Proceedings of the Fifth Harvard University Forum on Islamic Finance: Islamic Finance: Dynamics and Development Cambridge, Massachusetts. Center for Middle Eastern Studies, Harvard University. 2000. pp. 225-235

Managing *Shariᶜa*-Compliant Mutual Funds in a Volatile Equity Environment

The Emerging Market Experience and the Global Experience

Adam Ebrahim*[*] and Bernard R. Horn, Jr.*[†]

ABSTRACT

After the fall of apartheid in 1994, the economy of South Africa experienced a metamorphosis, principally marked by a liberalization of the economy and a relaxation of trade barriers. This has led to a period of higher stock market volatility, but the economic outlook for South Africa is still quite positive. The Oasis Crescent Fund was launched in 1998 by Oasis Asset Management in South Africa. The *shariᶜa*-compliant product has demonstrated excellent performance, marked by a consistently high alpha statistic and a low beta risk profile. The key to its successful stock picking has been to select Islamically acceptable companies priced below their true value. This can only be achieved by meticulous bottom-up research. Oasis uses a number of criteria to select companies, and it emphasizes downside protection to limit losses in bear markets.

I. INTRODUCTION

As emerging markets open and companies globalize, greater uncertainty prevails. This, in turn, increases volatility and implies higher risks. Globalization is therefore a very complex and fluid process, affecting indiscriminately all the productive sectors of a country and altering the national environment in several ways. However, greater integration into the global marketplace is positive for all countries because it increases the competitiveness of domestic products and ensures a better allocation of resources, thus generating positive pressure on economic growth, employment, and investments.

South Africa is one such emerging market. Global competition, falling commodity prices, and political transformation have prescribed action for South Africa in the form of a strict economic and social regimen that has forced its companies to adapt at a dizzying pace since the fall of apartheid in 1994. Keeping the emerging market paradigm in view, we analyze the South-African economy with particular reference to the *shariᶜa*-compliant Oasis Crescent Fund.

Due to these changes in the South African economy and the demands placed on its companies, risk and volatility have increased in the equity market. The fund manager thus needs to be a successful stock picker in order to keep ahead of the market and competitors. The new era of openness in South Africa coincides with increasing volatility of performance of asset managers. The variance of returns of asset managers highlights the need for successful stock picking.

In light of the success of the domestic Oasis Crescent Fund, we offer an analysis of the recently-launched Oasis Global Crescent Fund. The experience of Oasis with these funds indicates that active fund managers who focus on fundamental industry and corporate research should outperform at lower volatility due to their ability to generate a sustained positive alpha.

II. THE EMERGING MARKET EXPERIENCE: SOUTH AFRICA

The South African investment industry has experienced a metamorphosis since its first democratic election in 1994. Years of isolation prior to this had created a protected environment removed from the pressures of global competition. The resultant high inflation of 13% per annum on average created the illusion that companies were price makers. The average return on the Johannesburg Stock Exchange (JSE) All Share Index from 1973 to 1994 was 21.6% per annum. Exposure to the stock market was the most important ingredient of a fund manager's performance.

[*] Managing Director, Oasis Asset Management, Durban, South Africa.
[†] President, Polaris Capital Management, Boston, Mass.

South Africa's return to democracy resulted in the relaxation of trade barriers. As the economy opened and competition increased, profitability declined as more companies became price takers. This, coupled with lower inflation, reduced profitability and increased volatility of returns. This volatility may persist in the medium term.

Negative sentiment toward emerging markets during the 1998 Asian Crisis led to an increased flight of foreign investment capital and placed further pressure on the investment market. A lack of fixed investment and increased unemployment pushed South Africa into a period of low growth. Furthermore, the traditional manager definitions of value and growth—based on a cyclical relationship that does not include the quantification of risk—created an unstable fund management industry.

