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Strategies in the Islamic Funds Industry

An Exploratory Analysis

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ABSTRACT

The industry of Islamic funds has demonstrated a number of diverse strategies in recent years. Players in the industry have implemented combination strategies such as joint ventures, strategic alliances in the form of licensing and franchising, outsourcing, and co-branding in order to achieve competitiveness. Popular product-market strategies include innovative bases of segmentation along income, geographic, demographic, or gender lines. Product design strategies include differentiation achieved by selected exposure to different markets, the development of indices, and varying degrees of financial complexity. In order to measure the performance of Islamic funds, a metric in the standard risk-return space is not appropriate due to the different objectives of Islamic investments compared to conventional investments.

I. INTRODUCTION

The Islamic funds industry has been developing steadily. In the recent past, a large number of Islamic funds have appeared, competing for the savings of 1.2 billion Muslims around the world. While there were just about half a dozen Islamic funds a decade ago, the number increased to about a dozen in the mid-nineties. The growth has been exponential since then. The number of players in this industry has now crossed the three-digit mark.[i] Assets of these funds have grown at a rate of over fifty percent during the last five years. As the industry transitions from a pioneering phase to an expansionary phase, one can observe a range of strategies implemented by Islamic funds. The industry has also seen a wide variation in performance. In this paper we attempt to develop a framework enumerating various strategies implemented in this industry, specifically focusing on combination strategies that have been widely used. We also discuss various product-market strategies including bases for market segmentation and product design issues. Lastly, we argue that a performance measure in the conventional risk-return space is not appropriate for Islamic funds, given their unique set of objectives compared to conventional investments.

II. SOME HYPOTHESES FROM RELATED STUDIES

At the risk of stating the obvious, one may identify the growth of Islamic awareness and consciousness as the single most important environmental factor that has influenced the origin and development of Islamic financial services (At-Tawjiri, 1988; Habib et al., 1987; At-Tawjiri, 1991). The same also holds true for the industry of Islamic funds. However, there may be several additional factors that have contributed to its expansion. Preliminary findings from a recent online survey of Muslim investors conducted by IBF Net reveal that Islamic equity funds, which account for a major portion of the Islamic funds industry, are becoming better understood by the community of Muslim investors.[ii] Furthermore, Islamic funds may be perceived as more "Islamic" than other investment vehicles such as *wadiᶜa* and *mudaraba* deposits with Islamic financial institutions. Islamic windows at conventional banks score much worse in terms of perceived conformity to Islamic norms, as their products are perceived to be tainted by conventional interest-based investments and profits. On the other hand, Islamic funds have a high degree of perceived conformity to Islamic norms, perhaps because of the transparency that accompanies a fund in its investment policy and because of the use of a screen. Funds are required to state that investment is subject to market risk and may lose value under adverse market conditions. Moreover, the screen used by funds is perceived to be a constraint and a mechanism to ensure *shariᶜa* compatibility. No such transparent mechanism exists with Islamic deposits. Often the profit rates paid on deposits are perceived as disguised *riba*, no different from interest rates. Islamic funds are also characterized by greater agreement among *shariᶜa* scholars concerning their acceptability, unlike the controversies surrounding many Islamic banking practices.

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The above findings, though preliminary, provide supporting evidence to several hypotheses. The first is that transparency pays. Secondly, Islamic bankers would do well to avoid activities and products that are based on dubious and marginal viewpoints about their *shari^{c}a* acceptability. In the short run, an institution may manage to obtain approval for some of its products from a handful of scholars, but such a strategy may prove disastrous in the long run.

The findings above also corroborate recent assertions that the key driving force behind the industry is its "otherness" (Cunningham, 2000). Further research is needed into this very crucial hypothesis. However, if the hypothesis were true, then it would have profound strategic implications for Islamic fund managers. Firstly, it implies that Islamic fund managers need to react proactively to the growing Islamic consciousness in Muslim societies, instead of trying to bridge the gap between Islamic finance and conventional finance. Secondly, it suggests that the role of *shari^{c}a* scholars is of the utmost significance; hence fund managers should seek scholars with greater acceptance and better reputation among Muslim investors. Thirdly, it advocates greater transparency regarding the duties and responsibilities of *shari^{c}a* auditors.

