors contribute their surplus money to earn *®alāl* profits from investment in strict conformity with the injunctions or precepts of the *sharīʿa*, has gained wide acceptance in Islamic finance. According to some estimates, there are more than 100 Islamic equity funds worldwide (Table 1 indicates the recent statistics of the industry).

TABLE 1. ISLAMIC EQUITY INVESTMENT FUNDS

Name of Fund	Fund Promoter	Investment Advisor	Fund Size (US$m)	Return Since Inception
Global Equity Funds:				
AlFanar Investment Holdings	Worms & Cie/SEDCO	Permal Asset Management	120	43.90%
Al Rajhi Global Equity	Al-Rajhi Banking & Inv. Corp.	UBS Asset Management	–	55.01%
Al-Safwa Int'l Equity	Al-Tawfeek Co. for Invest. Funds	Roll & Ross Asset Mgmt.	22	56.10%
Oasis International Equity	Robert Flemings	Fleming Investment Mgmt	5.7	37.30%
Global Trading Equity	National Commercial Bank	Wellington Management	–	–
Al-Bukhari Global Equity	The Int'l Investor	Wafra Invest. Advisory Grp./TII	9.5	19.03%
Al-Dar World Equities	The Int'l Investor & Pictet	Pictet & Cie	61.1	45.54

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Riyad Equity Fund 2	Riyad Bank	Riyad Bank	–	28.60%
Global Equity Fund	Al Baraka Islamic Bank BSC (EC)	Mercury Asset Management	–	–
GAM Al-Kawthar	Al Baraka Islamic Bank BSC (EC)	Global Asset Management Ltd.	12.4	55.30%
Arab Investor Crescent Fund	Arab National Bank	Schroeder Invest. Mgmt. Int'l.	5.587	–
Miraj Global Equity Fund	Miraj Int'l Investment Ltd.	Royal Bank Invest. Mgmt.	–	18.76%
Barclays Islamic Portfolio	Barclays Private Bank		3.0	51.33%
Asia Equity Funds:				
Al-Nukhba Asia Equity	Al-Tawfeek Co. Investment Funds	Nomura Invest. Banking (ME)	–	3.63%
Middle East Equity Funds:				
Al-Rajhi Middle East Equity	Al-Rajhi Banking/Invest. Corp.	Bakheet Financial Advisors KSA	19	–33.36%
East European Equity Funds:				
Al-Dar East European Equities	The Int'l Investor & Pictet	Pictet & Cie	13	22.83%
European Equity Funds:				
Al-Sukoor European Equity Fund	Commerz Bank/ Al-Tawfeek Co.	Commerze Int'l Capital Mgmt.	18	38.4%
Al-Dar East European Equities	The Int'l Investor & Pictet	Pictet & Cie	21.5	–
Europe Trading Equity Fund	National Commercial Bank		–	4.70%
AlFanar Europe Ltd.	Worms & Cie/SEDCO	Permal Asset Management	19	–
Capital Protected Equity Funds:				
Al-Ahli US Secured Fund Index	Faysal Islamic Bank of (BH)	Banque National de Paris (Bahrain)	–	
Faysal Shield Fund	National Commercial Bank	Deutsche Bank	252	–
Al-Ahli US-Secured Fund				
Small Cap Equity Funds:				
TII Small Cap	The Int'l Investor	Pictet Asset Management UK Ltd.	23.1	41.00%
Small-Cap Trading Equity	National Commercial Bank		–	–
Small-Cap Fund	Al-Rajhi Banking & Inv. Corp.	Merrill Lynch	–	8.69%
ZAD Growth Fund	ZAD Assset Management LLC.	Awad & Associates/Roanoke A.M.	–	29.24%
Emerging Markets Equity Funds:				
Ibn Majid Emerging Markets	The Int'l Investor	UBS Brinson	19.8	19.20%
<u>Country Equity Funds:</u>				
Saudi Arabia Equity Funds:				
Al-Arabi Saudi Co. Shares	Arab National Bank		–	–
Al-Rajhi Local Share	Al-Rajhi Bank. & Invest. Corp.	Al-Rajhi Banking & Invest. Corp.	–	–
Saudi Trading Equity	National Commercial Bank	Bakheet Financial Advisors	–	35.48%
Egypt Equity Funds:				
Al-Rajhi Egypt Equity	Al-Rajhi Bank. & Invest. Corp.	EFG Hermes (Egypt)	–	24.68%
U.S. Equity Funds:				
Alkhawarizmi	The International Investor	Axa Rosenberg Invest. Mgmt. Ltd.	16.9	5.80%
US Trading Equity Fund	National Commercial Bank		–	–
AlFanar U.S. Capital Value	Worms & Cie/SEDCO	Permal Asset Management	30	2.80%
AlFanar U.S. Capital Growth	Worms & Cie/SEDCO	Permal Asset Management	27	7.80%

South Africa Equity Funds:				
Oasis Crescent Fund	Oasis Asset Management	Oasis Asset Management	–	–

The growth of the sector has been explosive. Without taking capital appreciation into account, Islamic mutual funds are growing at a rate of between 20–25% a year, making these investment funds one of the fastest growing sectors of the industry. The total value of equity funds under Islamic management has grown to $1–3 billion within a relatively short time.

