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The Realities and Challenges Facing Islamic Equity Funds

Islamic Bankers Are Missing the Point

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ABSTRACT

While the Islamic equity-fund industry has grown impressively, it mainly serves wealthy individuals and largely ignores the immense market of one billion Muslims worldwide, some of them middle-class professionals. Furthermore, the true size of the G.C.C. private-banking market that is open to Islamic banking is smaller than it at first seems, partly because there is so much competition to manage rich investors' money. Islamic banks' novelty, small size, and lack of reputation retard their competition with Western private banks. The Islamic fund industry remains primitive by Western standards: many Islamic banks are mere middlemen between fund managers and investors. A mass market for investment funds exists, but Islamic funds must adopt simple solutions to exploit it: increase the market size through investor education about the benefits of long-term investing; open the industry to competition; and provide full disclosure to investors.

I. INTRODUCTION

The growth of the Islamic equity fund industry over the past few years has been impressive. The industry was virtually non-existent before 1994, except for a few funds scattered across the globe. Today, there are at least 35 Islamic equity funds managed by some of the top fund-management companies in the world, such as Citibank, Deutsche Bank, and Robert Fleming and Company.

Merrill Lynch, one of the largest U.S. financial services firms, has begun an aggressive campaign to capture a larger slice of the Middle East private banking market. A study conducted by Merrill Lynch in 1996 estimates that Middle East private investors are worth US$800 billion, of which about half is held by Saudi individuals.[i] Islamic bankers and private bankers could not have been more pleased to hear the news. Islamic and Western financial institutions with Islamic finance departments are now vying to capture some of those assets. Some Islamic bankers claim that this presents an $800 billion market potential for Islamic asset management. Assuming that the study is accurate, since the study's methodology was not revealed, what percentage of these assets are looking for Islamic financial services?

It is important to note that Merrill Lynch's study included assets of high-net-worth individuals only, which is its target market. Islamic bankers are also after the same market as European and American private banks. Why? Is the purpose of Islamic banking to cater to a few wealthy individuals or to work for the benefit of Islamic society?

Other questions come to mind as well. Why are conventional banks and asset management companies entering the field? Why haven't these issues been discussed before? Failaka Investments, Inc. conducted research on these questions and suggests a common-sense, market-oriented solution.

II. THE $800 BILLION MARKET

Under ideal conditions, one can conclude that $800 billion of private assets are waiting to be managed Islamically, since the majority of people in the Middle East are Muslims. In reality, the true potential size of the Islamic private-banking market is much smaller. How much smaller? There is no data available that suggests an accurate size. Furthermore, the Merrill Lynch study focussed on the assets of high-net-worth individuals regardless of their investment preferences.

High-net-worth investors in the Gulf and elsewhere in the region are sophisticated individuals with knowledge of world financial markets. Many are indifferent to Islamic versus conventional investment products simply because conventional institutions are well established and have solid reputations in the market. They also view Islamically prohibited activities, such as the charging of interest, as necessary evils in order to achieve ones investment objectives.

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For example, many Swiss private banks have been around for over 100 years. They have brand-name recognition in the market, a reputation for service, and provide a sense of prestige for investors. Islamic banking, on the other hand, is relatively new, seen as a developing system, and has been associated with several scandals in the past, such as BCCI (which in fact was not an Islamic bank) and more recently, the newly-created Dubai Islamic Bank.

III. Everybody Is Chasing the Same Market

The term "high net worth" is often heard at Islamic banking conferences. It refers to the wealthiest segment of investors that nearly every Islamic and conventional banker is after. This segment represents approximately 1-2% of the world Muslim population.

Chasing such a segment is no doubt lucrative, but there are too many players after a small market. Conventional banks and asset-management companies saw this growing market niche years ago and are being rewarded for their early efforts. Conventional banks that have dedicated Islamic banking departments and subsidiaries, such as ABN AMRO, ANZ Investment Bank, and Citibank, deserve much credit for putting the industry on the map and developing innovative products to meet the market's needs. However, if Islamic investing is to go to the next level of catering to a broader clientele, there must be radical change in the mentality of Islamic financial institutions.