It would be useful here to briefly touch upon findings from a few empirical studies conducted on consumer behavior in the Islamic financial services industry in general. Ugur Yavas (1988) undertook a survey of Saudi Arabian customers and noted the role of "deeply ingrained values and religious beliefs" in shaping consumer behavior. He attempted to determine the importance of selected patronage factors and found that a financial institution's experience, reputation, quality of service, and helpfulness of personnel are prime considerations for consumers. Advertising and rate of return (implicit interest rates) were among the least important factors. In another significant study, Erol et al. (1990) conducted a survey of Jordanian customers and found that explicit interest rates and fixed-price related banking services do not play important roles in customers' selection of an Islamic bank when the bank directly addresses their concerns about *riba* and underscores the importance of religion. An analogous study conducted for Malaysian customers by Haron et al. (1994) has similar findings: the most important patronage factors for customers of Islamic financial institutions in Malaysia are image, reputation, confidentiality, friendliness of personnel, and speed of service. Furthermore, explicit interest rates and fixed-price related financial services do not seem to be important to the Malaysian consumer in his choice of financial institution. Although these studies relate generally to Islamic banking and financial services, they help explain and highlight factors that Islamic fund managers need to consider when formulating and implementing corporate strategy.

We now turn to a qualitative analysis of strategies that have been pursued in the Islamic funds industry in the recent past.

III. Strategic Analysis of the Industry

Before we undertake an examination of actual strategies at the company level or fund level, it may be helpful to briefly discuss the overall industry of Islamic funds.

A. Potential Opportunities

As stated earlier, the total assets in the Islamic funds industry are estimated at approximately $1.5 billion. This figure looks grossly insignificant if one considers the following statistics: the funds industry in the United States consists of about one trillion dollars worth of assets. Of this, ethical funds alone account for over 20 billion dollars. In the United Kingdom, ethical funds account for over 1.5 billion dollars, of which about half is managed by just one player, the Friends Provident Stewardship Fund. What should be noted here is that Islamic funds for Muslims are different from ethical funds in the sense that they are backed by *shari^{c}a* requirements, unlike the voluntarism that accompanies conventional ethical investment. Given the growing religious consciousness of Muslims, one would expect a large exodus of Muslim investors from conventional to Islamic funds. Given this scenario, it appears that competitive pressures are not very intense, and new entrants can grow along with older funds as long as they can maintain their distinct Islamic identity. The growing affluence of middle-class Muslims and the predominance of the internet which facilitates cross-border investments are two other contributory factors that add to the potential growth of this industry. What has been the nature of actual strategies in this industry so far?

B. Investment Objective(s)

Most of the Islamic funds state that their objective is to provide medium- to long-term capital appreciation through investment in *Shari^{c}a*-compliant equities. However, there are a few exceptions. For instance, the Tabung Ittikal Fund by Arab-Malaysian Unit Trusts Berhad states its objective is to produce income and, to a lesser extent, capital growth. The fund always maintains at least 10% liquidity. Amanah Saham Bank Islam by BIMB Unit Trust Management Berhad seeks "to achieve an optimal rate of return through investments in equities and money-market instruments in the medium to long term in compliance with *Shari^{c}a*." RHB *Mudaraba* also seeks "to invest in a portfolio of equities and debt securities which comply with *Shari^{c}a* in order to provide a balanced mix of income and capital growth."

Perhaps the only non-Malaysian fund that is income-oriented is by Saturna Corporation, a U.S.-based company which aims to produce current income and preserve capital by investing in U.S. equities. The reason for this difference in objective originates in the multitude of divergent scholarly opinions about the permissibility of *bay^{c} al-^{c}ayna* and *bay^{c}al-dayn*. Permissibility accorded to these mechanisms by scholars in Malaysia has led to a high-growth private debt securities market that is deemed Islamic and hence eligible for investment by the Malaysian funds.