What explains this growth? These funds have been noticeably popular among both Muslim and non-Muslim investors. Certainly, the simplicity and profitability of these funds deserve mention. Furthermore, *sharīᶜa* boards have demonstrated greater understanding of the mechanisms of these funds, so much so that even the conventional banking industry is emulating the Islamic finance sector and is appointing *sharīᶜa* boards in an effort to enter the Islamic investment fund market.

Recent growth of Islamic investment funds also owes much to the availability of Islamic indices that track the movements of *sharīᶜa*-compliant stocks in the global equity markets. These indices—such as the Dow Jones Islamic Market Index (DJIM), the FTSE Global Index and the four FTSE sub-indexes covering North America, Europe, the Pacific Rim and South Africa, and the MSCI Eastern European Index—serve as suitable benchmarks for Islamic investment funds. The presence of these equity indexes may further encourage growth of the sector.

II. ASSET CLASSES

Islamic mutual funds concentrate on various asset classes, most importantly trade finance and commodities, leasing, equities, real estate and venture capital. Each of these classes carries its own advantages and features.

A. Trade Finance and Commodities

Trade finance transactions are generally short-term with a fixed profit margin and are secured by tangible assets. Funds investing in such transactions provide a relatively safe and predictable return with little or no change in the fund's paid-up value. Commodity funds earn returns by trading of commodities, generally base metals. Such funds can have a relatively simple structure without the necessity for any offshore incorporation, custodian, or administrator.

B. Leasing

Leasing or *ijāra* funds securitize periodic, predetermined cash flows from leasing transactions. Like trade finance and commodities transactions, leasing transactions and fund structure are relatively simple and do not require extensive fund management input.

C. Equities

Islamic equity funds may be global or regional in scope. While most sponsors are located in Islamic countries, such funds' extensive investment focus necessitates professional investment management, both custodial and administrative. These are often located in the major financial centers. Many of these firms are incorporated offshore. Hence, unlike trade financing and leasing, these funds naturally have more complex structures.

D. Real Estate/Venture Capital

While the previous three asset classes are more common, other asset classes such as real estate and venture capital are being increasingly targeted and structured in a *sharīᶜa*-compliant manner. Al-Tawfeek, for example, has structured and marketed a real estate fund with paid-up capital of $52 million and a development fund with paid-up capital of $108 million.

III. *SHARĪᶜA* "SCREENING" FOR EQUITY FUNDS

Perhaps the defining characteristic of Islamic investment portfolios is the presence of *sharīᶜa* screening. All companies violating a certain set of conditions defined under the *sharīᶜa* are eliminated from the Islamic investment portfolio. The process is continuous in the case of Al-Tawfeek, where funds not meeting the criteria described below are removed from the investment portfolio.

A. Economic Activity

Securities that are issued by business entities that operate in any of the business lines prohibited by the *sharīʿa* cannot be included in an Islamic investment portfolio. Many scholars cite industries that are environmentally damaging or socially undesirable as prohibited business lines as well.

Thus companies that deal in impermissible products or services (including alcohol, pork, gambling, interest-based financial institutions) are excluded from the portfolio. The liquidity of Islamic funds cannot be invested in interest-based or conventional money market securities. Most Islamic funds therefore endeavor to be fully invested in their target markets, with cash reserves maintained to meet redemption requirements only.

B. Debt/Asset Ratio

Generally, a firm cannot exceed a maximum debt-equity ratio (normally 30% or lower) in order to remain *sharīʿa*-compliant. However, the definition of debt (whether it entails all financial debt) and equity (book value or market value) can significantly impact the number of qualified companies that can be invested in. As of today, there are no uniform ratios or definitions in the industry.

C. Interest Income Received

Companies in which funds are invested should conform to certain financial criteria, designed to ensure that their operations and assets are not predominantly financed by debt, and that their incomes, which ultimately accrue to the shareholder, do not include a significant amount of interest. The ratio of interest income to total income is usually restricted to 10% or lower; the total income is defined either as net income or as earnings before interest and tax.

D. Cleansing of Returns

Since it is not possible to have only debt-free companies in the portfolio, the proportion of the portfolio's return that can be ascribed to interest income is "cleansed" by its donation to charity.

E. Effects of *Sharīʿa* "Screening": The Problem of Benchmarking

The *sharīʿa* criteria usually result in a portfolio comprising of mature companies with conservative capital structures. This can be an advantage. But it can also be a disadvantage in that many rapidly growing companies that can generate higher returns due to higher earnings growth are excluded, as such companies usually require substantial debt funding.

The business line and financing criteria result in the exclusion of a large number of companies from the investment universe. In researching international equity funds, more than 10,000 companies were analyzed, and a *sharīʿa*-compliant universe of only 5% of that number—or only about 500 firms—was identified. 22% of the excluded firms dealt in prohibited business lines. 62% of the firms borrowed excessively. 8% of the firms had excessive interest income. 3% of the firms were excluded for other reasons.

The objective of diversification is to have securities that do not move together, so that the adverse performance of some securities is cushioned by the better performance of others. The degree of diversification increases with the number of securities in a portfolio. In an expanded portfolio universe, diversification is achieved simply by investing in a large enough number of firms.

Sharīʿa compliance significantly reduces the investment universe, and so diversification cannot be achieved simply by having a large number of firms in the portfolio. Instead, diversification must be achieved through the extended analysis by managers of the correlation among the performance of various securities, and the effect on portfolio diversification of each security.

