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Islamic Asset Management

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The last decade has seen increasing demand for *shariah* compliant asset management from institutional and private clients in the GCC, partly driven by the rapid rise in the region’s wealth, but also by the increasing number and breadth of asset classes now available for Islamic investors. International banks, notably HSBC, Citigroup, Deutsche Bank, UBS and Standard Chartered have seized the opportunity to adapt their existing asset management services to the needs of Islamic investors, and have appointed their own boards of *shariah* scholars to assure their clients that they are indeed Shariah compliant. This has been a learning experience for the banks themselves as well as the Islamic investors, the former learning about *shariah* principles, while the latter have learnt about asset management options and the implications for portfolios of the trade-off between risk and returns.

Asset management encompasses both fund management and discretionary portfolio services for institutions and individuals of high net worth. For private banking clients, this may involve the management of trusts, established for tax or inheritance reasons. *Shariah* compliance in all of these areas poses interesting, but usually solvable, challenges. Fund management is a good starting point, as over 100 *shariah* compliant funds are available for retail investors in the Gulf, but treasury, wealth management and investment portfolio services, including the holding of Islamic *sukuk* securities, will also be reviewed in this chapter, as these are crucial for both private and corporate clients in the GCC.

*Shariah* compliant fund management
Funds offer major advantage for investors who wish to have *shariah* compliant asset holdings as a *shariah* board is usually accountable for the criteria governing the portfolio selection and in the case of equities, the actual stock included. Muslim investors who purchase stock directly through a broker or invest in other types of assets such as commercial property can have no guarantee that their money is being utilised for *halal* purposes, unless they had the resources to engage personal *shariah* advisors to monitor all their investments. Few, other than high net worth investors, could contemplate such an approach, and in practice it is ruled out, not only on grounds of cost, but because it would delay investment decisions, and undermine potential gains in financial markets where timing is crucial for success. In contrast, fund managers can operate within known parameters that are established by the *shariah* boards of the institutions in which they are employed.

Unfortunately, none of the major specialised fund management providers such as Fidelity or Jupiter offer *shariah* compliant funds, most at present being offered by Islamic banks or conventional banks providing *shariah* compliant products. In these cases, it is the *shariah* boards of the banks that have the responsibility to audit the funds offered, their remit being to approve new product offerings and monitor the operation of existing funds, especially their purchase of equities and other financial assets. This requires different skills and experience however to those needed to audit Islamic banking activities. The task of *shariah* auditing consists in the authentication of the Islamic products to ensure they are compatible with the traditional contracts used in *fiqh* jurisprudence. In contrast, most funds comprise financial instruments such as equities that were unknown under *shariah*, although now regarded as conditionally permissible on the grounds that all instruments are allowed unless explicitly forbidden. Equities are not forbidden, as there are simply no references to such instruments in historical *fiqh* texts, the
emphasis instead being on partnership contracts such as mudarabah and musharakah that have quite different financial and legal characteristics.

Rather than relying on bank shariah board to authenticate assets as halal, the task can be outsourced. The Dow Jones Islamic Indices provide such a service, as when compiling their indices they have to exclude stock that is not shariah compliant. This information can therefore be shared with clients for a fee, as it is of commercial value to fund managers who are seeking to market their products to pious Muslim investors. It is therefore the shariah board of the Dow Jones Islamic Indices who are responsible to ensure the investments are halal, but as specialists in this area of finance, with almost a decade of experience, they are arguably better qualified to act than a bank’s shariah board that has little knowledge of stock selection criteria. Of course Dow Jones Islamic Market Indices does not have a monopoly in this area, as there are also the Financial Times Islamic Indices, and the specialist provider of shariah financial solutions, Yasaar Limited of Dubai and London, has expertise in this area through its access to leading scholars who undertake work on a freelance basis.