The only Islamic fund to focus on risk management is the Alkhawarizmi Fund by The International Investor (TII). This fund seeks "to achieve long-term capital growth from securities and other financial instruments while managing risk through hedging and efficient portfolio management techniques, using for example, short-selling. The fund aims to maintain a market-neutral strategy."

One notably different objective is that of the Amanah Saham Wanita (ASNITA) which seeks "to invest in a portfolio of equities and debt securities which comply with *Shari^{c}a* in order to preserve and enhance capital. The fund has the ultimate objective of facilitating the development of Malaysian women as informed savers and investors as well as achieving their financial independence."

A few funds like the Pure Specialist Fund by Futuregrowth Unit Trust Management in South Africa and the Tata Equity Fund in India initially had the objective of providing an investment medium acceptable to various religious groups including Muslims. However, while the former has increased its focus on Muslim investors over the years, the latter has diluted its objective and has neglected this group.

C. Criteria for Screening

Criteria for screening stocks to be included in the universe can be positive or negative. Positive criteria have been used by the managers of some ethical funds such as the Stewardship Fund in the U.K.. A company may be given greater weight in portfolio construction for factors such as a good record for quality products, safety, staff management, customer relations, involvement in environmental improvement, pollution control, sustainable woodland management, and energy conservation. Negative criteria exclude certain companies from the universe such as producers of alcohol and pork-related products, providers of conventional financial services (banking, insurance, etc.), and providers of certain entertainment services (casinos, cinema, pornography, music, etc.). Tobacco manufacturers and defense and weapons companies, although not strictly forbidden for investment under Islamic Law, are excluded as well.[iii]

Islamic funds have also been using a financial screen to exclude companies that rely on excessive interest-based debt and derive a significant portion of their income from interest. For instance, the Dow Jones Islamic Index Fund, which mimics the Dow Jones Islamic Market Index, uses the following filters to remove companies with unacceptable financial ratios. The three filters are as follows:

- Exclude companies if Total Debt divided by Trailing 12-Month Average Market Capitalization is greater than or equal to 33%. (Note: Total Debt = Short-Term Debt + Current Portion of Long-Term Debt + Long-Term Debt).
- Exclude companies if the sum of Cash and Interest Bearing Securities divided by Trailing 12-Month Average Market Capitalization is greater than or equal to 33%.
- Exclude companies if Accounts Receivables divided by Total Assets is greater than or equal to 45%. (Note: Accounts Receivables = Current Receivables + Long-Term Receivables).

Islamic funds in Malaysia pursue a somewhat more liberal screening strategy. For instance, the criteria set by the *Shari^{c}a* Advisory Council (SAC) of the Malaysian Securities Commission excluded stocks from the approved list based on the following criteria:

- Operations based on *riba*, like commercial banks, merchant banks, and financial institutions.
- Operations involving gambling.
- Activities involving the manufacture or sale of *haram* products such as liquor, non-halal meats, and pork.
- Operations containing an element of *gharar* (uncertainty), such as conventional insurance businesses.

As for companies whose activities consist of both permissible and non-permissible elements, the SAC applied several additional criteria, i.e.:

- The core activity of the company must not be against the *shari^c^a*, as outlined in the four criteria above. Furthermore, the *haram* element must be very small compared to the core activities.
- Public perception or the image of the company must be good.
- The core activity of the company must have importance and *maslaha* to the Muslim *umma* and to the country, and the *haram* element must be very small and involve matters such as *^c^umum al-balwa*, *^c^urf*, or the rights of the non-Muslim community which are accepted by Islam.

Some funds explicitly use a further purification methodology, after implementing the screens and filters. For instance, the RHB *Mudaraba* Fund was the first fund in Malaysia to introduce the purification process which separates and removes profits or income derived from a company's incidental activities that do not comply with *shari^c^a* principles. Proceeds from the purification process are paid to specific charitable organizations endorsed by the RHB *Shari^c^a* Panel.

D. Strategic Alliances and Partnerships

The Islamic funds industry has witnessed the widespread use of strategic alliances and partnerships to further the long-term objectives of the parties involved. These alliances have taken different forms such as joint ventures, co-branding, franchising, and outsourcing.