The *sharīʿa* parameters result in a portfolio that is not representative of the overall conventional universe. A *sharīʿa*-compliant fund cannot therefore be expected to track a conventional index. In this situation, one option is to go on using a conventional index that mirrors the fund's composition as closely as possible. Alternatively, an Islamic fund may have an investment policy that aims to mirror the broad parameters (allocation by region, country and/or industry) of an index. At the individual firm's level, however, the Islamic "bias" will show. For example, an Islamic equity fund comprising mainly of mature conservative companies may underperform a rapidly increasing index driven by growth companies, but would also have lower downside risk. The main advantage to the options mentioned here is that the conventional index will be familiar to most investors.

An alternative option is to take the Islamic investment universe as the relevant universe and develop a synthetic Islamic index based upon it. The fund manager's investment-selection skill can thus be reasonably assessed, against this synthetic benchmark. The disadvantage of this option is that many investors will find it difficult to conceptualize such an index.

Obviously, trade-offs are involved in either approach, and it is useful to keep these trade-offs in mind when analyzing the recent development of Islamic indices, a development that has been spurred by the growing popularity of Islamic funds.

IV. Does Adherence to the *Sharīᶜa* Lower Return on Investments?

The reduction in the investment universe due to the application of Islamic principles does not necessarily imply a lower return on investment. Empirical evidence, at least at the time of writing this paper indicates that the fears of lower performance are unfounded. The Dow Jones Islamic Market USA Index has outperformed both large and small capitalization stocks in the last four calendar years. The following sections will attempt to address the effect of *sharīᶜa* principles on stock performance by analyzing the funds of Al-Tawfeek.

Al-Tawfeek Company for Investment Funds Ltd., a major subsidiary of the Dallah Albaraka group is one of the first companies to recognize that *sharīᶜa*-compliant investments can potentially match or even outperform conventional investments at any given level of risk. It particularly specializes in structuring and managing funds with medium- to long-term horizons. This involves financing of venture capital, infrastructure projects, and equity participation in listed and unlisted businesses in diverse economic sectors.

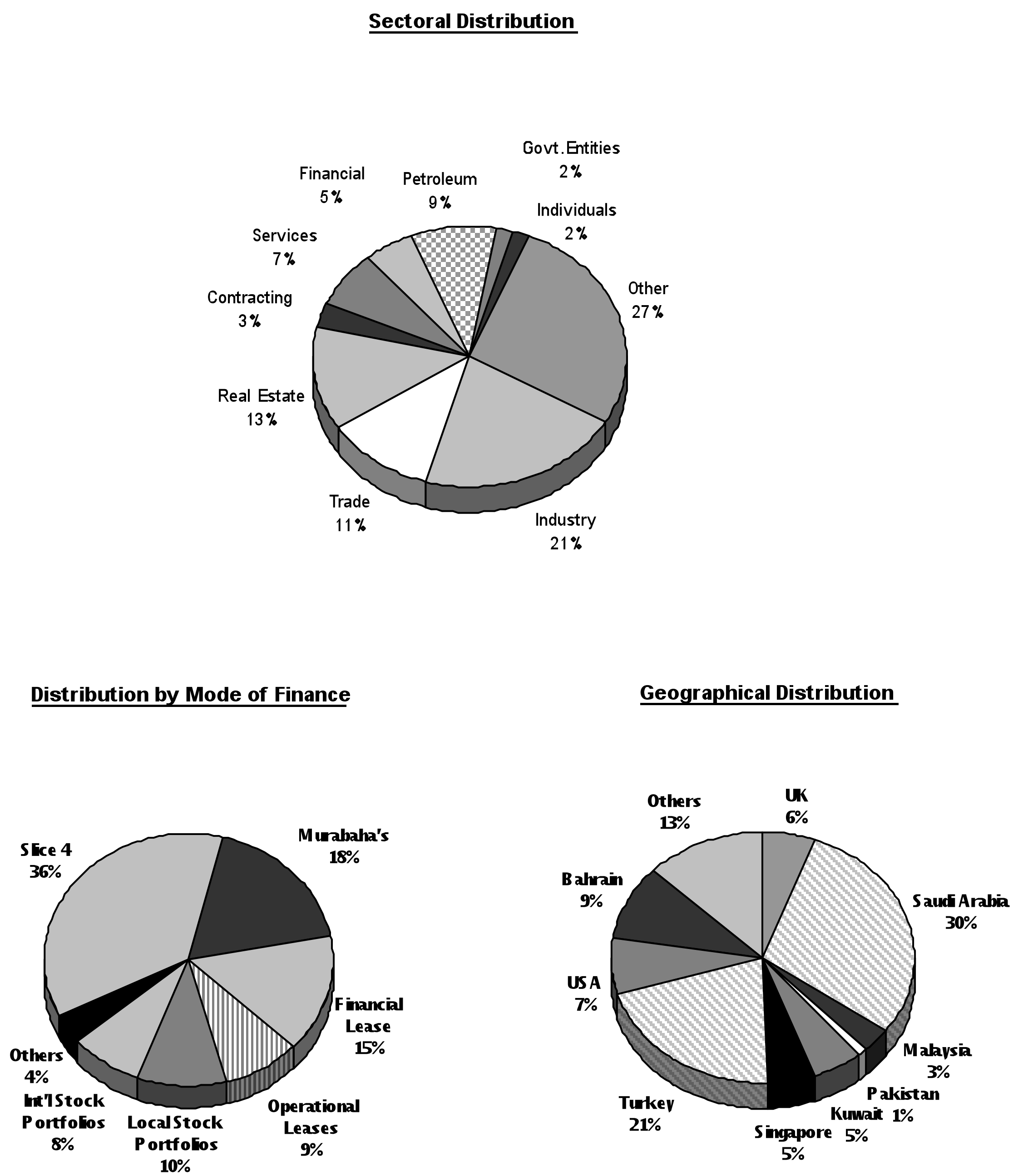
All investments made by Al-Tawfeek are governed by the *sharīᶜa*. Al-Tawfeek's *sharīᶜa* board is constituted of five eminent *sharīᶜa* scholars. Investments are in five risk categories:

1. No Risk, such as the Al-Amin Company issues that are specifically structured to be riskless asset-backed instruments. It is useful to note here that the realized returns of this company's investments are consistently above expectations, and consistently above normal bank rates.
2. Low Risk, such as the Al-Baraka General fund that was launched by Al-Tawfeek.
3. Medium Risk, such as the GCC Leasing Fund and the International Leasing funds launched by Al-Tawfeek.
4. Moderate Risk, such as equity funds like the Al-Safwa International Equity Fund, the Al-Nukhba Fund, and the recently launched Al-Sukoor Equity Fund.
5. High Risk, such as the private equity funds that are based on the acquisition of small and medium-size companies that comply with the *sharīᶜa*. These funds have potentially high long-term returns. Al-Tawfeek is in the process of developing private equity funds.

Since its incorporation in 1992, Al-Tawfeek has structured and launched 10 investment funds with aggregate issued-capital of more than $900 million. These funds cover almost all asset classes that comply with the *sharīᶜa*. Al-Tawfeek provides asset management and investment banking services to both institutions and individuals. Its open and closed-end funds and private placements are designed to fit the needs of various market sectors and different investors' categories.

The sector profile of Al-Tawfeek's investment portfolio clearly reveals a dominant weight on industrial, real estate and trade sectors (21.20%, 12.77%, and 11.38%, respectively). Petroleum ranks next at 9.01%, followed by services at 6.9%. The greatest concentration of investment activity is in equity participation, 36% of the total. This is followed by *murāba®a* and financial leasing, at 18% and 15%, respectively. The remaining 31% is represented by *mu∞āraba*, local and international stock portfolios, and other Islamic financing modes. Half of Al-Tawfeek's investment activity is in two main regions, namely Saudi Arabia (29.41%) and Turkey (20.86%). Overall, Al-Tawfeek's investments are spread-out well over the Muslim countries, reflecting Al-Tawfeek's moral commitment toward effective participation in Muslim world development (see Figure 1).

FIGURE 1. INVESTMENT PORTFOLIO ANALYSIS AS OF FEBRUARY 29, 2000



V. Performance Review of Al-Tawfeek's Funds

The Al-Baraka General Fund invests in trade, leasing, and commodity transactions, and offers three share classes with different holding periods and returns. Unit A can be liquidated at any time. The average rate of return (ROR) over the referenced period for Unit A was 3.4%. Unit B can be redeemed every three months, and had an average ROR of 5.6%. Unit C, redeemable yearly, had an average return of 7.5% (see Figure 2).

The GCC and International Leasing Funds invest exclusively in lease transactions. Each has a different geographical focus. The GCC Leasing Fund shows an average ROR of 7.34% over the referenced period (see Figure 3). The International Leasing Fund showed an average ROR of 6.51% in the referenced period (see Figure 4).