On the other hand, there is some encouraging corporate restructuring taking place in this new open economy. There has been an ongoing restructuring of South Africa's major conglomerates. Its virtually closed economy during the apartheid years resulted in excessive domestic diversification and a complex structure of crossholdings. As exchange controls were gradually relaxed, many South African companies expanded internationally and divested themselves of non-core domestic businesses. Announcement of several high-profile mergers and acquisitions suggests that this trend is quickly gaining momentum. Investors should benefit from this in the long term due to improved management, greater synergies, increased liquidity, and better ratings of the underlying businesses.

A. Overview of the Economy

The South African population is 41.4 million, its GDP is $129 billion (0.4% of the world GDP), and its GDP per capita is $2967. In the year 2000, GDP grew by 3.0%, and over the last 5 years it grew by 2.1%.

The economy has gone through a phase of fundamental reconstruction as it evolves into an open economy. Tariffs have declined significantly, opening the economy to competition. Foreign trade now accounts for 50% of GDP, a 40% increase since 1994. The balance of the current account has improved in the year 2000 to about 0.3% of GDP. This number has decreased phenomenally from a peak of 2.7% and is expected to remain below 1.5% at the peak of the business cycle. The phase of reconstruction is approximately 70% complete.

Foreign reserves grew by $654 million to a total of $10.79 billion at the end of 2000, a low level by international standards. Foreign debt is also low: it stands at 30% of GDP. Foreign direct investment into South Africa is $282 million. However, this figure is lower than would be expected due to the restrictive foreign exchange control policy and a weak rand which has also resulted in the poor performance of investments from companies such as Petronas and Telecom Malaysia.

The South African rand has depreciated by 13% per annum since 1995. As was the case with other currencies such as the Australian dollar, the rand did not perform well against other major currencies during the year 2000. It depreciated by 15% to the euro and 23% to the U.S. dollar. A major cause of the depreciation of the currency is the net open forward position. This position peaked within the last five years at over $25 billion and has since reduced to $9.5 billion.

The South African Reserve Bank (SARB) is committed to settling the oversold position from the revenues that are generated by the privatization of the public companies. On settling the position the SARB intends to abolish the present exchange rate control mechanisms to substantially stabilize the currency. This will promote an environment for lower inflation and significantly increase foreign direct investment.

The budget deficit for the 2000-2001 fiscal year was 2.4%. This figure has fallen from a peak of 5.2% and is expected to decline to 2.1% by 2004. The ratio government debt to GDP has fallen from 57% to 44.3% as of the end of February 2001. Within three years the current budget sees the debt ratio falling to 39.1%. Such a forecast is highly probable since revenues from privatization campaigns will decrease debt substantially. Interest rates have also declined remarkably over the last five years. Long-term bond rates have declined from 16% to approximately 12%, and short-term rates have declined from 15% to approximately 10% over this period.

Due to the opening of the economy and financial markets, monetary policy has been tightened. Amid rapidly increasing productivity, headline inflation has decreased from 15% ten years ago to 10% four years ago and finally to 7% at the end of the year 2000. This decrease has been maintained despite the large increase in the price of oil and a weaker currency. The target for inflation has been set at between 3% and 6% by end of 2002. Lower inflation has had a negative effect on company profits, which translates into lower stock profits and lower stock market returns for retailers and financial institutions, respectively.