<u>1. Joint Ventures</u>

When two or more capable firms lack a necessary component for success in a particular competitive environment, the solution is a joint venture, which is comprised of commercial companies (children) created and operated for the benefit of the co-owners (parents). A good example of such a cooperative arrangement is between American Express Bank and Faisal Finance in order to offer Islamic Multi-Investment Funds. While the former is an international banking institution with over 80 offices in 36 countries, the latter is part of one of the largest financial groups in the world, the Dar Al-Maal Al-Islami (DMI) group. Another example of a joint venture is the arrangement between DBS Asset Management Ltd, a wholly owned subsidiary of DBS Bank (one of the leading managers of unit trust funds in Singapore), and Mendaki Holdings Pte Ltd, a wholly owned subsidiary of Yayasa Mendaki, a charitable organization whose mission is to develop the Malay Muslim community in Singapore. The objective of this joint venture is to set up the Mendaki Global Fund and the Mendaki Growth Fund. Yet another good example of a joint venture is between Al Tawfeek Company for Investment Funds Ltd and Nomura of Japan in order to launch the Al-Nukhba Asia Equity Fund, which targets the South East Asian companies in which both parties have invested an equal amount of 10% of the subscribed capital.

<u>2. Strategic Alliances</u>

Strategic alliances are different from joint ventures because the companies involved do not take an equity position in each other. In a few instances, strategic alliances are synonymous with licensing and franchising arrangements.

A major proponent of franchises is the Kuwait-based The International Investor, a company that has used this strategy to expand operations into Bahrain, Qatar, and the United Arab Emirates. TII regards franchising as a way of combining Islamic expertise and brand name with its partners' knowledge of their own domestic markets. The objective goes beyond merely delivering products; it entails channeling Islamic expertise, technology, and a brand name with a proven track record to the franchisees. When successfully implemented, the result is an effective low-cost and low-risk entry into a growing niche market.[iv] The franchising arrangement is targeted at conventional players for whom establishing in-house capabilities in order to reach the Islamic market effectively is both expensive and risky: in order to gain full access to the Islamic market, conventional players would need to employ specialized personnel trained in the intricacies of Islamic finance. Conventional players may also have to overcome certain market perceptions such as not possessing sufficient Islamic expertise to achieve *shari^c^a* compliance.

TII entered into its first franchise relationship with Gulf Bank, a significant player in the Kuwaiti market, with the Al Deema range of products. Al Deema provides investors with a choice of portfolios containing Islamic products developed by TII with the objectives of income, growth, or income-cum-growth. While the Gulf Bank is entrusted with distribution and administrative functions such as sales, collection of investment amounts, investing those monies with TII, maintaining an investor register, and processing redemption requests, TII assumes all managerial responsibilities regarding Al Deema and has authority over the asset allocation of the products in each portfolio. Of course, this is done in cooperation with Gulf Bank which is supposed to have a greater insight into customer needs.

Outsourcing is another approach to strategic alliances that enables a firm to gain a competitive advantage. Islamic funds have made widespread use of this strategy to procure fund management expertise—a key ingredient for success. Al Tawfeek Company for Investment Funds Ltd, a subsidiary of the Dallah Al Baraka Group, provides an excellent example of outsourcing. Its Al-Safwa International Equity Fund is managed by the well-known Roll and Ross Asset Management. Roll and Ross Asset Management, which is both the manager and advisor of the fund, uses its proprietary Arbitrage Pricing Technique risk control screens in addition to the *shari^{c}a* screen.

Another example of outsourcing is the Al Kawthar Fund of the National Bank of Kuwait which seeks to achieve its goal of capital growth through *shari^{c}a*-compatible long-term investments via investment in another fund—the National Commercial Bank Global Trading Equity Fund. It also retains the services of Wellington Management Company as investment advisor. Another example is that of Permal Asset Management, which has allied with various fund managers to offer non-U.S. investors access to independent fund managers through a family of open-ended multi-manager and single manager funds. For instance, its Alfanar Investment Holdings serves as a fund of funds or a holding company for four other Islamic funds—Alfanar Essex Technology managed by Essex Investment Management Co. LLC, Alfanar Capital Growth managed by Forstmann-Leff Associates LLC, Alfanar Capital Value managed by Apex Capital LLC, Alfanar Europe managed by TT International Investment Management. Other alliances for outsourcing fund management include that between GAM AlKawther and Global Asset Management and the alliance between Pure Specialist Fund and Futuregrowth Unit Trust Management.