Figure 2. Performance of Al-Baraka General Fund

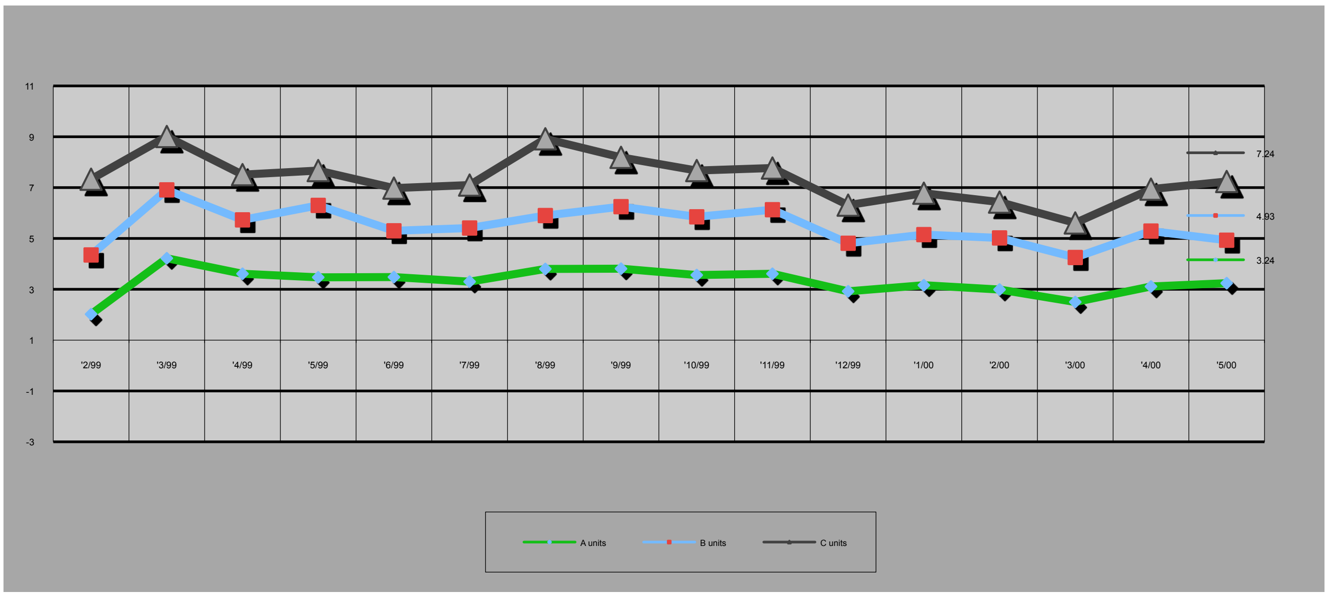


Figure 3. Performance of GCC Leasing Fund

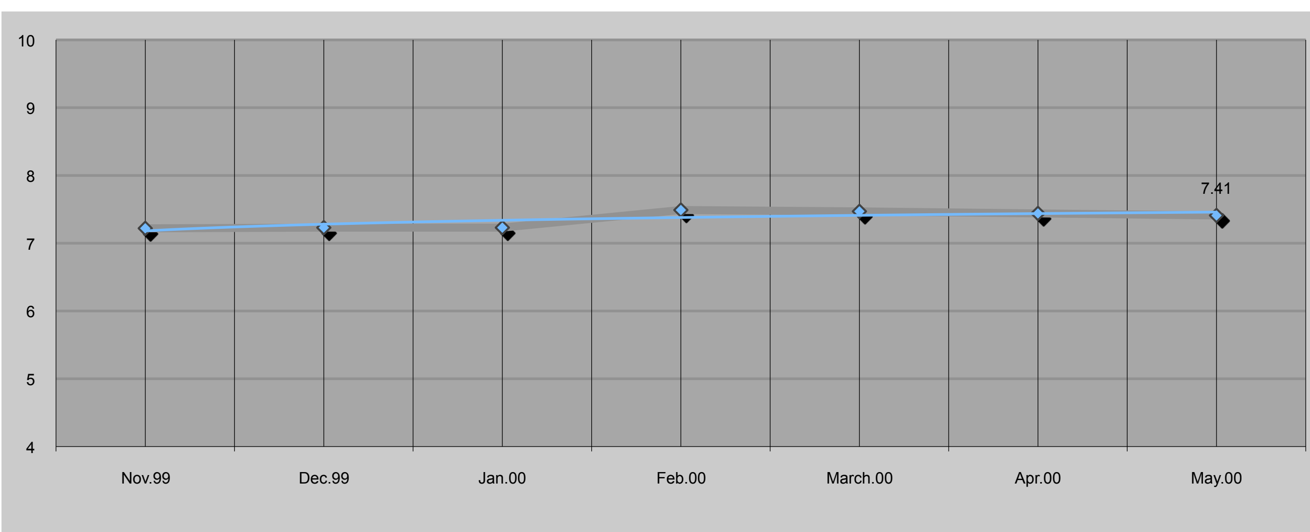
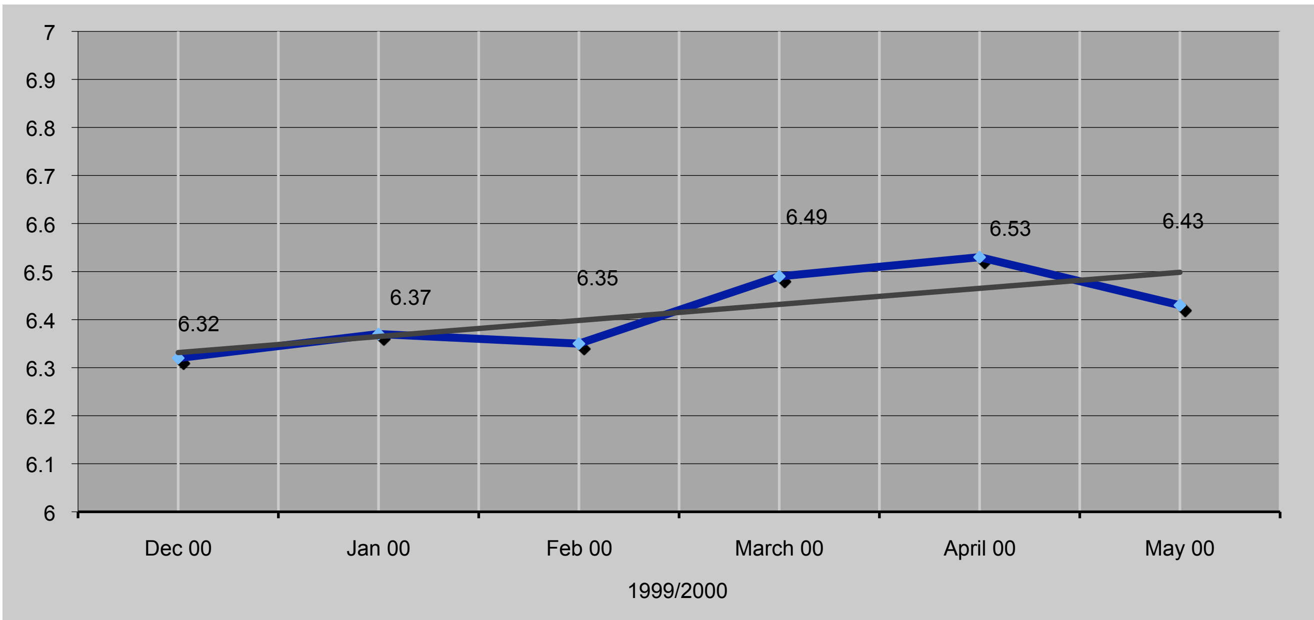
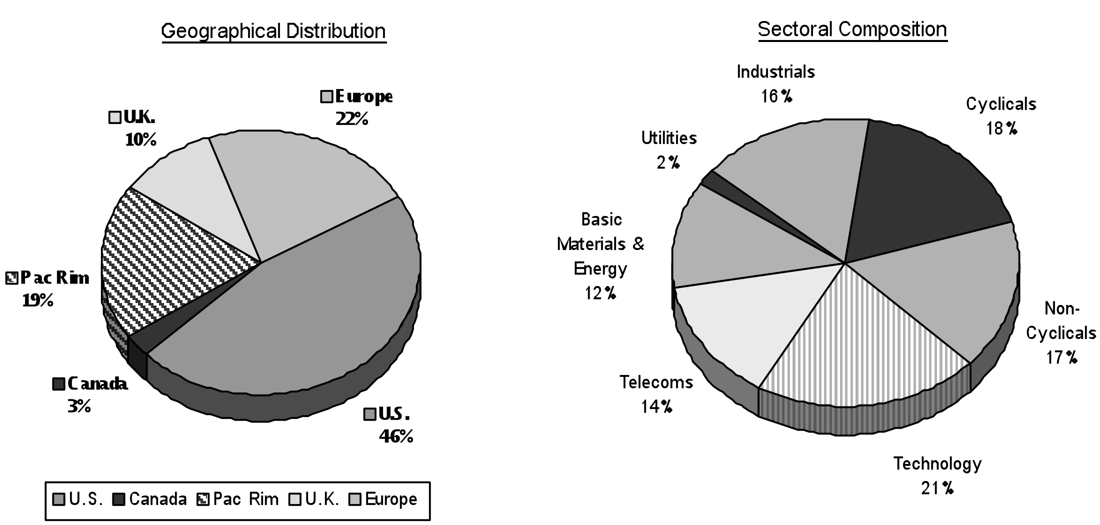