Commodity funds
The National Commercial Bank of Saudi Arabia ("NCB") was the first institution in the world to introduce shariah compliant funds, its initial offering being the Al Ahli International Trade Fund that was launched in 1987. The aim of the fund was to provide to retail clients a shariah compliant alternative to a conventional savings account paying interest, as many savers in Saudi Arabia equated all interest payments and receipts with riba, which is forbidden under shariah. Furthermore savings in conventional accounts could, and usually were, utilised for interest based lending, resulting in deposits from Muslims actually promoting riba financing. Instead, the Al Ahli Fund was used for murabahah transactions, mainly involving the trading of commodities on the London Metal Exchange, with the funds placed with specialist brokers. The mark-up from the transactions would accrue to the bank, who in turn would pass it on to the investor. Shariah conditions were satisfied, as the return was a mark-up from real trading transactions, not simply earning interest from dealing in money. In 2006, the return on these US dollar denominated investments was 3.5 percent, comparable to the return from conventional savings accounts, but although the capital was not guaranteed, the risk was minimal, and investors have never suffered from capital losses in the two decades of operation of the Al Ahli Trade Funds. Today, the range of Al Ahli Trade Funds has been extended to encompass Saudi Riyal and Euro based murabahah investments, as well as more diversified offerings that place funds in sukuk securities rather than in commodity trading.

Although NCB continues to account for over forty percent of the market for managed funds in Saudi Arabia, Al Rajhi Bank has challenged its dominance in recent years, and currently offers fourteen different funds, most of which are cross sold to its own banking clients. Like NCB, Al Rajhi Bank offers commodity funds in US dollars and Saudi riyals to provide income to investors but these are structured using a mudarabah profit sharing arrangement rather than murabahah mark-ups, although the underlying transactions still involve commodity trading and premiums for deferred payments. Each of these structures has merits, but the Al Rajhi Bank structure can be seen as a substitute for the specified or restricted investment mudarabah accounts offered by institutions such as the Jordan Islamic Bank, but not offered by banks in Saudi Arabia.

Equity investment
For investors looking for higher returns, but with greater risk, most Saudi Arabian banks offer a range of equity funds, either investing in the local market and denominated in Saudi Riyals, or investing internationally, and either US dollar or Euro denominated. The oldest established and
The largest is the Al Ahli Global Trading Equity Fund, first offered by NCB in 1995 with $274 million under management by 2006. Its major competitor is the Al Rajhi Bank Global Equity Fund which was launched in 1996, and has experienced a similar performance. Both funds provide significant exposure to the US market where over half the investments are placed, but in the case of the Al Rajhi Fund there is greater exposure to South East Asia, given its increasing presence in the region through its Malaysian subsidiary.

The concept of equity investment is not of course Islamic as already indicated, but it is permissible under shariah provided the companies selected are screened to ensure they are halal. This is part of the responsibility of the shariah board that oversees the Islamic fund. Investment in most sectors is permissible, the major exclusions being conventional banks and insurance companies, companies involved in alcohol or pork production and media companies distributing pornographic material. In practice, it is the exclusion of conventional banks that determine how shariah compliant funds perform in comparison to unscreened funds, shariah investors doing well when conventional banks underperform the market, but faring less satisfactorily when conventional banks are out performing other sectors.

In addition to sector screening, there are also concerns about investing in excessively indebted companies or firms that have significant treasury holdings and therefore substantial riba based income. All listed companies, including those in the GCC, borrow from conventional banks, and therefore to exclude them for this reason would preclude Muslims from all equity investment. The shariah scholars have therefore taken a pragmatic approach. There is no explicit reference of course in the Koran or Hadiths dealing with gearing ratios, but it is widely accepted by contemporary Islamic scholars that if a company has bank borrowings that are in excess of one third of its market capitalisation, then it is no longer shariah compliant. This one third ratio is also used to exclude firms that receive more than one third of their income from riba, usually in practice conventional banks, but these are excluded in any case under the sector criteria. Receivables are also an issue, as companies that extend significant supplier credits are in practice operating like banks, especially as receivables can be sold at a discount through factoring, with the discount given usually determined by interest rates. Firms with receivables that exceed one half of their market capitalisation are therefore excluded.

Building an equity portfolio

There are sectors that seem especially worthwhile for shariah compliant investment such as healthcare (for example, NCB’s Al Ahli Healthcare Fund launched in October 2000 with much of its investment being in pharmaceutical companies such as AstraZenica and Roche). Small capitalisation firms are also favoured, partly on financial grounds as they often outperform major listed companies, but also because some are managed by pious Muslim businessmen. Shariah compliant funds are also offered that focus on emerging markets, with Al Rajhi providing an India and China equity fund and NCB its Al Ahli Asia Pacific Fund.