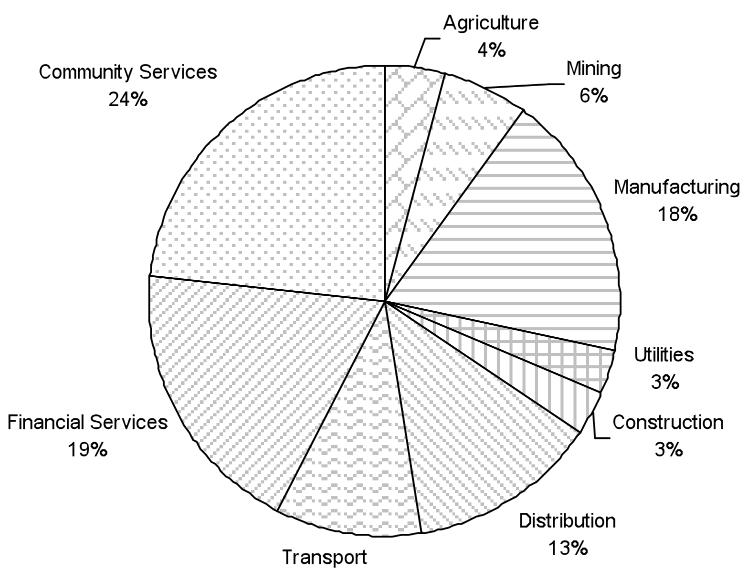
The private sector has become more competitive as real output per worker in the non-agricultural sector continues to rise. In the 1980s real output per worker was only 0.2%, and during the 1990s it increased to 3.5%. In the year 2000 real output per worker increased by 6.2%.

The current state of the economy indicates several future developments. Not only is productivity booming, but lower real wages will result in decreased inflation, the creation of competitive companies, and additional real wealth for individuals in the economy. Furthermore, both consumer and private sector debt have followed a declining trend to current their current low values, and debt servicing costs have decreased from 15% to 8% of disposable income; therefore disposable income will continue to rise. In the year 2000, gross savings as a percentage of GDP increased by 15%, and given the positive outlook on debt, the scope for further growth is significant. With a stable interest rate environment, normalized inflation, globally competitive companies, an efficient fiscal policy, effective privatization campaigns, controlled government and private debt, the economic outlook for the country is extremely positive.

B. Negative Factors Affecting the South African Economy

Unemployment in the formal public and private sectors has remained high and is increasing at approximately 3% per annum. Although the employment in the informal sector has increased, this has had minimal repercussions for social or fiscal policy, such as taxes and savings. Given the spread of AIDS in Africa, life expectancy has fallen significantly, which may result in a decrease in skilled labor and the number of consumers in South Africa. The recent escalation of crime also contributes to a negative sentiment throughout the country and affects the rate at which skilled individuals leave its shores.

FIGURE 1: COMPOSITION OF GDP BY TYPE OF ECONOMIC ACTIVITY



C. Positive Factors for the South African Economy

South Africa is rich in natural resources and is responsible for the majority of the world's platinum, chrome, gold, and diamond production. The country is also a net exporter of coal which has generated significant revenues while the price of oil remains high. Furthermore, the cost of energy is relatively low in South Africa; it is estimated that its cost of energy is 20% of the cost in the U.S. and Japan. And since South Africa is able to produce its energy from its own coal resources, it is relatively insulated from exogenous energy shocks. The government's privatization efforts also ensure that the cost of infrastructure to business will decrease. Furthermore as a result of successful fiscal policy, South Africa is experiencing tax relief and increased growth in all areas of its economy.

III. THE SOUTH AFRICAN FINANCIAL SERVICE SECTOR

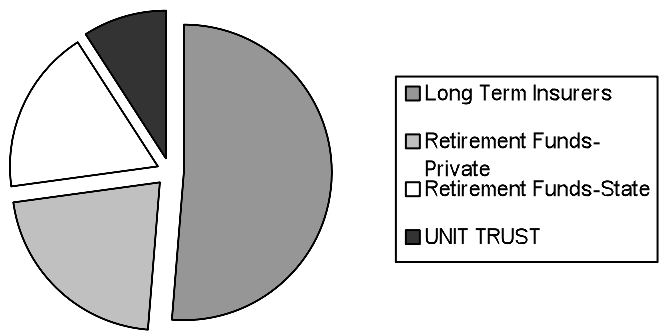
Bank assets total R 821 billion or $110 billion. Six banks dominate the industry with a combined market share of 89% The long-term savings market totals R 1267 billion or $169 billion. Long-term insurers dominate the financial services sector with assets of R 660 billion, with 10% per annum growth (13% market and 3% outflows). Retirement funds total R 488 billion (R 264 billion in private retirement accounts and R 224 billion in public sector retirement funds), with a private sector growth rate of 15% (13% market and 2% volume).