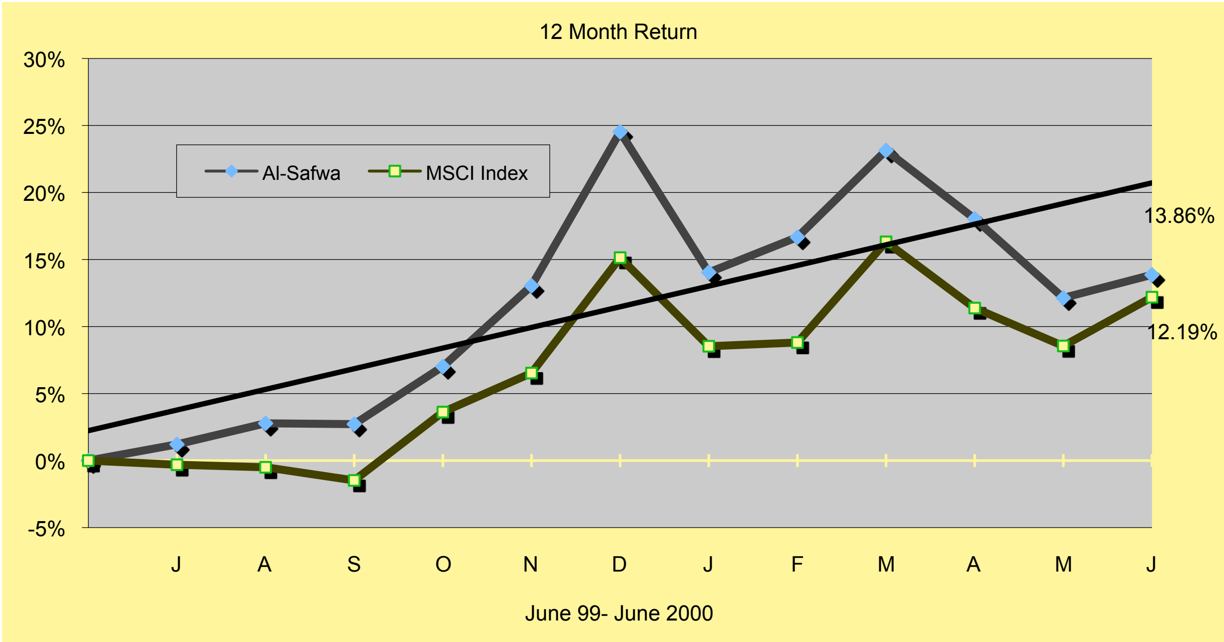
FIGURE 4. PERFORMANCE OF INT'L LEASING FUND



The Al-Safwa International Equity Fund is a global equity fund with relatively strict *sharīʿa* screens (5% leverage and 10% interest income). Geographically, the fund is invested in three major regions, based on the availability of ethical securities in those regions. About 50% of the fund is invested in U.S. and Canada, and the rest is split almost equally between the Pacific Rim and Europe. With over 100 securities, the fund is heavily exposed to technology, consumer cyclicals, and non-cyclicals. It has no exposure to finance, insurance and other activities deemed unethical by the *sharīʿa*. The fund has outperformed MSCI during the last 12 months (refer to Figure 5).