For GCC investors, geographical and currency spread is desirable, as although the capital gains on local equity investments were impressive over the 2001-2005 period; the inevitable correction came in 2006. The performance of the Al Ahli Saudi Equity fund illustrated in the table reflected what was happening in the market as a whole, the problem being that the Saudi market lacks breadth, as although it is the largest in the Islamic world in terms of capitalisation, there are less than eighty listed companies.

<table>
<thead>
<tr>
<th>Fund</th>
<th>1 year</th>
<th>3 years</th>
<th>5 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Saudi</td>
<td>-23.6</td>
<td>200.2</td>
<td>441.9</td>
</tr>
</tbody>
</table>

Exhibit 1: Selected Al Ahli Fund Performance as of 31st August 2006
<table>
<thead>
<tr>
<th>Equity</th>
<th>11.7</th>
<th>48.3</th>
<th>39.4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Global Equity</td>
<td>5.9</td>
<td>27.6</td>
<td>14.5</td>
</tr>
<tr>
<td>US Equity</td>
<td>20.1</td>
<td>79.3</td>
<td>62.5</td>
</tr>
<tr>
<td>Asian Pacific Equity</td>
<td>18.0</td>
<td>55.2</td>
<td>61.8</td>
</tr>
<tr>
<td>Healthcare</td>
<td>11.3</td>
<td>39.6</td>
<td>22.0</td>
</tr>
<tr>
<td>Small Cap Equity</td>
<td>13.7</td>
<td>46.3</td>
<td>50.8</td>
</tr>
<tr>
<td>Riyal Murabah ah</td>
<td>5.3</td>
<td>10.3</td>
<td>16.1</td>
</tr>
<tr>
<td>US$ Murabah ah</td>
<td>5.1</td>
<td>9.3</td>
<td>14.0</td>
</tr>
</tbody>
</table>

Source: National Commercial Bank, Jeddah

From a *shariah* perspective, investing in GCC markets actually presents greater problems than investing in western markets, as the conventional banks, which must be excluded from the portfolio, account for between one quarter and one third of market capitalisation, compared to between ten and fifteen percent in most western markets. There is no *shariah* objection to investing in western markets, as *shariah* is concerned with enduring moral principles, not the politics of the moment. This is fortunate, as from a financial perspective the advantages from investing in western markets is evident, as the one, three and five year returns on the Al Ahli Global, US and European Funds demonstrate. Although GCC equities performed much more impressively over 3-5 years driven by high oil prices, even the record high prices in 2006 failed to sustain the capital gains, while western markets continued their bull run despite high oil prices which would normally be expected to have an adverse effect on oil consuming countries.

**Management of risk and portfolio diversification**

As compared to an investment in a single stock, mutual funds offer investors portfolio diversification. For most investors (even of modest means), it is also sensible to invest in more than one fund. There is usually a trade-off between risk and return, and this applies as much for *shariah* compliant portfolios as for conventional portfolios. For investors with modest amounts of money who perhaps can only afford to buy into one fund, a balanced fund is probably the best choice. Such funds aim to provide the investor with a small income, possibly comparable, or slightly less than the profit share investment *mudarabah* depositors receive from an Islamic bank, but unlike a bank deposit, which does not appreciate nominally in value, the investment in a balanced fund should provide limited capital gains, at least to maintain the real value of the investment after allowing for inflation, but possibly outperforming inflation.

The risk and return profile for Al Rajhi Bank managed funds demonstrates the choices facing an investor insisting on *shariah* compliance. The Al Rajhi Balanced Funds invest in both equities and commodity *mudarabah*, with one fund investing over 75 percent in the latter, and the other 40 percent in commodity *mudarabah* with the remainder in equities. These are in practice funds of funds, with the investment distributed into a portfolio of Al Rajhi Funds. It should be noted
that the Al Rajhi Mudarabah Fund, although it invests in commodity trading, is structured to provide a profit share rather than a fixed mark-up like the Al Ahli Commodity Trading Funds.

