

Islamic Equity Funds

Opportunities and Challenges for Fund Managers

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ABSTRACT

Due to the moral and financial guidelines of the *shar'ah*, Islamic investing brings challenges not associated with creating and distributing other mutual funds. Credibility that an Islamic fund is *shar'ah*-compliant is essential in order to attract potential Muslim investors. This is especially difficult for newcomers to establish in the Islamic world, and most fund managers are not successful at it. Moreover, many Islamic institutions with *shar'ah* credibility lack the resources to create and manage their own mutual fund. As both fund management expertise and *shar'ah* credibility are necessary, it is difficult to succeed in the Islamic market. Many questions must be addressed when a manager elects to create an Islamic fund. Should a *shar'ah* supervisory board be appointed, and who shall be its members? How should *shar'ah* principles and guidelines be applied in the fund management process? Should one actively manage a portfolio or follow an index? Who and where is the market? How will the fund be distributed?

I. INTRODUCTION: THE ISLAMIC INVESTMENT MARKET

As competition for assets intensifies, fund managers are looking for new markets to penetrate. One of those markets is the Muslim market. The size of the Islamic investment market has been estimated at more than \$100 billion,ⁱ while demand for Islamic investments has been growing at 12%-15% per year.ⁱⁱ In order to tap into this potential new client base, many fund managers are looking to create and distribute Islamic funds. This has resulted in an explosion of Islamic funds over the past five years. Presently there are over 80 Islamic funds, 70% equity and 30% non-equity. Islamic fund promoters are found in most major international markets: 48% are located in the Middle East, 30% in Europe and North America, and 22% in Asia. Due to the moral and financial guidelines of the *shar'ah*, Islamic investing brings challenges not associated with other funds, and because credibility is especially hard for newcomers to establish in the Islamic world, many fund managers are unsuccessful. Conversely, many of the banks that have credibility lack resources to manage their own fund. As a result, the Islamic market is a difficult one to succeed in because both expertise and credibility are necessary.

II. INVESTMENT ISSUES IN THE CREATION OF AN ISLAMIC EQUITY FUND BY A FUND MANAGER

If the manager elects to create an Islamic fund, many questions particular to Islamic investing must be addressed. For example: determining who the market is and where they are located, what types of products will be offered, whether to actively manage or follow an index, the practical application of *shar'ah* principles in fund management, and how the fund will be distributed to the Islamic community. All of these questions raise issues, the successful addressing of which determines a fund manager's ability to penetrate the Islamic investment market.

When fund sponsors are considering the creation and distribution of an Islamic fund, the first decision is whether to out-source the management of the portfolio or to perform that function in-house. Of the over eighty existing Islamic equity funds, most outsource the portfolio management to third parties.ⁱⁱⁱ The reasons to outsource are lack of key resources (knowledge, credibility, funding). Many of the Arab banks that have credibility in the Islamic community lack the resources and knowledge base to manage their own fund, and because the Islamic market is fast moving and complex, long-term focus and in-depth understanding are necessary. Outsourcing provides these banks with the fund management expertise that they lack, and at the same time, outsourcing is cheaper to implement. Conversely, many fund managers that do have expertise in portfolio management do not have credibility in the Islamic community. Without this credibility and a strong, reputable presence in the market, investors will be reluctant to invest in the fund.

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Both fund managers and distributors must have a *sharī'a* board in order to gain credibility; creating a *sharī'a* board and screening stocks are both costly and time-consuming ventures. Outsourcing to a specialist Islamic banking firm provides perceived value by bringing authenticity and a venerable reputation as well as a less costly, lower risk alternative. For institutions without the resources to manage a fund or without credibility in the Islamic community, outsourcing is a viable way to approach the Islamic investment market.

If a fund manager has both established credibility and resources, it is to their advantage to manufacture their own fund, obviating the need to pay another manager. In addition, the firm can then make the fund available for distribution by other institutions, bringing in additional capital and profits to both. Creating a fund is the best option when the company not only has established credibility in the Islamic investment community but also has a broad knowledge of the fund management business.