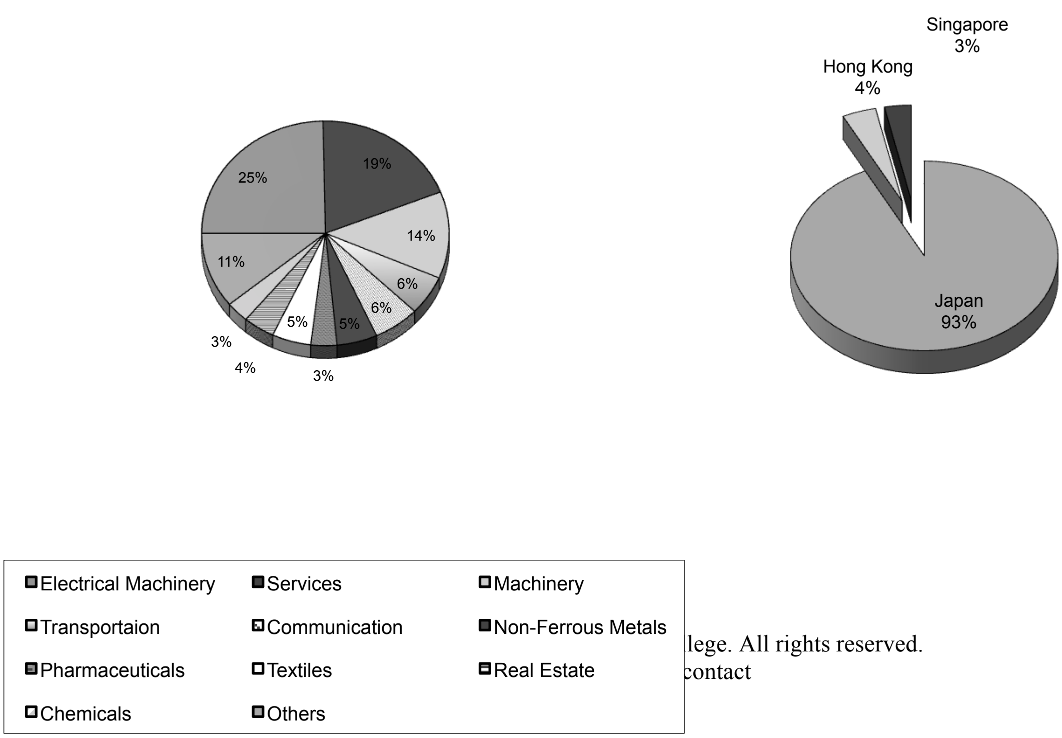
FIGURE 5. AL-SAFWA INT'L EQUITY FUND, JUNE 30, 2000

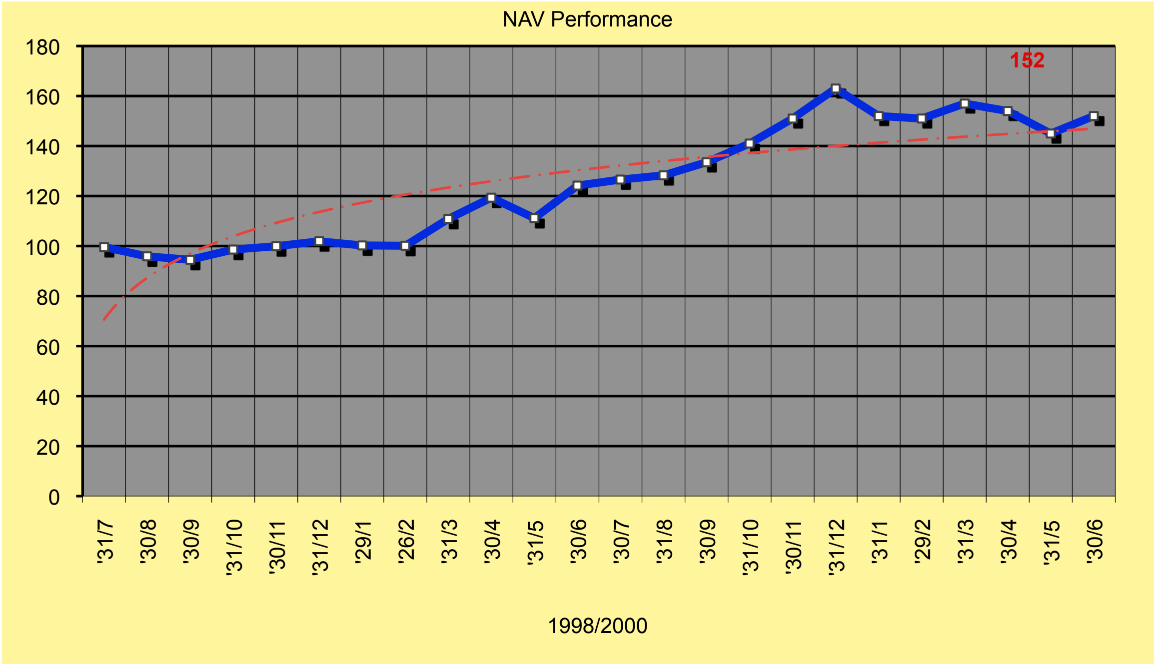




The Al-Nukhba Fund is focused on listed shares in seven Far East/Southeast Asian markets, and has been developed to capitalize on low valuations currently available. In terms of sector, it shows greatest concentration in corporate shares of machinery, electric machinery, communication, telecommunications, and transportation (62.3%). The remainder is distributed among real estate, services, and various miscellaneous classes. Geographically, Japan commands the greatest share of corporate equities with 86.88%. There has been a general upward trend in the value of Al-Nukhba's net assets, from an initial $100m to the $152m at around September 2000 (see Figure 6).