Exhibit 2: Risk and return profile of the Al Rajhi Bank managed funds

<table>
<thead>
<tr>
<th>Risk</th>
<th>Returns</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commodity mudarabah</td>
<td>Local shares</td>
</tr>
<tr>
<td></td>
<td>GCC equity</td>
</tr>
<tr>
<td></td>
<td>India &amp; China</td>
</tr>
<tr>
<td></td>
<td>European</td>
</tr>
<tr>
<td></td>
<td>First real estate</td>
</tr>
<tr>
<td></td>
<td>International small cap</td>
</tr>
<tr>
<td></td>
<td>Global equity</td>
</tr>
<tr>
<td>Ladies and children's funds</td>
<td></td>
</tr>
<tr>
<td>Balanced funds</td>
<td></td>
</tr>
</tbody>
</table>

Both the Ladies and Children’s Funds adopt a similar policy, and can be regarded as low risk investments, with 25 percent placed in commodity mudarabah in the case of the Ladies Fund, and 15 percent allocated to commodity mudarabah with the Children’s Fund. The rationale for this is that the Children’s Fund can be regarded as a long term investment, and it is therefore appropriate to allocate 85 percent to equities, as the duration of the holding is likely to be longer than any equity market cycle. The aim of the Children’s Fund is to encourage parents, and more often grandparents, to save on behalf of younger family dependents, with the money ultimately being used to finance higher education, or even the deposit on a house when children grow up and reach marriageable age.

For investors wanting greater exposure to risk, Al Rajhi offers a Global Equity Fund comparable to the Al Ahli Global Equity Fund. This invests primarily in North America, Western Europe and South East Asia, with a concentration on companies listed on Wall Street. This is safer for Saudi Arabian investors as compared to investing funds in the local market, which has less depth and breadth, and therefore is subject to greater volatility. Indeed, investing funds in local equities can be regarded as the most risky form of investment, as although there is no foreign exchange risk, the evidence from 2006, when the market lost 60 percent of its value, is of substantial exposure to risk. Investing in larger emerging markets such as India and China is safer, although diversifying into all GCC markets also reduces risk, as the markets are imperfectly correlated. Equity placements in companies with small market capitalisation is more risky than that in global equities, which usually mean multinationals or large companies, but the breadth and depth of markets in small capital stock in the developed world is often greater than that of entire emerging markets.
**Investment in sukuk securities**
Conventional investors normally hold a significant proportion of their portfolios in bonds and floating rate notes, as these provide a higher return than bank deposits, the major risk being of default, as unless this occurs the investors can expect to receive on maturity of the bond a sum equivalent to its face value. Muslim investors cannot hold conventional bonds or notes if they want their portfolios to be shariah compliant, as these are debt instruments which pay interest. What is permissible is the holding of sukuk securities that have the same financial characteristics as conventional bonds and notes, but are governed by legal contracts that have been approved as shariah compliant by competent scholars. In the contract there should be no explicit reference to interest, and the securities must be asset backed, so that if they are traded, what is being bought and sold is a right to an underlying real asset, not simply a debt security.

Different types of sukuk are now available, including (a) salam sukuk, which mature after three months and are the equivalent of treasury bills; (b) murabahah sukuk or Islamic bonds, which pay a fixed mark-up and usually run from three to five years; and (c) ijara sukuk, which are equivalent to floating rate notes, and run are for five to ten years. The latter are the most popular type of sukuk, the returns to investors being in the form of a variable rental payment, with the rent generated from the lease held by the issuer after the initial sale of the asset to raise finance. The rental payments can be benchmarked to LIBOR, the London Inter-Bank Offer Rate, but although this is an interest index, the crucial difference is that the returns are paid as rent, not interest.