The unit trust sector is the fastest growing at 25% per annum with assets totaling R 120 billion. The unit trust industry is gaining market share at the expense of the long-term insurers. The top 6 unit trust management companies have a market share of 66%.

TABLE 1: SOUTH AFRICA'S SAVINGS MARKETS (NON-BANKING)

	R (billions)	$ (billions)	Growth Rate
Long-term Insurers	660	88	10%
Retirement Funds: Private	264	35	15%
Retirement Funds: State	224	30	
UNIT TRUST	119	16	25%
	1267	169	

FIGURE 2: SOUTH AFRICA'S SAVINGS MARKETS (NON-BANKING)



The fund management industry is concentrated among large insurers and banks, which often have cross-shareholdings. International players like Prudential, Franklin Templeton, and Alliance Capital are rapidly expanding their South African businesses. Institutional investors invest 10% of their assets (R 100 billion) offshore.

The financial service industry is undergoing significant change, characterized by increased competition, lower fees, and tougher regulations. The size of the Johannesburg Stock Exchange (JSE) is R 1520 billion. The number of listed shares has decreased from 750 to 525 over the last 10 years, mainly due mergers, acquisitions, and delisting. Liquidity in the JSE has risen from 5% to 35% over the same period. Foreigners own a substantial fraction of the JSE, constituting about 50% of daily trading.

TABLE 2: SECTORAL SPLIT IN THE JOHANNESBURG STOCK EXCHANGE

	%	Earnings Growth	PE
Resources	40%	96	11
Financial	25%	30	10
Industrial	35%	1	14

South African natural resource companies—such as those dealing with platinum, gold, chrome, diamonds, and coal—are world competitive, supported by high quality reserves, cheap energy, good infrastructure, and a favorable currency. The industrial sector has been the affected by lower tariffs, increased competition, and lower inflation. However, the outlook is improving significantly.

In order to survive, companies must focus on their core competencies since increased competition may erode their domestic base, thus decreasing profitability. Since 1994, the top South African companies have been successful in globalizing their businesses. But smaller companies have struggled with increased competition.

TABLE 3: TOP TEN LISTED SHARES ON THE JOHANNESBURG STOCK EXCHANGE

Company	Val (Rb)	PE	Listing	Comment
AngloAmerican	195	12	London	2nd Largest Mining Co.
DeBeers	128	11	-	Largest Diamond co.
Richemont	90	17	Zurich	BAT and Vendome
Billiton	85	15	London	4th Largest Mining Co.
Angloplats	70	11	-	Largest Platinum Co.
Old Mutual	62	9	London	Global Insurance
Didata	48	30	London	Global IT
Sasol	45	7	-	Oil and Chemicals
SAB	42	14	London	African + European bev.
Stanbic	42	10	-	Banking

The South African stock market is attractively priced, with a price-earnings ratio of 11.4 and historical earnings growth of 38%. While earnings growth will eventually slow, it will remain robust at 20 to 25% per annum over the next two years. Earnings will be supported by a significant rebound in domestic consumer spending, corporate capital expenditure, and state spending on infrastructure. The macroeconomic environment is favorable, characterized by low levels of inflation, interest rates, and taxes. It is also boosted by a R 200 billion privatization program over the next 3 years. The JSE should be one of the best and most stable markets over this period.

IV. THE CRESCENT FUND: DOMESTIC

The Johannesburg Stock Exchange has experienced increasing volatility over the last decade. There have been 10 moves of 20% since 1994. The period of liberalization of the South African economy has coincided with an increasing volatility of performance of asset managers. The variance of returns of asset managers, the best and worst of which were of 37% per annum and 5% per annum, respectively, highlights the need for successful stock picking. In June 1997, Oasis was born as an active fund management.