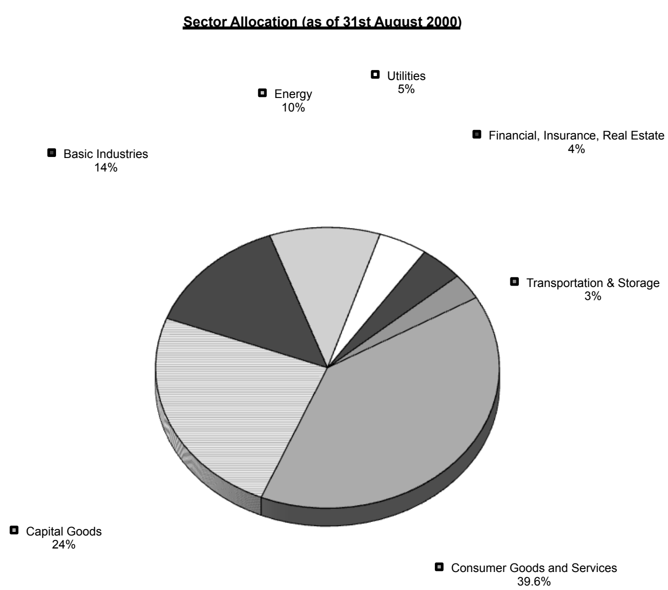
FIGURE 6. AL-NUKHBA ASIA EQUITY FUND

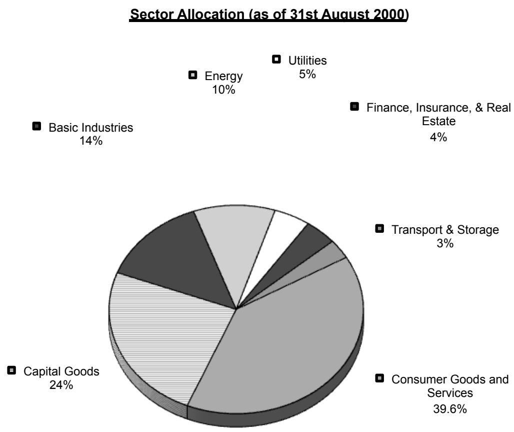


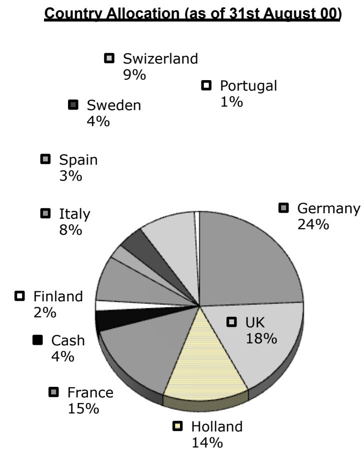


The Al-Sukoor European Equity Fund is a closed-end fund that is incorporated in Ireland and aims at investing in a diversified portfolio of European equities. The fund is benchmarked to MSCI Europe and has outperformed this index in the eight months prior to September 2000. It shows the greatest concentration of corporate shares in consumer goods and services, capital goods, communications, basic industries, and energy (88.20%). The remainder is distributed among utilities, transportation, and various miscellaneous classes. Almost 75% of investments are in Germany, UK, France, and the Netherlands, and the remaining 25% in Finland, Italy, Spain, Sweden, Switzerland, and Portugal (see Figure 7).

FIGURE 7. AL-SUKOOR EUROPEAN EQUITY FUND, AUGUST 31, 2000







The following table shows the recent performance of the Fund:

Performance	Fund	Benchmark
August 2000	5.63%	3.01%
2000	11.33%	-0.28%
3 months	6.79%	1.73%

VI. Conclusion

The operation of Islamic investment funds is not very difficult to understand. The *sharīᶜa* screening process is easily summarized. Though there are still issues to be ironed out, the general principles and methods are well defined. The *sharīᶜa* screening process does raise the interesting issue of how to check the performance of funds, since the funds cannot be expected to match the normal benchmarks. The development of Islamic indices has made this task easier. This development promises to augment the rapid growth of this sector. However, important caveats must be kept in mind when using these indices.

Investors in Islamic funds do not necessarily have to receive lower rates of return. This is clear from a perfunctory look at the DJIM figures. The case study of Al-Tawfeek further confirms this belief. While Al-Tawfeek targeted all types of investment funds, its equity-based funds are particularly attractive for investors with long- to medium-term horizons and who are ready to bear risk to a reasonable extent. Islamic investment funds then can match and even outperform the market. Like all investment funds, what matters at the end of the day is the ability of management to diversify risk optimally, given the needs of the clients.