Proceedings of the Fourth Harvard University Forum on Islamic Finance: Islamic Finance: The Task Ahead Cambridge, Massachusetts. Center for Middle Eastern Studies, Harvard University. 2000. pp.135-138

Islamic Investing

An Institutional Investor's Perspective

Omer Ahmed*

ABSTRACT

With the maturation of the Islamic financial mindset, many Islamic investors are seeking more concerted efforts toward an application of the principal philosophy of Islamic finance and shunning conventional financial instruments that are window-dressed as Islamic investments. This paper outlines some old concepts that are incorporated into a new paradigm of Islamically managed assets. A three-component asset-management format shall be discussed, beginning with a "flow-through" method that is initiated by private equity investments. This is followed by trade- and lease-finance exposure, which also provides for an adequate cash management function. The process culminates in a public equity structure, which can also be regarded as an exit strategy for some investors. A comprehensive Islamic investment management vehicle shall be discussed from the institutional perspective.

I. INTRODUCTION

A significant aspect of Islam is the extent of its involvement in social, commercial, and political issues. The Islamic economic system differs quite substantially from the liberal, capitalist system that most Western-trained economists take as their base case. It is vital to appreciate that Islamic economic theory is defined in the context of an Islamic society, the objectives and structures of which differ substantially from the societies that many of us inhabit today.

While it is critical to define and envisage an ideal Islamic economy (essentially an academic and theological process), it is also crucial to examine the transition from our current state toward the ideal (essentially a practical exercise).

The process of defining an ideal Islamic economy can occur in the context of an Islamic society. However, the practical process of defining a transition must work in the context of a secular society or an interest-based economic system and must, as a staring point, concern itself with individual persons or institutions that operate in an alien environment.

II. ISLAMIC ATTITUDES TOWARD WEALTH

Islamic attitudes toward wealth underpin Islamic economies. Islam does not suggest that wealth possesses any intrinsic ethical qualities, whether good or bad. Unlike some cultures and religions, Islam does not teach that the absence of wealth is a virtue or a vice, nor that its presence implies any particular character.

> "Wealth properly acquired is a good thing for the good man."
> (*ßākim al-Mustadrak*, Vol. 2, p.2; Hyderabad, 1340 A.H.)

Instead, Islam judges the manner in which wealth is generated, deployed, and consumed. It does not place any specific or unique responsibilities upon the wealthy.

> "The honest, truthful Muslim trader will be in the company of the martyrs on the Day of Judgment."
> (Ibn Mājah, Sunan, *Asbāb al-Tijāra*, *Bāb al-ßa¥¥ al-Makāsib*)

Islam stresses modesty in consumption and avoidance of waste. On the other hand, it also emphasizes the importance of self-reliance.

> "To earn an honest living is a duty [ranking] next to the chief duty [of offering prayers]."

* President, Crescent Capital Management, Chicago, Ill.

(Mishkāt, *Kitāb al-Buyūᶜ*)

In terms of precedent, it is important to note that the Prophet Muhammad and those close to him carried out commercial businesses on a successful basis.

III. Participation and Risk

One of the few obligations that Islam places on those who control wealth is to invest it productively. The hoarding of wealth has been strictly prohibited, as has taking advantage of wealth. Islam defines wealth in terms of assets, not in monetary terms. Money is seen as a medium of exchange but not as a store of value: money has no value of its own. Islam places great importance on fairness and justice: in the context of finance, owners of capital are not permitted to exploit, take advantage of, or protect their positions. The *sharīᶜa* places the providers of all the various factors of production on an equal footing. In particular, a strong body of evidence suggests that the providers of capital cannot obtain favorable treatment over the providers of labor, skills, and entrepreneurship. There are numerous references to the fact that Islam recognizes the separation of ownership and control. Hence, investments can be made in ventures that are not managed by the owner.

IV. Philosophical Mandate

Islamic finance in its truest form comes down to a philosophical mandate:

1. Wealth must be deployed productively, i.e., invested rather than saved.
2. The hoarding of wealth is unlawful.
3. Money is not considered to be an asset.
4. Islam recognizes the separation of ownership and control.
5. Providers of capital cannot take advantage of their position.

Although none of these points are controversial in themselves, when taken together as a whole they have far-reaching implications. A closer look at the implications permits a better understanding of the true characteristics of Islamic finance. Consider the stipulation that wealth be invested in an economic venture, which by definition is risky. Lending is only permitted for altruistic purposes. Providers of capital must share in the outcome of the business; they cannot protect their capital or extract other forms of guarantees (of capital returns). Capital cannot take preference over other factors of production and therefore cannot secure the cash flows or assets of the business by way of guaranteed profits, certain returns, or predetermined returns. Under the Islamic financial mandate, investors may reduce risk by diversifying their investments across a number of different ventures. Money cannot be bought and sold for itself (nor can any other commodity). Neither is money a fixed asset; thus, it cannot be rented out. Islamic economics, unlike conventional economics, does not recognize the concept of financial capital. Money is not a factor of production, and it is, at best, a deferred or a potential asset. These implications are important defining characteristics of Islamic finance and must be taken into account by any Islamic financial institution.