The approach of Oasis Asset Management to stock picking has allowed the firm to reap upside potentials and limit downside risks. The success of its approach manifests itself in a high and consistent alpha statistic. Oasis uses a number of criteria to select stocks. Some of its major selection characteristics are that the companies:

- Are internationally competitive or niche operators.
- Own well maintained world-class assets and are strong cash generators.
- Have management with a proven track record of investing in projects that generate above-average returns on equity.

A. Oasis Crescent Fund

The Oasis Crescent Fund was launched in August 1998. It is a *shari^{c}a*-compliant product and the first unit trust launched by Oasis. It is a major success and has established a very substantial brand in the South African market.

OASIS ASSET MANAGEMENT: A CHRONOLOGY

June 1997	Moved into offices in Cape Town
October 1997	First institutional clients
August 1998	Launched Oasis Crescent Fund
December 1999	Own Unit Trust Man Co license
February 2000	R 1000m assets under management
October 2000	Launched Oasis Property Equity Fund
November 2000	Launched Guernsey Global Funds
March 2001	Launched Oasis Balanced Fund
April 2001	R 3000m assets under management

The Muslim market in South Africa is estimated at R 152 billion. A number of institutions have focused on this market in the past but due to poor service and performance, even bankruptcy, there has been little growth and increased skepticism among investors. A major dilemma that most Muslims in South Africa face is that their employer-provided retirement plans invest more than 75% of their contributions in non-permissible instruments. When moving to a monthly pension at retirement, more than 90% of income is of a non-permissible nature. It is in this environment that Oasis saw the opportunity to establish a *shari^{c}a*-compliant fund in South Africa.

The universe of stocks for the Crescent fund has a value of about R 1051 billion and consists of 364 companies, about 70% of the JSE. The main sectors that are excluded are financial, beverages, hotels & leisure, furniture and retail, and some other company specific exclusions.

TABLE 5: SIZE OF THE OASIS CRESCENT FUND

	Rand (billions)	Number of shares
JSE	1,520	525
Crescent Universe	1,051	364

The Oasis Crescent Fund also excludes companies from its universe based if they meet the following criteria:

- Involvement in liquor, gambling, and financial services
- A net debt to equity ratio greater than 33%
- A ratio of non-permissible income to sales greater than 5%

Based on these criteria, companies selected by Oasis have a low risk of bankruptcy and tend to outperform.

Stock selection varies between fund managers depending on their respective risk profiles and investment styles. At Oasis Asset Management, a high alpha and low beta risk profile has always been one of the key successes to excellent performance. Using the alpha statistic implies that fluctuations linked to company-specific events have been considered.

The approach of Oasis to stock picking has proved to be more rewarding than attempting to time market movements. Oasis believes that superior returns can only be gained by the intelligent application of proven investment principles supported by meticulous bottom-up research. In addition to the *shari*ᶜ*a*-compliant selection criteria, Oasis focuses on companies operating in low-risk industries with high operating margins. On top of the criteria mentioned earlier, the fundamental criterion for selection is that a company must be priced below its intrinsic value.

In addition to valuing companies on the basis of their financial records (risk, earning growth, quality of earnings, dividends, and cash flows), one must understand management's philosophies, strategies, and other factors that will affect a company's future. Bottom-up fund mangers look mainly at individual companies and are more willing to invest in firms with good fundamentals and management, although their industries may not be in vogue at the moment. The shares of such companies are likely to fare well over longer periods of time despite volatility.

Oasis emphasizes downside protection. In order to ensure this objective, companies require certain attributes, namely:

- Low price-earnings ratio
- High dividend yield
- High cash flow
- Low debt

For example, if a company is in a strong cash flow position, it will limit the downside in bearish period.