Exhibit 3: How ijara sukuk are structured

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**Ijara sukuk structure**

- **Issuer**
  - Sale of asset
  - Lease agreement
  - Rental payments
  - Guarantee of SPV obligations

- **SPV**
  - Rental payments/coupons
  - Cash
  - Certificate of participation
  - Reimbursement of issue price on maturity

- **Islamic investors**
  - Buy back of asset at maturity
  - Reimbursement of SPV obligations

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*Sukuk* securities have been widely traded in Malaysia for over a decade, and RHB Bank offers *sukuk* funds to Islamic retail investors that are comparable to the corporate bonds funds marketed to conventional investors. The problem for Islamic investors in the Gulf was that until 2006 there was little trading in *sukuk* securities, the Islamic liquidity centre in Bahrain serving mainly for the initial public offerings of *sukuk* rather than secondary trading. As Islamic banks and takaful insurance companies could not hold conventional bonds or notes, they eagerly subscribed to all the *sukuk* issues, but then simply held the securities to maturity given the shortages of product in the market. The institutions therefore squeezed out potential individual investors, including high
net worth investors, and there was little incentive for fund managers to offer sukuk funds to retail investors as in Malaysia.

Fortunately with the explosion in sukuk issuance in the GCC since 2004, and the value of new sukuk exceeding $25 billion by 2006, the situation has started to change, with secondary trading on both the Dubai International Financial Exchange ("DIFX") and the Dubai Financial Market ("DFM"). The DFM is the first financial market globally to declare that all its dealings and quoted stock are shariah compliant. At present only two sukuk issuances are listed: (a) the Dubai Global Sukuk, which was first launched in November 2004; and (b) the Amlak Sukuk, issued by the financing subsidiary of Emaar in July 2005 to securitize its shariah compliant mortgage portfolio. The DIFX has become the largest exchange in the world for sukuk listings by value because both the Nakheel and DP World Sukuks are listed on the DIFX. The DP World Sukuk in January 2006 was used to finance the takeover by DP World of P&O Ports. The Nakheel Sukuk in December 2006 was used to contribute to the financing of Nakheel’s portfolio of property projects, with the asset specified in the sukuk application for listing being the land and buildings at Dubai Waterfront, which were valued at $4.2 billion. The Nakheel Sukuk raised $3.52 billion (over $1 billion more than the amount originally envisaged).

**Ijara leased assets**

For investors preferring a shariah compliant portfolio, leased assets are especially attractive as in classical Islamic jurisprudence ijara was a popular form of leasing contract. The emphasis was on contracts, with the returns to the lessor reflecting their ownership responsibilities. In modern terms, this means that operational leases are permissible, as the owner will normally be liable for the insurance of the leased assets, but financing leases are not, where all the obligations are transferred to the lessee, including the liability for insurance premiums. Shariah scholars cannot see any justification for the rent the lessor receives under what they perceive is an unfair contract.

Islamic banks have increased their own leasing financing through ijara, which is more profitable than murabahah financing because of the transactions costs incurred with the latter for contracts of a very short duration. With ijara there is a lower turnover of bank assets, although of course also more risks given the longer period to maturity. Some institutions have become so heavily involved in ijara they can almost be regarded as leasing companies rather than banks, and most Islamic banks have built up considerable leasing experience and expertise.

It was a natural progression to use this leasing expertise to design ijara funds that could be offered directly to investors in return for a management fee. The National Bank of Kuwait ("NBK") has been especially active, offering three Islamic ijara funds to investors. The Islamic ijara funds currently available include NBK’s Ijara Fund IIB launched in July 2003 for a four-year term to maturity and NBK’s Ijara Fund III launched in December 2004 with a five-year term to maturity in November 2009. The minimum investment in the second fund was $10,000, but this was reduced to $1,000 for the third fund. For both funds, the initial sales charge was 2 percent, with a one percent annual management charge. Workstations and warehouse equipment each account for around one quarter of the assets of the second fund, with printers and servers accounting for 14 and 12 percent of fund assets respectively. For NBK’s Ijara Fund III, vehicles account for one quarter of the assets, industrial plants a further 17 percent and food and soft drink vending machines a further 14 percent.