V. The Islamic Law of Contract

To imply a philosophical mandate, one must have a means to uphold these principles. Islamic law governs Islamic finance and its principles. There are four main sources of Islamic law: the Qur'an; the Sunna of the Prophet, which reflects his way of life and hence sheds light on the Qur'an; the consensus (*ijmāᶜ*) of the great jurists and interpreters of Islamic law; and finally the principle of analogy or precedent (*qīyās*) by which the rules of Islamic law are extended to similar or analogous situations. These sources of Islamic law prescribe lawful means of transacting and provide the criteria for judging the legality of transactions that are not strictly covered by the four sources mentioned previously. Islam does not dictate a particular contractual format; in fact, the concerned parties possess the freedom to choose the most convenient form of contract from the array of permitted contracts.

VI. An Islamic Asset Management Product

Given the starting point for most Islamic investors and institutions, one must accept that there are costs to complying with Islamic requirements and that one must be realistic and accept that it is not possible to achieve full compliance on a mass scale. Any Islamic financial product must pass several tests: it must be productive, involve full participation (profit-and-loss sharing), free of interest, and free of *®arām* elements.

While these criteria do not appear particularly onerous, they have far-reaching practical implications when viewed together and in the context of a conventional economy. The presence of Islamic requirements in a conventional macroeconomic framework can possibly have detrimental side effects, such as a greater level of risk and a loss of liquidity. These side effects are not entirely offset by the benefits of an Islamic macroeconomic framework, such as greater economic stability, increased investment, and the absence of inflation. In fact, substantial synergies can be achieved by applying Islamic requirements in an Islamic macroeconomic framework, including a reduction in the risk and volatility of equity investments, greater economic growth, and higher returns on equity.

The Islamic macroeconomic framework is the foundation for a three-tiered paradigm of Islamic asset management. First, investment is initiated through a private equity transaction. It is then enhanced through a trade or lease finance structure. Finally, it is enhanced through a public equity structure, which can be regarded as an exit strategy that includes public equity floatation and the management of public equity exposure.

The Islamic macroeconomic framework defined above can take asset management one step further and apply it to an institutional investor's customized portfolio. This portfolio obviously must be structured to meet specific requirements and preferences: Islamic restrictions, geographic and sector allocations, risk preferences, diversification and risk control, and benefit to Islamically inclined businesses or regions.

The customized portfolio is put through a comprehensive screening process to ensure that it meets Islamic financial conditions. The typical screening begins with individual companies and progresses on to various sectors, different stock markets, and the attributes of each company. Moreover, portfolios are continuously screened in order to ensure adherence to the principles of Islamic finance and a bias toward Islamically inclined regions and companies.

VII. Investment Strategy and Process

Each portfolio should contain a comprehensive Islamic investment management vehicle that is managed from an institutional perspective. The vehicles include a specific investment strategies and processes that involve four steps:

1. focus on deal-screening criteria;
2. the investment process;
3. the structure of the investment vehicle; and
4. investment constraints.

A. Focus on Deal-Screening Criteria

Deal-screening criteria center on due diligence procedures. The due diligence review prior to a private equity investment, while adhering to Islamic principles, should include a number of other components. Each private equity investment should have an attractive and proven business model that includes advantageous positioning within the industry. The investment should also have an organized and focused management team and exhibit significant competitive advantage. The amount of debt should be low to negligible, and total debt should not exceed 25% of total equity or capital, whichever is higher. The private equity investment should have an established business plan that manages and maintains these criteria. The target of the Islamic investment should not engage in a prohibited business (gambling, tobacco, alcohol, pork, pornography, weapons of mass destruction, and conventional finance). Here, a socially responsible investment strategy acquires paramount importance. Finally, the screening process entails the inclusion of a plan to effect an initial public equity offering within three years.

B. The Investment Process

The investment process includes the above-mentioned procedures as well the standard due diligence prior to an investment. This process involves the extraction of information on the investment's true characteristics as well as the driving forces behind each company. It includes an extensive look into the background of the company's management team and the basic economic premises that drive the firm's business model.

C. The Structure of the Investment Vehicle

The structure of any investment vehicle used in Islamic investing should be based on equity. The Islamic law of contract and Islamic macroeconomic ideals (when juxtaposed with conventional methods of structuring investment vehicles) suggest that limited partnership is the most desirable structure for an Islamic investment vehicle. It is imperative to base the said vehicles on a profit-and-loss model and not burden them with debt finance or any interest-based financial instruments.

D. Investment Constraints

The final investment strategy pertaining to Islamic investment vehicles managed from an institutional perspective involves the actual constraints on investment. No more than 10% should be invested in any single company. Investments should contain trade and/or lease-finance opportunities as well. The investment should also have a regional bias (more Islamic focus, if applicable) while maintaining global exposure.

VIII. Conclusion

The long-term strategy of Islamic financial institutions must be to expand their influence and spread Islamic finance. This will be accomplished by demonstrating the greater effectiveness and efficiency of the Islamic financial system. So far, Islamic institutions have established themselves but have not yet demonstrated to the institutional investor that Islamic investing generates superior long-term returns. Now that Islamic institutions are reaching a level of maturity, it is time for them to implement the substance of Islamic finance. When they have achieved sufficient size, prominence, and power in the financial industry, they will be able to convince the companies in which they invest to amend the legal form of transactions to comply with Islamic requirements. The commercial imperatives of competing in the deposit market, gaining size and critical mass within it, are important and have largely been achieved, yet progress in the substance of Islamic finance remains elusive.