IV. Market Potential

There are over one billion Muslims worldwide, more than the combined populations of North America and the European Union. Of the Muslim population, there are a large number of middle-income professionals, many of whom live in developed countries. However, there have been minimal efforts to attract such investors to the Islamic banking system. Part of the reason is that there are virtually no investment alternatives for these investors; they are forced to seek conventional financial instruments to meet their investment objectives. However, a few exceptions exist, most notably the *Halal* Mutual Investment Company, based in Ireland. It has developed a system to invest small amounts of Muslims' savings (minimum £250) into short-term trading facilities acting similar to money market funds. The fund is open to European residents and is the only fund of its kind at the moment.

Fund companies have made some efforts to attract a wider spectrum of investors by lowering the minimum investment requirements, from as high as US$150,000 to as low as $10,000 in some cases. Two major problems, however, continue to restrict the growth of Islamic funds: investor education and disclosure policies. Islamic financial institutions, it seems, do not want to spend the time or the money managing the assets of the "average" Muslim. The concepts of long-term market penetration and economies-of-scale do not even appear on their radar screens.

V. Industry Bottlenecks

The growth of the U.S. mutual fund industry proves that a mass market for investment funds exists. In 1982, the size of the mutual fund industry was about $300 billion. Today, total mutual fund assets total more than $5 trillion. Fidelity Investments, the largest fund-management company in the world, managed $3 billion in assets in 1975, pennies by today's standards. By 1997, Fidelity was managing in excess of $500 billion, more than double the GDP of the G.C.C. countries.[ii] One of the factors leading to this phenomenal growth was the successful attempt by fund-management companies at educating the population at large on the benefits of long-term investment strategies. Comprehensive disclosure requirements by the Securities and Exchange Commission (SEC) were another factor. SEC requirements not only opened the door to criticism of shady investment practices, they also provided investors a sense of security in knowing that their assets were being managed appropriately.

Islamic funds, on the other hand, provide limited education to attract new investors, and disclosure requirements are virtually non-existent. Failaka Investments recently began publishing quarterly performance data on Islamic equity funds. Of the estimated 35 funds, less than half agreed to provide information on a quarterly basis.

The Islamic fund industry remains primitive by Western standards. Many Islamic banks simply act as middlemen between fund managers and investors. For example, an Islamic bank wanting to launch an equity fund would seek an investment advisor and/or fund manager, *Shari'ah* advisors, a custodian and sometimes even an administrator for back-office operations. Thus, most day-to-day activities of fund management are outsourced and the bank is left collecting fees without any added value. Very limited operations remain in-house, mainly marketing.

Why can't Islamic financial institutions manage their own funds? Conventional banks are more than willing to manage assets for them, which brings up another problem. Several *Shari'ah* scholars have mentioned that equity funds, so far, are not serving their purpose. Islamic equity funds today are restricted by several *Shari'ah* screens and purification processes in order to fall within the acceptable limits dictated by the *Shari'ah*. Companies whose securities are held by Islamic funds no doubt are involved in some types of unacceptable activities, such as paying and receiving interest. However, since they fall into the acceptable limits of the *Shari'ah* (i.e. *haram* activities are minimized), they are approved for inclusion in an Islamic portfolio.

As such, *Shari'ah* scholars argue that one of the goals of equity funds is to "Islamize" companies' activities and making them 100% compliant with the *Shari'ah*. What incentives do conventional financial institutions have in "Islamizing" public companies? Many of the securities in conventional fund managers' Islamic portfolios are also included in their conventional portfolios. Until the time arrives when Islamic financial institutions manage their own funds and voice their opinion regarding the way companies are managed, they will continue to be no more than fee collectors.

VI. Conclusion: Common-sense Solutions

The solutions to the Islamic fund industry's problems are simple: to increase the market size through investor education, to open the industry to competition, and to provide full disclosure to investors. The purpose of Islamic funds is to serve the needs of the community at large and not of a select few. Today, the industry is very small, and very little information is offered to investors. One of the reasons is fund managers' fear of losing large investors from the already limited market size. However, a market of one billion people for Islamic financial services is much larger than one can imagine. Until there are billion dollar funds on the market, bottlenecks will remain.

The terms "let's not reinvent the wheel" and "let's not duplicate our efforts" come up frequently at industry meetings and conferences. These terms simply mean "let's not compete and improve ourselves." If one had invented a square shape and called it a wheel, it would obviously need to be reinvented because it would not work properly. Given the current state of the Islamic fund industry, the wheel needs to be reinvented. Reinventing and/or redesigning products and services should not be a one-time event; it should be an ongoing process.

[i] Source: MEED, 16 January 1998.
[ii] Source: Mutual Funds Magazine, August 1997.