**Exhibit 4: Performance of the National Bank of Kuwait Ijara Funds, %**

<table>
<thead>
<tr>
<th></th>
<th>Ijara</th>
<th>Ijara</th>
<th>Ijara</th>
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<tbody>
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<td></td>
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<td></td>
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</tbody>
</table>

9
<table>
<thead>
<tr>
<th></th>
<th>Fund II A</th>
<th>Fund II B</th>
<th>Fund III</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annualised return</td>
<td>4.81</td>
<td>4.37</td>
<td>5.28</td>
</tr>
<tr>
<td>One year return</td>
<td>6.11</td>
<td>5.24</td>
<td>6.62</td>
</tr>
<tr>
<td>Standard deviation</td>
<td>0.55</td>
<td>0.48</td>
<td>0.69</td>
</tr>
</tbody>
</table>

Source: National Bank of Kuwait

Usually leasing funds are closed ended, as the fund manager cannot easily sell the leased assets until they mature to cover redemptions. Solidarity, the Bahrain based *takaful* company, offered an open ended leasing fund in 2004, the assets being *ijara* based *sukuk*, which could potentially be sold to meet redemptions. The fund was valued at $100 million, with the minimum investment being $100,000, clearly an amount that would rule out most retail investors. No redemption was permitted for the first six months, and the maximum redemption amount permitted cannot exceed ten percent of the total value of the fund. Redemptions are monthly, on the first dealing day, but 30 days notice must be given to allow Solidarity time to identify a substitute investor. The initial subscription fee is 2 percent, and the annual management charge 1.2 percent.

**Shariah compliant real estate investment**

Leasing funds seldom provide exposure to property markets, as although the leased assets can include commercial buildings or residential property and not merely equipment, the rental returns are seldom benchmarked to property prices, and there is little likelihood of capital gains. Real estate has to be viewed as a distinctive asset class, but one that is attractive for investors wanting *shariah* compliance, the main concern being with the uses made of the property. Investment in shopping malls is for example permissible, but not if the tenants include betting shops or establishments selling alcohol. Conventional bank branches are also problematic because of their involvement in *riba*, but bank ATMs within the mall may be acceptable, as Islamic banks issue cards that can be used in these machines to withdraw cash. Generally, *shariah* compliant investment in single tenanted property is more straight-forward, although even with this sub-letting could be an issue.

The advantage of including real estate in a *shariah* compliant asset portfolio is that prices in property markets are seldom closely correlated with those in equity markets, hence bringing real diversification and lowering risk. The major problem with property investment, whether Islamic or conventional, is the limited liquidity compared to holding financial assets, as turnover in property markets is often slow, and property is usually viewed as a long term investment. One solution to this is investment in Islamic real estate investment trusts ("REITS"). REITS have limited potential in the GCC however, as the main purpose is the avoidance of corporation tax, but property companies in the Gulf are not subject to such taxation. For GCC nationals investing in Malaysia, Singapore or Europe, Islamic REITS may be beneficial, as even though the investors themselves, if they are non-residents in these markets, will not incur a tax liability, the property companies in which they invest will be liable for tax, unless they are structured as REITS, which means all profits are distributed to investors.

Until Islamic REITS become widely available, the best alternative asset class for investors wanting *shariah* compliance in property are Islamic real estate funds. A number of these are available in the Gulf, one of the most successful being that offered by SAMBA, the Saudi American Bank, in February 2007. The aim of the fund is to achieve medium to long term capital
growth through the acquisition, development and sale of residential, commercial and industrial property. The investment portfolio comprises four leading Saudi developers including the Omar Kassem Alesayi Group and AQARAT. The fund is Saudi riyal denominated, with the minimum initial subscription SR 25,000, a subscription fee of 1.75 percent and an annual management charge of 2.25 percent, which is relatively high. Although the fund is open ended, no redemptions are allowed for the first year, and thereafter until year five only one quarter of the purchased units can be redeemed, after which there is no redemption limit, or even a redemption fee. From year two the redemption fee is 1.5 percent, declining to one percent in year three and 0.75 percent in year four. The absence of subsequent exit charges partly compensates for the management fee. For those wanting foreign currency exposure Solidarity of Bahrain offers both US dollar and Euro denominated real estate funds similar to its leasing fund in terms of pricing and redemption conditions.

**Islamic private equity**

Private equity placements have long been favoured by high net worth investors in the GCC with an appetite for risk to liven their portfolios, but it is only since 2003 that such assets have been available on a *shariah* compliant basis. The Global Investment House of Kuwait was the first to foray into this territory when it launched its private investment fund in May 2003, with the investments being channelled into six relatively small unlisted Kuwait companies operating in diverse fields, including health care, building materials, investment and *takaful*. Although diversity has merits, it can be argued that private equity investments are more likely to be successful if they are more focused, and the fund manager has specific business knowledge and not simply financial expertise. Consequently the returns to investors have been negative since inception, with the worst loss of almost 17 percent in 2005, and no figures yet declared for 2006. The fund is Kuwaiti dinar denominated, with a minimum investment of KD 50,000, and a management fee of two percent per annum. The fund applied in 2006 to the Central Bank of Kuwait to extend its investment coverage from the domestic market to the wider GCC, which may increase future returns.