For the year ending March 31, 2001, the Johannesburg Stock Exchange All Share Index increased by 1.21%, while the Oasis Crescent Equity Fund increased by 23.02%, outperforming the market index by 21.81%. For the six months prior to March 2001, the JSE All Share return was a negative 2.67%, while the Oasis Crescent Equity Fund returned 10.46%, outperforming the index by 13.13%. The Oasis Crescent Fund has outperformed both the JSE All Share Index and the average unit trust by 31% and 39.5%, respectively, which indicates the sustained superior returns driven by superior stock picking.

While the performance of the Oasis Crescent Equity Fund has been phenomenally high, its risk has been exceptionally low. Its beta (which measures risk relative to the market), for example, is the lowest of all domestic equity unit trust funds and is less than half of the average of these funds.

Following the annual distribution on March 31, 2001 the Oasis Crescent Equity Fund declared a total of 2.536 cents per unit. Of this total distribution only 11.75% is taxable and the remaining 88.25% represents non-taxable dividends.

TABLE 6: NPI RETURNS

Year	TRR (%)	Inc (%)	NPI (%)	NPI/TRR (%)	PI (%)
1999	32	2.9	1.5	4.7	95.3
2000	55	2.7	0.7	1.3	98.7
2001	23	1.0	0.1	0.4	99.6
Cumulative	153	6.7	2.5	1.5	98.5

The portion of non-permissible income which has been earned by the fund amounts to 1.5% of its total return since inception. In keeping with *shari[c]a*-compliance guidelines this amount has been taken from the fund and has been placed into the trust account of the advisory board, which will pay the monies to worthy charities.

TABLE 7: TRACK RECORD AND PERFORMANCE (AUG 98 - APR 01)

	1998	1999	2000	2001 (ytd)	Annualized
Oasis Crescent	15.5	79.9	12.5	15.1	43.3
ALSI	-20.9	61.4	-0.1	8.8	12.3
Gen. Equity	-21.2	44.7	-6.1	3.9	3.8

August 1998 to April 2001

TABLE 8: OASIS EQUITY MANDATE: MAY 2001

Share Themes	Oasis	ALSI
Rand Sensitive	43	50
Foreign Assets	12	17
Exporters	24	16
Export Conglomerates	7	17
Domestic	57	50
Financials	18	24
Domestic Conglomerates	5	2
GDFI	2	2
Consumer Staples	23	8
Total	100	100
PE	11.3	12.8
Earnings Growth	44	39

This performance was realized through two key factors: a) downside protection through a focus on stock picking and a positive alpha and b) splitting the portfolio into themes to ensure sufficient diversification.

This split is different from the JSE sector split because the Oasis Crescent Fund groups companies based on the impact of economic drivers and currency sensitivity. The portfolio is monitored on a daily basis to ensure that there is sufficient diversification against the impact of all the macroeconomic variables including economic growth, inflation, currency, and interest rates.

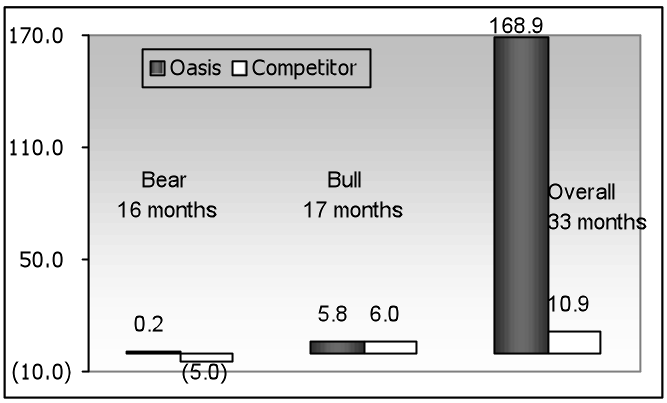
The weighted average price-earnings (PE) ratio of the Oasis Crescent Fund is 11.2, almost at a 15% discount compared to the ALSI PE. At the same time, the weighted average 12 month historical earnings growth is substantially higher than the market. This trend has been consistent over the last three and a half years and is proof that its stock picking is successful in protecting downside risk through stronger earnings growth and choosing companies whose value the market does not fully appreciate.