Strategic alliances with investment advisors are much more common. Examples include: GAM AlKawther with Husic Capital Management, Albaraka Global Equity Fund with Mercury Asset Management, Al Rajhi Global Equity Fund with UBS Asset Management, Al Rajhi Egypt Equity Fund with Hermes Financial Management, Al Rajhi Middle East Equity Fund with Bakheet Financial Advisors, Al Rajhi Small Companies Fund with Meryll Lynch International Bank, Amanah Saham Wanita with Metrowangsa Asset Management, and Miraj International Investment with Royal Investment Bank (U.K.).

There is a minority of funds that do not use outsourcing. Some include: Tabung Ittikal Fund by Arab-Malaysian Unit Trusts Berhad, Amanah Saham Bank Islam by BIMB Unit Trust Management Berhad, RHB Mudaraba Fund, Citi Islamic Portfolios, Oasis International Equity Fund by Flemings, SAMBA Global Equity Fund, Amana Funds by Saturna, and Hegira Global Equity by Wellington Management.

E. Product-Market Strategies

A significant component of a firm's overall product-market strategy is its target investor community. Islamic funds have been using various bases to segment the market and target their products.

1. Market Segmentation and Target Marketing

The basis for market segmentation and target marketing is often geographic. Some Islamic funds—such as the Islamic Multi-Investment Fund, Citi Islamic Portfolios, Miraj Global Equity Fund, Oasis International Equity Fund by Flemings, Amana Funds by Saturna, Hegira Global Equity by Wellington Management, the TII group of funds, and the Zad Growth Fund—have targeted the entire global Muslim investor community. Others have targeted specific regions and countries for a variety of economic and legal reasons. Examples of such regionally targeted Islamic funds include the Al Rajhi group of funds which targets Saudi investors, the RHB Mudaraba Fund which targets Malaysian Muslim investors, the Mendaki Global Fund which targets Muslims in Singapore, Alfanar Holdings which targets non-U.S. investors, the SAMBA Global Equity Fund which targets Saudi high-net-worth investors and institutional investors in Muslim countries, and the Pure Specialist Fund which targets Muslims from South Africa. Similarly, PrimeCorp Investment Management of London, in association with Kuwait's Al-Maal Islamic company, is set to launch a new Islamic fund—the Khaled Ibn el-Waleed Fund—to tap the oil-funded Kuwaiti market.

Income has also been widely used to segment markets. Many funds are targeted at high-net-worth investors with a very high minimum investment requirement. For instance, the minimum investment requirement is as high as $50,000 for Islamic Multi-Investment Fund by AMEX-Faisal Finance, $15,000 for GAM AlKawther, $25,000 for Albaraka Global Equity, $10,000 for Citi Islamic Portfolio A, $1,000,000 for Citi Islamic Portfolio B, $10,000 for the Miraj Global Equity Fund, $10,000 for the Al Kawther Fund, $100,000 for Class A Alfanar Holdings, $25,000 for Class B Alfanar Holdings, $10,000 for Oasis International Equity Fund, and $50,000 for the Zad Growth Fund. All seven funds of The International Investor have a minimum investment requirement of $100,000. Hegira Global Equity by Wellington Management has a requirement as high as $5,000,000.

Other funds target the average investor. For instance, the minimum investment requirement for Al Rajhi Local Share Fund is just one share at NAV. Al Rajhi Middle East Equity Fund and Al Rajhi Small Companies Fund have a requirement of 200 units at NAV. The requirements for the Tabung Ittikal Fund, Amanah Saham Bank Islam, and the RHB Mudaraba Fund are each 500 units at NAV. The requirement for SAMBA Global Equity Fund is $2000; for Mendaki Global Fund, $1000; for Mendaki Growth Fund, $500. Requirements can fall as low as RM100 for Amanah Saham Wanita, $100 for Amana Funds by Saturna, or R25 (monthly) and R200 (lump sum) for Pure Specialist Fund by Futuregrowth Unit Trust Management in South Africa.

