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Structuring Islamic Equity Funds

Sharīᶜa *Board, Purification, Portfolio Management, and Performance Issues*

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ABSTRACT

In today's ever-evolving world of banking and financial services, one thing remains constant: the need to develop and deliver top-quality financial products and services in order to satisfy the demands of investors and develop a loyal and satisfied client base. The need for increased client service levels is at an all-time high. But keeping clients happy is only one part of the equation. Banking and financial services companies face constantly changing market, regulatory, and investor conditions, as well as the daily challenge of running a smooth business practice. There are strict advertising and disclosure limitations. Licensing, registration, and regulatory compliance issues must be constantly reviewed and kept current. Increased competition arises from within the industry, including many new and low-cost Internet banks, stock trading and online brokerages. Companies serving the Islamic community must be prepared to structure and deliver top-quality products and provide increased levels of client service in order to compete effectively in today's financial product and services industry.

I. INTRODUCTION

Investment management companies have been structuring and managing public equity funds in the United States for 76 years, but only recently have begun to seriously integrate compliance with generally accepted *sharīᶜa* precepts. The founders of MFS Investment Management of Boston, Massachusetts, formed the first mutual fund, Massachusetts Investors Trust, in 1924. Members of the North American Islamic Trust (NAIT) established the first Islamic equity fund, the Amana Income Fund, in 1986. A small asset-management company, Saterna Capital Corporation of Bellingham, Washington, manages this fund. Currently there are 97 known Islamic equity funds in the world.[i] There are 7,791 mutual funds in the U.S., of which 3,952 are equity funds.[ii] Presently there are only 3 Islamic equity mutual funds in the United States.

Islamic banks and other types of Islamic financial institutions, in general, have enjoyed impressive growth rates in terms of capital, total deposits, and assets under management. Total assets are growing at approximately 15% per year. At the beginning of 1998, there were over 190 Islamic financial institutions worldwide. It is estimated that $150 billion to $200 billion in Islamic funds is presently available for investment in equity and venture capital funds, and as much as $500 billion may be seeking shorter-term, income-oriented investment vehicles. About $90 billion is currently in equity-based Islamic funds and accounts. In the Arab Gulf countries, there are more than 200 local and foreign banks, only 20-25 of which are Islamic banks. These Islamic banks had deposits in 1998 of approximately $150 billion, which would represent about a 32% share of the Gulf's regional banking deposits. The rate of growth in terms of funds and companies serving this developing market has been accelerating globally over the last three years, and new "Islamic" financial products, services, and companies are burgeoning.

The United States contains an estimated 8 million to 12 million Muslims. The median income of Muslims nationally is about $40,000.[iii] Islam, with about 1.2 billion followers around the world, is the fastest-growing religion in the United States, with an estimated 2.5% annual growth rate.[iv] In 1999 alone, as many as 10,000 Muslims from Kosovo moved to the United States.[v] With only three Islamic equity funds in the U.S., it is safe to say that this growing financial and consumer market is underserved. For this reason, Bashar Qasem, a group of Gulf business leaders, and the author founded Azzad Asset Management, Inc., in 1997 and created two Islamic equity funds: the Azzad Growth Fund, L.P., a private small-cap equity fund; and the Azzad/Dow Jones Islamic Index Fund, an enhanced index mutual fund based on the extra-liquid version of the U.S. components of the Dow Jones Islamic Market Index (DJIM).

The Azzad Growth Fund was structured as a private equity fund under Regulations D and S of the United States Securities Act of 1933. The Azzad/Dow Jones Islamic Index Fund was structured as an open-ended mutual

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fund and filed with the U.S. Securities and Exchange Commission in the summer of 2000. In addition to utilizing a traditional investment and portfolio management process, Azzad employs a *sharīᶜa*-based process that involves several areas of responsibility—the seven pillars of *sharīᶜa*-based investing.

II. The Seven Pillars of *Sharīᶜa*-Based Investing

Sharīᶜa-based investing incorporates seven main pillars that work together to deliver competitive performance and to promote socially and ethically responsible business practices, which in turn, contribute to improvements in the quality of life throughout society.

A. *Sharīᶜa* Supervision

Sharīᶜa supervision by a qualified *sharīᶜa* supervisory board is an integral component of any serious Islamic equity fund structure. The board is typically made up of prominent scholars well versed and disciplined in the *sharīᶜa*, particularly in areas of transactions and business dealings. The board should be independent, should act in an advisory and supervisory role with the fund's management, and should assist in the development of fund management policy, *sharīᶜa* screens, investment strategy, implementation, monitoring, and reporting.