TABLE 9: LOW VOLATILITY ASSET MANAGEMENT CRESCENT EQUITY MANDATE

	Beta	Annual Mkt Return	Beta *Mkt	Annual Alpha	TRR
Oasis Crescent Equity Fund	0.31	12.3	3.8	39.5	43.3
Average General Equity Unit Trust	0.86	12.3	10.6	-6.8	3.8
Source: Micropal since inception August 1998 to April 2001					

The fruits of active management are clearly visible when one separates the total 43.3% return of the Oasis Crescent Fund between the alpha contribution of 39.5% and the beta contribution of 3.8%. This indicates that 90% of its performance is driven by active money management. The average competitor has a negative alpha, indicating the poor stock selection and market volatility in the South African fund management industry (which includes major international fund managers). The beta of the Oasis Crescent Fund will probably remain relatively low because of continuing market volatility.

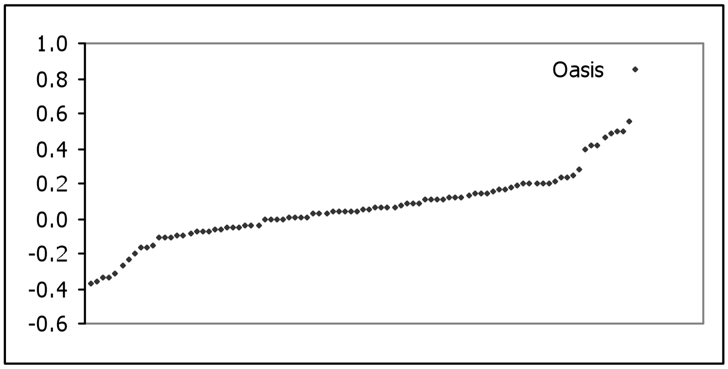
FIGURE 3: UNIT TRUST – CRESCENT EQUITY FUND



Source: Micropal, from August 1998 to April 1999

If the performance of the Oasis Crescent Fund is categorized into bull and bear months, one confirms that its outstanding performance is driven by superior stock picking and downside protection. In bull months, the monthly return was 5.8%, compared to 6.0% for competitors, and Oasis captured 96% of the upside despite having a lower beta. The cumulative return of the Oasis Crescent Fund is 168.9% compared to the average of 10.9% for all general equity unit trusts. In bear months, the monthly return on the Oasis Crescent Fund was 0.2%, while for competitors it was -5.0%. The ability of the Oasis Crescent Fund to avoid the downside during bearish markets is the major driver behind its excellent returns and is the key to delivering a sustainable positive alpha and superior long-term returns.

FIGURE 4: SHARPE RATIO: CRESCENT EQUITY FUND



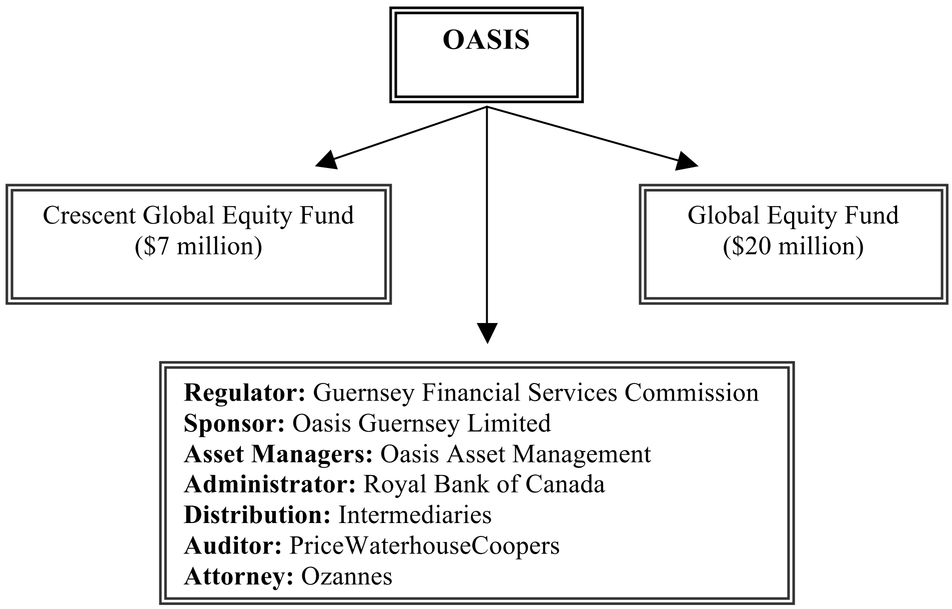
Source: Micropal, from August 1998 to April 1999