Gender is also the basis of market segmentation for at least two funds in the market. The Amanah Saham Wanita targets Malaysian Muslim women, and the new Az-Zahara Unit Trust Fund by the Malaysian Hijrah Unit Trust Management Bhd (HUTM) is specifically designed to cater to Muslim women in West Asia.

Another basis for segmentation is the stage in life of the investor. A new offering from HUTM, the Islamic Marriage Unit Trust Fund, is targeted at UAE nationals, who wish to marry but are short of money to conduct the ceremony.

2. Product Characteristics

Another significant component of product-market strategy relates to product design. Key variables include investment exposure, benchmarks, product enhancement, complexity of offerings, and managerial expenses.

Concerning investment exposure, Islamic funds can generally be seen to follow two types of strategies. Some funds have been designed and marketed as global funds having exposure to mainly developed markets such as the U.S., Japan, and other developed markets in Europe. Examples are the GAM AlKawther Fund, Albaraka Global Equity Fund, Al Rajhi Global Equity Fund, Al Rajhi Small Companies Fund, Al-Safwa International Equity Fund, Citi Islamic Portfolios, Miraj Global Equity Fund, Al Kawther Fund, Oasis International Equity Fund, Alfanar Holdings, SAMBA Global Equity Fund, Amana Funds, Hegira Global Equity Fund and Zad Growth Fund. Some funds like the Mendaki Global Fund and the Mendaki Growth Fund have primary exposure to the Asia-Pacific markets, but also include companies from developed markets.

Others have targeted markets in specific countries and regions and have exposure to these markets alone. For example, Al Rajhi Egypt Equity Fund has exposure to only the Egyptian market; Al Rajhi Local Share Fund, the Saudi market; Al Rajhi Middle East Equity Fund, the Middle Eastern and North African markets. Malaysian funds such as Tabung Ittikal Fund, Amanah Saham Bank Islam, Amanah Saham Wanita, and RHB Mudaraba Fund have exposure to only Malaysian markets. Alfanar Europe has exposure exclusively to European markets, and Pure Specialist Fund has exposure only to South African companies.

The various funds of The International Investor have different types of exposures. Its Ibn Majid Emerging Markets Fund, as the name suggests, has exposure to emerging markets from around the globe, while its Al-Dar Eastern European Fund has exposure to Eastern European markets in Russia, the Czech Republic, Poland, Croatia, Hungary and others. Others have exposure to developed markets.

An issue that often invites criticism of Islamic funds relates to the flight of capital from Muslim countries to developed markets. It is contended, perhaps correctly, that most of the global funds are instrumental in this unhealthy mechanism whereby savings mobilized from Muslim countries is used to fuel developed economies. Proponents argue that global funds simply provide a *shariᶜa*-compatible alternative to Muslim investors. A fund that perhaps seeks to benefit from this controversy is the Khaled Ibn el-Waleed Fund. The Fund is the first to invest in Islamic markets, covering all member states of the Islamic Development Bank.

In addition to variation in exposure to specific markets, Islamic funds also vary with respect to sectoral exposure. While most funds target the full universe (after due *shariᶜa* screening), there are Islamic funds that have exposure to specific sectors. For instance, Al Rajhi Small Companies Fund, TII Small Caps Fund, Zad Growth Fund (small capitalization of less than $1 billion) all have exposure to small and medium companies. Alfanar Essex Technology Fund has exposure primarily to technology stocks. There also are non-equity funds, which deal with leasing funds, real estate funds, and commodity market funds.

Complexity of a product in terms of its financial characteristics and how well it is understood may at times be a deciding factor in the future success or failure of a fund. Most funds, specifically equity funds, have a highly simplified structure and their risk-return-*shariᶜa* compliance dimensions are easily understood. However, there are exceptions.