The Unicorn Global Private Equity Fund offered from Bahrain in May 2006 has a much wider investment remit, with 40 percent being placed in the GCC, 35 percent in the Levant, including Turkey, and one quarter in the US and South East Asia. It is US dollar denominated, with a minimum investment of US $100,000 for individuals and US $ 1 million for institutional investors. The target companies for investment are medium sized, with revenues greater than US $10 million and earnings in excess of US $ 2.5 million. The companies should be engaged in four business areas, consumer products, health care, business services and light manufacturing. These areas would appear to have little in common, and it is not clear what Unicorn will bring to its target investment companies other than finance. Unicorn is charging a placement fee of 2 percent, and an arrangement fee in addition of 1.25 percent, which seems high. The management charge is 2 percent, with a performance fee of 20 percent for returns in excess of an IRR of 10 percent. It remains to be seen if this will be achieved, although the target IRR of 20 percent is extremely ambitious.

Although private equity finance is often equated with *musharakah*, the existing private equity funds in the GCC do not use these structures, unlike their Malaysian counterparts. The *shariah* compliance is purely through the screening, not the structuring. There is arguable scope for the development of a more innovative type of private equity funds in the GCC, using a structure where the Islamic investors or Islamic bank enter a partnership agreement with a sole proprietor or shareholders in an unquoted company, and invest in a *musharakah* special purpose vehicle with a pre-determined life of five or seven years. Such a structure is favoured by sole proprietors as they do not lose control of their existing businesses, but can benefit from any knowledge the
private equity investors may bring to the business, especially in the case of venture capital, a sub set of private equity.

Exhibit 5:

Alternative investments and Islamic hedge funds
Many shariah compliant investors are risk adverse and want capital protection, the concern with wealth preservation not least because of the disastrous stock market performance in the GCC during 2006 that left many facing substantial losses. Consequently it was not surprising that a number of capital protected investment products have been launched. Such products are usually structured using derivatives such as equity futures and options, but although such contracts are potentially permissible under shariah, trading in these contracts is regarded by most scholars as prohibited, as firstly the derivatives are remote from the underlying asset and secondly most of the trading is speculative, with buyers not actually wanting to acquire the underlying asset, but rather sell for a capital gain before maturity.

Dubai Islamic Bank offered a three year capital protected note in January 2007 the aim being to deliver a return of 7 percent in the first year by investing in a diversified basket of equities, commodities and real estate denominated in a range of currencies, although the notes themselves are US $ denominated, with a minimum investment of US $ 10,000. The capital protection comes from the murabahah based short term commodity investments, with the real estate and equities offering some degree of mutual offset because of their different cycles. No derivatives are used to provide capital protection.

A more complex shariah compliant protected note was offered by ABN AMRO in December 2006, with the valuation date December 2012 when investors are guaranteed to get their capital back at the same nominal value as they initially paid, although hopefully they will also make a profit. The aim of ABN AMRO's shariah compliant protected note is to track an index of the top 20 Middle East listed equities on the Bahrain, Egypt, Jordan, Kuwait, Oman, Qatar and UAE exchanges. However, the Saudi Arabian market, by far the largest, oddly seems excluded from the index. The notes, each with a nominal value of $ US 1,000, are tradable, with the total issuance valued initially at $ US 20 million, a rather modest amount. The administrative fee is a
mere 0.25 percent, but the protection fee is 1.65 percent, and there is a further strategy fee of 0.2 percent. The fund can leverage up to 50 percent of its nominal value, with the *shariah* compliance coming through the stock screening which uses a methodology similar to that of the Dow Jones Islamic Market Indices.