B. Screening

Screening is the practice of including or excluding publicly traded securities from investment portfolios or mutual funds based on the religious and ethical precepts of Islamic law. Generally, Muslim investors seek to own profitable companies that make positive contributions to society. Certain businesses are incompatible with the *sharīᶜa*. Therefore, stocks of companies whose primary business is not permissible according to the *sharīᶜa* are excluded, including: companies that receive a major portion of their revenues from alcohol, tobacco, and pork-related products; interest-based financial institutions, such as banks, brokerages, and insurance companies; and entertainment companies, including most hotel, gaming, pornography, and music concerns. In addition, most *sharīᶜa* screens currently in use by fund managers include three financial-ratio filters:

1. Excluding companies if total debt divided by total assets is equal to or greater than 33%.
2. Excluding companies if accounts receivable divided by total assets is equal to or greater than 45%.
3. Excluding companies if non-operating interest income is equal to or greater than 5%.

C. Purification

Purification is the process of eliminating or cleansing the portfolio from income or gain resulting from interest (*ribā)* or other impure revenue sources. The fund should have a strict, quantifiable formula and methodology of separating interest-related income and impure income, including dividends and capital gains, from the portfolio.

D. Shareholder Advocacy

Shareholder advocacy describes the actions that many socially aware investors take in their roles as owners of public corporations. These efforts include dialogue with corporate management on issues of concern and submitting and voting proxy resolutions. Socially responsible proxy resolutions are generally aimed at influencing corporate behavior and practices toward a more responsible level of corporate citizenship.

E. Monitoring and Reporting

Monitoring and reporting involves a process of vigilance over the fund's holdings to ensure compliance with *sharīᶜa* filters, fund strategies, and policies. A screened portfolio is only the first step toward *sharīᶜa* compliance. *Sharīᶜa* compliance is an ongoing process and requires diligent analysis of company financial statements, practices, and revenue sources. Ongoing management and shareholder reports are necessary to provide fund principals and investors with timely information related to *sharīᶜa* issues, the fund, its practices, and performance.

F. Charity and Community-Based Investment

Charity and community-based investment programs provide capital to people and organizations that have difficulty attaining it through conventional channels or that are underserved by conventional financial or lending institutions. Impure portfolio income can be donated to many different non-profit organizations as long as the monies are not used to build a mosque or print the Qur'an. Venture capital funds for low-income housing and small-business development in the United States and abroad may also be established. Community-based investments enable people to improve their standard of living, develop their own small businesses, and create jobs for themselves and their neighbors.

G. *Zakāt* Calculations

Zakāt calculations may be provided through the accounting process of the fund for investors. The matter of calculating *zakāt* is complicated in equity portfolios due to the timing of portfolio income and capital gains. Tax-deferred and tax-exempt arrangements, as well as trusts, can further complicate this. Nonetheless, *sharīᶜa* supervisory boards may be asked to suggest guidelines that may then be incorporated into specialized software. Many Muslim shareholders would undoubtedly appreciate a *sharīᶜa*-supervised service for the timely and accurate payment of *zakāt*.

III. Portfolio Management (The Azzad Growth Fund)

The investments of the Azzad Growth Fund consist predominantly of the equity securities of small- to mid-capitalization companies selected in accordance with the investment methodology of Azzad and the portfolio managers selected by it, consistent with applicable *sharīᶜa* principles and restrictions. Azzad's basic investment approach is to diversify the fund's assets between the two predominant styles of fundamental-based investing, namely value and growth, and allocate fund capital equally between value- and growth-oriented portfolios. The portfolios are entrusted to experienced portfolio managers with demonstrated superior historical investment performance. At present, the master fund utilizes a single portfolio manager in each of the two basic investment styles.

A. Investment Methodology

Azzad has established basic investment methodologies for both the growth portfolio and the value portfolio of the Partnership. These methodologies are reviewed with the relevant portfolio managers and are further refined and developed as appropriate.

The fund's growth style strategy begins with research using fundamental analysis, including the application of Azzad's Islamic filter process. Stocks are selected according to the following quantitative measures: sales growth of greater than 20%; earnings growth of greater than 20%; analysis of income statements as to, among other factors, operating margins and above-average profitability ratios; and analysis of balance sheets for *sharīᶜa* compliance as well as for financial ratios and overall strength. The portfolio manager analyzes a variety of qualitative considerations, including, among others, entrepreneurial management, dominant market position, pricing flexibility, and new product flow. The sell discipline is utilized when the *sharīᶜa* is violated, price objectives are achieved, a position becomes too large, fundamentals deteriorate, a sector's outlook changes, or there is unfavorable relative price performance.