The Oasis Crescent Fund delivers twice the return for the same level of risk. The success of Oasis demonstrates that investing in a *shari^ca*-compliant way can be rewarding and that its active management skills have contributed significantly to the excellent performance of the Oasis Crescent Fund, as indicated by a high positive alpha and a low beta.

V. THE CRESCENT FUND: GLOBAL

The growth in the number of *shari^ca*-compliant mutual funds can be attributed to an increase in demand for these investments, spurred by rising wealth and heightened confidence in and awareness of the various Islamic investment products available. In light of this growth, Oasis has recently registered a new global fund so as to serve a South African as well as a global client base and to build an internationally recognized track record. After two years of diligence and after consulting with large global fund managers, regulators, investors, and advisors, Oasis decided to remain independent and to continue with this fund its strategy of active money management.

FIGURE 5: THE ORGANIZATION OF OASIS



The Crescent Global Fund focuses on developed markets, seeking out companies with a strong franchise, good management, quality assets, and strong earnings. The valuation focuses on a low price to cash flow ratio and a high return on average equity (ROAE).

The global economic slowdown we are currently experiencing affects company earnings and share prices. Shares that are most vulnerable are those:

- With high PE multiples (tech, telecom, media)
- That have excess capacity and have lost pricing ability (motor, tech, telecom)
- Highly geared (telecom)
- Rely on share options to reward management (banks, telecom)
- Have poor quality assets (banks)

Industries, countries, and companies that are likely to do better are those:

- With low PE multiples and strong cash flows (resources)
- That are well regulated
- Are in a highly consolidated industry and have limited capacity (resources)
- That are strong franchises

TABLE 10: OASIS CRESCENT GLOBAL: REGIONAL SPLIT

	(%)
United States	18
Canada	2
Britain	5
Finland	2
Germany	1
Ireland	1
Italy	1
France	1
Spain	1
South Korea	3
Hong Kong	1
	36
Cash	64
Total	100

TABLE 11: OASIS CRESCENT GLOBAL: SECTORAL SPLIT

Sector	%
Basic Materials	4
Communications	2
Consumer (Cyclical)	10
Consumer (Non-Cyclical)	2
Energy	1
Financial	0
Industrial	8
Technology	6
Utilities	3
Total In Portfolio	36
Cash	64
Total	100

TABLE 12: THE CRESCENT FUND'S PERFORMANCE, 1 DECEMBER 2000 TO 31 MAY 2001

	Performance
Crescent Global Fund	+3.4%
Dow Jones Islamic Index	-11%
MSCI World Index	-8%

The Crescent Global Equity Fund has started off with an excellent 6 months, outperforming the Dow Jones Islamic Index by more 14% and the MSCI World Index by 11%. However, it is important to note that the data are for a short period. The continued underperformance of the Dow Jones Islamic Index is a concern that highlights the importance of structuring an index and the adding value through active management.

VI. CONCLUSION

Both the Crescent Global Equity Fund and the Oasis Crescent Fund demonstrate on global and local levels that morally responsible investing with proper management can be highly profitable.