Once a manager decides to create an Islamic fund, there are many crucial choices to make. The first decision is the type of product to offer. There are four major types of funds that can be created: *istisnā'*, *murāba'ah*, *mu'ārabah*, and *ijārah*. *Istisnā'* funds are contracts of acquisition of goods by specification or order, where the price is paid progressively, in accordance with progress of job completion. *Murāba'ah* funds are funds in which a bank purchases goods for a client, which are then sold to the client with a mark-up. Repayment, usually in installments, is specified by the contract. *Ijārah* funds invest in leases. This is a contract under which a bank buys and leases out, for a rental fee, equipment required by the client. Ownership remains with the bank, and terms are dictated beforehand. Lastly, *mu'ārabah* funds are agreements between two parties: one, which provides 100% of the capital for the project and another who manages the project. Profits are distributed according to a predetermined ratio. These can be equity funds, property funds, and commodity funds. Islamic fund managers select the type of fund that either fits the customers' needs or about which they are most knowledgeable.

III. ACTIVE OR PASSIVE PORTFOLIO MANAGEMENT?

If an equity fund is selected, then a decision must be made whether to actively or passively manage the fund. This decision has much to do with the personal style of the fund manager. Passive management is when the fund is invested according to an index, such as the Dow Jones Islamic Market Index (DJIM). In Islamic investing, indices, such as the Dow Jones Islamic Market Index, track *sharī'a*-compliant stocks from around the world. For example, the DJIM starts with 2,700 stocks and then eliminates those that fail to meet *sharī'a* guidelines, including financial ratio filters.^{iv} After screening, a pool of approximately 640 stocks qualifies and the individual stocks are selected for the portfolio.

There are two approaches to portfolio management: active or passive (indexing). In the past few years, investors have been increasingly interested in tying their assets to indices rather than relying on active portfolio management.^v When the market is performing well, indices tend to mimic that behavior. As a result, managers that follow an index make profits for the investor. This is a cheaper way to invest because the fees are lower. But indices can also be seen as “tyrants” where “to be underweight [in a stock] is to be in danger of dismissal.”^{vi} Passive fund managers often have to follow the index rigidly, even when other market information would advise against the index's investments. This is because they make few value judgments, but blindly accept all newcomers to their benchmark. Because benchmarks choose the stock with the fastest rising price gain, index followers essentially follow price momentum. Index followers cannot invest in a blend of different types of stocks.

As opposed to passive managers, active managers do not follow an index. Each fund manager provides personal attention to the investor and then “actively” chooses what securities to buy or sell. These managers use the indices as benchmarks by which to measure the fund's progress or to measure the market climate. When creating a fund, it is important to pick an appropriate market for comparison. With active management, the goal is always to make money for the client, as opposed to beating an index. Active managers attempt to outperform the index in a good market. In a bad market, active managers ideally can pick the pockets of profitability and opportunity, therefore performing much better than the index. Active management carries a higher risk, with the possibility of greater profits.

IV. LIQUIDITY MANAGEMENT

Fund managers must carry cash balances in order to have the ability to respond to withdrawals of cash by investors at very short notice. They also need to derive income from these short-term funds in order to contribute toward the fund earning competitive returns to investors.^{vii} Because interest income is prohibited under the *sharī'a*, investment of short-term funds in a *sharī'a*-compliant manner becomes problematic. With the investment of liquid

funds, there is the problem of a lack of Islamic interbank markets. It is also difficult for Islamic funds to deposit and borrow liquidity because of a lack of “acceptable instruments, proper credit ratings, operational standards, *sharīʿa* compliance, and market practice.”^{viii} As a result, Islamic funds try to minimize liquid funds for customer withdrawals and investment needs for fear of earning a low or no return on them.^{ix}

The obvious solution to the problem is to create a fund comprised of *sharīʿa*-compliant instruments that produce a money market return (i.e., LIBOR) and that have daily liquidity. There are very few of these vehicles available and few traditional fund managers have the skill sets to manage such a fund. While *murābaʿa* funds do exist, most fail to pass the *sharīʿa* and liquidity tests. One example is the ABC Clearing Company, where assets are invested in *murābaʿa*, *ijāra*, and other *sharīʿa*-compliant instruments providing “cash” returns with daily liquidity. This fund is an example of a way to make profits above what leaving cash on the table.^x One word of caution, there are some regulatory jurisdictions that do not allow investment into “non-transferable” securities such as *murābaʿa*, thus taking this option away.