An example of a product with a high degree of financial complexity is the Islamic Multi-Investment Fund by AMEX-Faisal Finance, which consists of five portfolios: 1) Islamic Market Opportunities (investment in Islamically acceptable options, futures, and forward contracts, 2) Emerging Markets Equity, 3) Global Equities, 4) Trade Finance, and 5) Parallel Purchase and Sale of Currencies and Commodities. Investors may invest in the entire portfolio through a predetermined asset allocation formula, choose to invest in an individual portfolio, or develop a unique portfolio allocation. The issue of Islamically acceptable options, futures, and forwards is not fully comprehendible even to Islamic scholars, not to mention the community of Muslim investors. The additional feature of an option of determination, or *khiyar al-tayeen* in *shariᶜa* parlance, only adds to its complexity.

Another example is the Al-Khwarizimi Fund by TII which is supposed to be a hedge fund. While the fund objectives include the use of short-selling and other Islamically acceptable hedging mechanisms, the average Muslim may not regard them as *shariᶜa*-compliant.

The development of proprietary benchmark indexes has been the cornerstone of some fund strategies. For example, the Dow Jones Islamic Index Fund, as the name suggests, is the only Islamic index fund that mimics the Dow Jones Islamic Market Index. Other funds have also set up proprietary indexes to serve as benchmarks for themselves and for the market as a whole. In Malaysia, the RHB Unit Trust Management Berhad has been a pioneer in developing Islamic indices for Malaysian and Indonesian markets with its creation of the RHB Islamic Index in 1996 and the RHB Indonesian Islamic Index in 1999. In the United States, Saturna Corporation, which is behind two Amana Funds, has also developed two Islamic indices. The first one is based on the S&P 500 and is called the Islamic 500 Index, and the second is based on the Russell 2000 and is called the Islamic 1500 Index. The latest in the series of global indices are the five TII-FTSE indices launched by The International Investor with FTSE international—FTSE Global, FTSE Americas, FTSE Asia Pacific, FTSE Europe, and FTSE South Africa. Another example is the collaboration of Parsoli (U.K.) with IBF Net to launch an Islamic index for Indian markets.

Some funds seek product enhancement by providing additional benefits. For instance, Amanah Saham Wanita offers value-added benefits like a health insurance ratio of one to one up to RM200,000 without medical check up, scholarships for eligible children of unit holders after a year in operation, direct investment opportunities for petty traders after a year in operation, and funeral expenses up to RM1000.

Liquidity is an important dimension of any financial product. Though listing in a secondary market is not a pre-requisite for Islamic funds, it is certainly desirable as improved liquidity always reduces risk. However, a large majority of Islamic funds are not listed in any stock exchange. The list is long and includes GAM AlKawther, Albaraka Global Equity, the Al Rajhi groups of funds, Al-Safwa International Equity Fund, Miraj Global Equity Fund, Al Kawther Fund, Alfanar Holdings, SAMBA Global Equity Fund, Hegira Global Equity by Wellington Management, Tabung Ittikal Fund, Amanah Saham Wanita, Mendaki Global Fund, and the Mendaki Growth Fund. It appears that neither the absence of an active secondary market nor the targeting of funds to private and institutional investors are reasons for not listing a fund.

Funds that are listed in secondary markets include Amanah Saham Bank Islam by BIMB Unit Trust Management Berhad, Citi Islamic Portfolios, Oasis International Equity Fund by Flemings, Amana Funds by Saturna, and all seven funds of The International Investor.

3. Offshore versus On-Shore Funds

An offshore fund is a fund organized in a jurisdiction other than the home country of the investor. Many Islamic funds—such as GAM AlKawther by Al Baraka, Al-Safwa International Equity Fund by Al Tawafeek, Citi Islamic Portfolios, Miraj Global Equity Fund, Alfanar Holdings, Oasis International Equity Fund by Flemings, SAMBA Global Equity Fund, The International Investor group of funds, Hegira Global Equity by Wellington Management—are organized offshore, often patronized by Middle Eastern investors but organized under the regulatory framework of, say, the Cayman Islands, the Bahamas, the British Virgin Islands, or Luxembourg.