Capital protected notes should not be confused with hedge fund investments, which usually rely on a short selling strategy to make profits in falling markets. As short selling implies promising to provide equities or other financial assets which the hedge fund manager does not currently possess at a fixed future price, many *shariah* scholars are sceptical about such practices. However, the managers of *shariah* compliant hedge funds argue that the concept of *arboun*, paying a deposit to guarantee a purchase at a fixed price, and *salam*, paying in full in advance to secure an asset at a pre-determined future date, are applicable to their operations. At present, debate still continues on these issues among the scholars, but Islamic investors should be aware that hedge funds involve high management fees, limited transparency and considerable risk, as although most of the time the investment is safe, when hedge funds collapse, investors invariably lose all their money.

**Shariah compliant private banking and asset management services**

So far the major route for accessing *shariah* compliant asset management services has been through major international banks such as HSBC Amanah, UBS, Citigroup, and to a lesser extent through the larger Islamic Banks such the Dubai Islamic Bank and Al Rajhi Bank. Private banks have largely ignored the market potential, apart from Coutts, which is part of the RBS Group. There is also potential for stock broking firms that provide discretionary services to become involved, and indeed law firms, as although many leading international law firms are involved in drawing up contracts that are *shariah* compliant on behalf of their Islamic banking clients, few provide specific advice on *shariah* compliant assets to their private clients. At present, law firms do not employ *shariah* scholars, but this could be a possibility for the future if the objective is to offer one shop asset management services, given that many are involved in financial planning.

Independent financial advisors could also have a role to play in *shariah* compliant asset management services, as although some have this expertise in Malaysia, at present there is a gap in the GCC. Given the wide array of instruments for *shariah* compliant asset management, and the complexity of designing portfolios to suit the financial circumstances of individual investors and their appetite for risk, further specialist financial advice is clearly needed from *shariah* aware professionals.

**Information sources for Islamic asset managers and client advisors**

On-line web based data services have improved considerably for Islamic funds, with the Islamic Financial Information Service (IFIS) in London and Eureka Hedge in Singapore both providing comprehensive coverage. IFIS, a product of ISI Emerging Markets, offers links from its home page to leading fund prospectuses, fact sheets, quarterly and annual reports. In 2007 it launched a dedicated Islamic fund database that enables the user to access information on specific classes of funds, with eleven separate categories identified. Categories include equity, income, index trackers and balanced funds as well as funds of funds. Commodity funds are also listed, as these are important for *shariah* compliant investors, as well as leasing, real estate, shipping and the more exotic hybrid funds. Classification by year and country is also provided, the latter including offshore jurisdictions. The information on each fund is provided in a standardised format facilitating comparisons, with contact details of the fund, its manager and type, such as open or closed ended. Management fees and a chart indicating recent performance are also reported.
Eureka Hedge provides information on 333 Islamic funds, with much more detail on the larger and more active funds. Individual funds can be found using convenient search tools from the home page. For each fund there is a profile indicating its history and contact details, and information is given on each fund’s investment strategy. Performance statistics are reported, including risk and return statistics where available, together with a graph illustrating recent price movements. Through the advanced search option more statistical analysis can be undertaken, including the calculation of yields, annualised returns, standard deviations and Sharpe Sortino ratios. As with the IFIS database, fees and redemption terms are also cited. Eureka Hedge compiles an index of Islamic fund performance which is reported on their website and reproduced weekly in Islamic Finance News under an arrangement with Redmoney of Kuala Lumpur. Researchers at Eureka Hedge write informative articles on particular sectors and types of Islamic funds, most of which also appear in Islamic Finance News on a regular basis.

Conclusion

Shariah compliant asset management has emerged as an important segment of the wider asset management industry. Only a decade ago there were few products that could be used to include in a portfolio, but now almost as complete a range is available as for the conventional investor. The shariah compliant investor is no longer at a financial disadvantage because of his or her religious beliefs. To a considerable extent the extended supply of products has created its own demand, as in the past many Islamic investors had little choice but to hold conventional assets in their portfolios. Now comprehensive shariah compliance is possible, and holding conventional assets can no longer be justified on the grounds of expediency. There remains nevertheless much scope for further expansion, both in terms of breadth through new product offering, as well as in depth, as trading volumes in sukuk and shariah compliant mutual fund markets increase. This should widen choice even further, while providing more price stability as increasing depth reduces volatility.