Similar to the growth style, the fund's value style strategy also begins with fundamental analysis, including the application of Azzad's Islamic filter process. Value stocks are selected according to the following characteristics: steady earnings and cash flow growth; dominant market position or strong niche franchises; good (or improved) balance sheets; excess cash flow from operations; and a high degree of management stock ownership. Companies that meet many of these criteria are further reviewed to identify those with low absolute and comparative price-to-earnings ratios; low price-to-book value; and low price relative to the company's industrial value, as a strategic acquirer may view the same. As with the growth portfolio, a strict sell discipline is employed when: the *sharīᶜa* is violated; a stock achieves a target price or moves to "market level" valuations; or is sold and replaced by other undervalued securities.

B. Limitations on Investment Techniques

By reason of *sharīᶜa* principles and restrictions, as well the Azzad's own investment approach, the fund does not engage in a variety of investment practices and techniques typically employed by private investment partnerships or "hedge funds." The fund does not employ leverage, or the use of borrowed funds, to increase investment exposure. The fund does not engage in short selling, in options strategies, or the use of other derivative securities. As a result, the fund's portfolios are exclusively "long" and therefore unhedged. Interest-based securities such as bonds, convertible bonds, and preferred stocks are avoided.

C. Holding Periods and Turnover

On account of Azzad's investment strategy, most positions in both the fund's growth portfolio and value portfolio are acquired with a view to holding them on a long-term basis, with some holding periods in excess of one year or more. Portfolio managers may at times trade around core positions on a short-term basis. On account of the foregoing, the rate of portfolio turnover for the fund is low to moderate.

IV. PERFORMANCE (AZZAD GROWTH FUND, LP)[vi]

Period		The Fund			Benchmarks [(a)] S & P 500			Benchmarks [(a)] Russell 2000		
From	To	Quarter-to-Date	Year-to-Date	Inception-to-Date	Quarter-to-Date	Year-to-Date	Inception-to-Date	Quarter-to-Date	Year-to-Date	Inception-to-Date
February 12, 1998	December 31, 1998			3.67%			20.51%			-6.73%
January 1, 1999	March 31, 1999	-2.59%	-2.59%	0.99%	4.65%	4.65%	26.11%	-5.77%	-5.77%	-12.11%
April 1, 1999	June 30, 1999	20.00%	16.89%	21.18%	6.71%	11.67%	36.38%	15.10%	8.47%	0.49%
July 1, 1999	September 30, 1999	6.65%	24.66%	29.24%	-6.56%	4.35%	25.76%	-6.64%	1.27%	-6.77%
October 1, 1999	December 31, 1999	30.12%	62.20%	68.16%	14.54%	19.53%	44.03%	18.13%	19.62%	11.11%
January 1, 2000	March 31, 2000	17.18%	17.18%	97.07%	2.00%	2.00%	46.91%	6.80%	6.80%	18.67%
April 1, 2000	June 30, 2000	-11.40%	3.82%	74.58%	-2.93%	-0.99%	42.60%	-4.05%	2.47%	13.85%

V. CONCLUSION

Sharīᶜa-based investment companies, funds, and portfolios are beginning to grow significantly in terms of number of funds, assets under management, and performance gain. The demand for these niche financial products and services stems from one-fifth of the world's population. Muslim investors, as well as most ethical and social investors, desire to own profitable companies that make positive contributions to society. They are knowledgeable and informed consumers with a high level of discretionary income. They strive for self-improvement and perfection and demand quality and service. Financial companies that desire to serve these devout consumers need to customize their operations, products, and services to conform to generally accepted and supervised *sharīᶜa* precepts in order to prosper. Their funds and portfolios must produce competitive performance. The recent returns of Azzad's investment portfolios using *sharīᶜa*-based principles and processes suggest that investors do not sacrifice performance when investing according to their religious principles and beliefs.

[i] Failaka International, Inc.
[ii] Investment Company Institute 1999 Fact Book.
[iii] Center for Muslim Research and Information, New York, N.Y.
[iv] Ibid.
[v] Abdurahman Almoudi, President of the American Muslim Foundation, Alexandria, Va.
[vi] Without dividends reinvested.