Offshore funds hope to benefit from a lax regulatory framework. When a fund is required to comply with a complex array of regulatory requirements, costs can increase dramatically. Many offshore funds have minimal regulatory requirements, resulting in potential cost savings. Furthermore, investors may consider their local jurisdiction less stable than an alternative jurisdiction for the purpose of protecting their investment. Since many investors may be prevented from investing in funds located in the United States and the United Kingdom due to compliance considerations, an offshore fund may be an ideal alternative.

While offshore jurisdictions try to provide reliable infrastructures, lower taxes, and varying degrees of regulatory oversight, the lax regulatory regime may have its own pitfalls. It requires an additional element of vigilance on the part of the investor. Some funds targeting Middle Eastern investors have preferred to remain onshore. A notable example is the Al Rajhi group of funds. There are also onshore Malaysian funds like Tabung Ittikal Fund, Amanah Saham Bank Islam, and U.S.-based funds like Amana Funds by Saturna.

F. Performance

In this section, we do not attempt a performance evaluation of Islamic funds, as this process would require data for a reasonably long time period to get statistically significant results. A look at the returns alone shows that Islamic funds have reported varying returns (see table 1). However, their history is too short to be subjected to this analysis in a meaningful way. But a few comments are in order. Firstly, the objectives of Islamic funds are different from conventional funds: Islamic funds exist primarily to provide *shariᶜa*-compliant investment alternatives to Muslim investors. Islamic investment can be viewed as three-dimensional. Investors seek to maximize returns, minimize risk, and to ensure that their investment is not only *shari^{c}a*-compliant, but also contributes to economic development of the *umma*. Given this, it would not be proper to evaluate Islamic funds in the two-dimensional risk-return space. There is obviously further research needed to find a suitable mechanism to evaluate Islamic funds.

IV. CONCLUSION

The Islamic funds industry demonstrates a wide range of strategies for growth as well as a wide variation in performance. Most players in the industry have implemented combination strategies such as joint ventures, strategic alliances in the form of licensing and franchising, outsourcing, and co-branding in order to increase competitiveness. Popular product-market strategies also commonly use innovative bases of segmentation. A large majority of funds are off-shore, permitting exposure to both developed and regional markets. These funds have primarily targeted institutional and high-net-worth investors, neglecting the retail market. Concerning the issue of performance, we argue that a measurement in the conventional risk-return space is not appropriate. We also contend that transparency and greater concern for *Shari^{c}a*-compliance will benefit Islamic funds in the long run.

APPENDIX: PERFORMANCE OF FUNDS

Name of the Fund	Ave. Annual Return since inception (%)
Alfanar Essex Tech Ltd	101.67
Alfanar Europe Ltd	13.27
Alfanar Invt Holdings	18.16
Alfanar U.S. Cap Growth Ltd	19.56
Alfanar U.S. Cap Value Ltd	16.89
Al-Bait Global Equity	-27.95
Al-Bukhari Global Fund	11.66
Al Dar East Euro Equity	-8.48
Al Dar Euro Equity	11.82
Al Dar World Equities	21.35
Miraj Global Equity	22.57
Taib Global Crescent Fund	-4.48
TII Global USD Lease Fund	0.78
TII Small Cap – Euro Active	87.25
TII Ibn Majid Emerging Market	4.45
TII USD I Fund Lmt	5.54
TII KD I Fund Lmt	6.83
TII Short Term Sterling Fund Lmt	6.42

(Source: IslamiQ Fund Supermarket, IslamiQ.com)

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[i] Estimates by Failaka Islamic Funds Quarterly, www.failaka.com.
[ii] Online Survey on Investor Perceptions of Islamic Financial Products, conducted on visitors to www.islamic-finance.net, the Web site of the Islamic Business and Finance Network.
[iii] Screening criteria in use at Dow Jones Islamic Market Index, www.djim.com.
[iv] Andrew Clout, Franchising at The International Investor, Paper Presented at IBFF Forum on Islamic Finance held in Bahrain, 1999.