V. SHARĪʿA COMPLIANCE

Developing an Islamic fund has many challenges particular to Islamic investing. The first step toward *sharīʿa* compliance is the creation of a *sharīʿa* advisory board by either the fund's sponsor or the fund manager. This board is an independent body of specialized jurists in *fiqh al-muʿāmalāt* or Islamic jurisprudence. It may include one expert in the field of Islamic financial institutions. The board is appointed by the Fund Company and should consist of at least three people, with the option of seeking expert consultants. The board should not include directors or significant shareholders of either the sponsor or the fund manager. The selection of respected members of the community is essential because this board will bring reputation and credibility to the fund.^{xi} The Board issues guidelines of *sharīʿa* investing that are provided in the form of a *fatwā*. First, Islamic funds must comply with *sharīʿa* guidelines that prohibit investment in companies whose primary business are not consistent with *sharīʿa* principles such as alcoholic beverages, tobacco, entertainment, hotels and leisure, financial services, and pork products.^{xii} One of the key elements of Islamic investing is the avoidance of interest. Stocks that do not meet specified financial parameters are excluded, examples of which are limits on debt, interest income, and accounts receivable.

In order to comply with the guidelines, stocks must not only be screened initially but also constantly updated as to compliance. (A company might buy or sell something overnight, becoming non-compliant.) This screening may be done in-house by the fund manager or outsourced to a specialist such as Dow Jones or The International Investor.

Another guideline of *sharīʿa* investing is purification. There may be stocks that pass the screens but do generate income that is not *sharīʿa*-compliant. Interest income is an example. Each quarter the fund manager or his designate must determine how much of the income is impure and determine what proportion of the dividend must be earmarked as such. Some *sharīʿa* boards insist that impure income be donated to charity. In this case the amount of impure income for each stock must be determined and then deducted from the dividend. The *sharīʿa* board then gives the sub-fund manager a list of approved charities to which the deducted amount is donated. Pure income is then credited to the fund and the net asset value (NAV) is adjusted accordingly.^{xiii} Other *sharīʿa* boards allow impure income to be credited to the fund and simply reported to investors so that each may decide how they want to deal with it.

The *sharīʿa* supervisory board will issue an annual report stating whether the institution's contracts and related documentation are in compliance with the *sharīʿa*.^{xiv} In addition, quarterly reviews of the portfolio are made.

VI. DISTRIBUTION

Most fund managers are “manufacturers” of investment products and rely on other institutions to distribute them. In order to be successful in attracting assets, Islamic funds must be distributed by institutions with good access and relationships in Muslim markets. There are several ways to accomplish this:

- To sponsor, manage and distribute the fund through a network in Muslim markets. This is the best alternative although one that few fund managers can achieve. Saudi American Bank through Samba Capital Management International is one of the exceptions, doing both the manufacture and distribution of Islamic funds.

- To create and manage the fund but appoint distributors. Most fund managers take this approach although it has met with limited success. Examples are Fleming Asset Management, Citi Islamic Investment Bank, Global Asset Management, and Permal Asset Management.
- To sponsor and distribute the fund but outsource the fund management. This approach is very common in Muslim markets. Examples include National Commercial Bank (Wellington), Al-Rajhi (UBS), Faysal Islamic Bank of Bahrain (recently renamed Shamil Bank of Bahrain) (BNP), and Arab National Bank (Schroeder SSB).

The alternative that a fund manager selects depends upon its structure and resources. Once that decision is made, several factors are critical for success:

- *Product design and selection.* Ideally, a distributor should have a “family of Islamic Funds” with a choice of risk levels and liquidity so that clients can match the best product(s) to their need.
- *Quality of the relationships maintained by the distributor.* At this point, reputation and credibility are paramount. Reputation determines the level of trust by existing clients and access to new clients. The existing client base must be not only willing to invest in the new fund but also trust his investment business to the distributor.
- *Reputation of the shari‘a board in the market.* Familiarity of one or more members of the *shari‘a* board helps to build confidence with potential investors that the fund is *shari‘a*-compliant.
- *Quality of the regulatory oversight and ability to obtain prompt approval in key target markets.* When preparing to distribute the fund, managers must decide where to register the fund. This is partially based on where the target market is located and type of fund. If much of the market is in Europe, the fund should be registered in Europe. Luxembourg registration increases credibility although the fund still must be approved by each respective country’s central bank and Luxembourg registration makes the process much easier. Alternatives to Luxembourg include the Channel Islands, Cayman Islands, Bahrain, Bermuda, and others. Unfortunately, it is difficult to register equity funds in the Middle East unless the distributor is a local bank or other financial institution. Those registered in the Middle East cannot be distributed in Europe until central bank approval is obtained in the targeted countries.
- *Product knowledge and skill sets of relationship officers.* Employees of commercial banks must be trained to deal with Islamic clients and must understand Islamic investing. Even more basic, most banks' staff do not have the skill sets to effectively market investment products. Some remedies to this problem include launching one product at a time and having staff focus only on that one product; placing Islamic investment specialists out in the field on a full time basis to support the distributor's staff; use of sales incentives to motivate staff to learn about and market mutual funds.
- *Ability to access multiple distribution channels.* There are several alternatives: distribution through another institution's retail and private banking networks; use of independent contractors who act as wholesalers to high-net-worth individuals or other financial institutions that may distribute and sell the fund to their clients; the Internet, a relatively new channel, can be used to penetrate the market. Estimates of potential markets for *shari‘a*-compliant financial markets are in the range of 1.5 billion Muslims worldwide controlling well over \$100 billion of available funds.^{xv} This is probably 1-2% of the potential market.^{xvi} It is thought that many of these Muslims can be reached through the Internet. This is a developing business that is in its infant stages of development.

VII. CONCLUSION

Fund managers that wish to capitalize upon opportunities and penetrate the Islamic investment market have many choices to make. The most general question is whether to create or outsource a fund. This choice should be based on the company’s credibility in the Islamic world, the prior expertise in the fund management field, and the financial resources available to them. After this decision has been made, the personal investment style of the manager dictates whether investment will be active or passive. An investor should look at which style suits the individual’s risk and investment capital levels. A slew of additional choices only affects Islamic funds.

Fund managers must carefully track their compliance with the tenets of Islam, as dictated by a *shari‘a* board and its guidelines. These issues include screening, liquidity management, and purification. Finally, the fund has to be carefully registered and distributed with an eye on the largely untapped Muslim population. If all of these aspects are successfully addressed, a new market can be accessed. Although Islamic fund management is more

complex and has more rules and guidelines than mainstream investing, the potential opportunities in the market are great.

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- ⁱ Creating Online Self-selection Investment Portfolios for Islamic Investors Worldwide: Product Partner Information Guide. Jersey ii-online Ltd., 2000.
- ⁱⁱ The FTSE Path to Islamic Investment: Introduction. London: FTSE International Ltd., 2000.
- ⁱⁱⁱ Global Equity Trading Fund. London: Samba Capital Management International, 2000.
- ^{iv} Dow Jones Indexes. Princeton: Dow Jones Indexes, 2000.
- ^v Siddiqui, A. Rushdi. "Investment Strategies in a Changing World." Presentation at the Samba Annual Global Investment Conference. Kingdom of Saudi Arabia. May 23, 2000.
- ^{vi} Coggan, Philip. "The Tyranny of Indices." Financial Times. June 12, 2000.
- ^{vii} El-Kafsi. "Liquidity Management." Presentation at the Islamic Investment Products Conference. May 21, 1998.
- ^{viii} Ibid.
- ^{ix} Ibid.
- ^x El-Kafsi, *supra*.
- ^{xi} Yaquby, Nizam. "Regarding Auditing Standards for Islamic Financial Institutions Related to *Sharġa* Supervisory Boards." Presentation at the Islamic Investment Products Conference. May 21, 1998.
- ^{xii} Global Equity, *supra*.
- ^{xiii} Ibid.
- ^{xiv} Yaquby, *supra*.
- ^{xv} Creating Online Self-selection Investment Portfolios, *supra*.
- ^{xvi} Ibid.