

## Islamic Asset Allocation

This is a description of a simple asset allocation model, which is how we suggest investors can choose between the following four different asset classes:

**Fixed Income** which includes cash, money market instruments, sukuk and some structured fixed income products;

**Equity** which includes listed equities, tracker funds (often referred to as "passive management"), and professionally managed stock selections (often referred to as "active management");

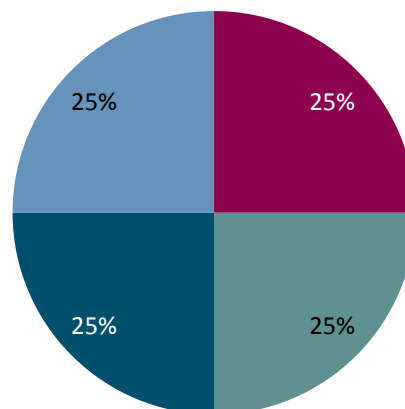
**Property** which includes individual properties or property portfolios funded with cash, not debt, but which excludes equity investments in listed property companies which fall within equity risk (above); and

**Alternative Assets** which mainly comprise private equity funds, but also include some structured products, agriculture and energy, as well as esoteric asset classes like art.

Investors often refer to fixed income and equities as "core" asset allocations and property and alternative assets as "satellite" asset allocations. This important distinction is discussed further below.

## Simple Asset Allocation

■ "Core" Fixed Income    ■ "Core" Equity Risk    ■ Property    ■ Alternative Assets



Our starting position is to assume that an investor's portfolio is equally distributed between all four classes, 25% each, and that these "asset allocations" are subsequently adjusted to reflect three major factors:

- The liabilities of the investor which naturally change over time;
- The distinction between investing and speculating; and
- The investment performance of each of the above asset classes.

## **The Liabilities of the Investor**

A common feature of all asset allocation models is that your short term liabilities govern how you should divide your "core" assets between fixed income and equity risk. The risk tolerance of the investor then governs how much equity risk is kept in "core" listed equities and how much is transferred into less liquid "satellites". These are common themes to both conventional and Islamic asset allocation.

For example, a pension fund making monthly payments to its members needs a much higher defensive allocation to fixed income than an enterprising sovereign wealth fund whose current income vastly exceeds its current payments and whose liabilities may be a generation away. The pension fund must hold the right assets to meet its monthly obligations as they fall due. In contrast, the sovereign wealth fund may not have any short term liabilities and therefore has freedom to invest both in "core" equity risk, plus a wide choice of "satellite" investments (in search of increased capital gain). The wealth fund's portfolio can swing in value with the business cycle.

## **Investment or Speculation**

We use a textbook definition of investments because we consider this distinction is critical to all investors, whatever their ethical or religious backgrounds. Our favourite definition is "an investment operation is one which, upon thorough analysis promises safety of principal and an adequate return. Operations not meeting these requirements are speculative."

This is a very demanding definition which most professional investors ignore at their cost, so some contrasting examples of investment and speculation may be useful.

Firstly, consider a property investment company that previously built an office complex for a fixed price on behalf of a blue chip tenant whose rental payments, over a term of many years, not only repaid the cost of the project but also made the property company an adequate return on capital. This description includes no mention of debt, no discussion of future values and no discussion of occupancy rates. In short, this describes an "investment" and any property development that does not meet this description (or one very similar to it) is speculative. Many cities these days have cranes sitting idle on top of half finished building projects, standing next to finished but empty developments. It would not be difficult to establish how many of these properties were built as investments and how many were built speculatively, but it is difficult to control our irrational love of buildings.

Next, consider a private equity group buying a good company on the basis that earnings will rise significantly for the next 5 years. Assume the ambitious growth assumptions make it possible to secure external funding representing as much as 80% of the purchase price. But stress-testing the projected growth rate soon demonstrates when covenants would be broken and when the 20% equity could be reduced or written off. If growth is not certain (it rarely is), there can be no "promise" that the investor's principal is safe, so geared investments almost invariably meet the above definition of speculation and would not qualify as investments under our model.

Using the above definition, most (but not all) "satellite" operations fail to qualify as "investments" at all. This distinction is important because most speculators lose money in the end. We therefore recommend you limit the amount at risk and separate it completely from your investment programme. This is not a gentle warning about a balance of probabilities close to 50:50 that one day

a speculator will lose a little of the money with which he started his journey. At the end of every business cycle, we believe it is highly likely that many speculators will be left with nothing and there are numerous recent examples to support this point.

With these points in mind, investors can take five steps to use our asset allocation model.

### **Step 1 - Distinguish between Investments and Speculations**

Our first recommendation to both Islamic and conventional investors is to separate investments and speculations so that they can be managed independently. Quantify (as rigorously as you can) how many of your existing operations are investments and how many are speculative. When you know the exact division (your speculative asset allocation may come as a bit of a shock), create different accounting and management systems for investments and speculations.

The danger during the early part of a business cycle is that most people mistake temporary prosperity for earnings power and allocate more and more of their wealth to speculative operations, only to suffer when the cycle turns. Ultimately it is a question of attitude and, for what it is worth, we recommend you should reduce your existing speculative exposure through gradual but determined realisations, even if you have to treat each case as a workout opportunity.

But just imagine for a moment that all those with excessive "speculative" asset allocations were able to reduce these exposures easily. There would be a significant flow of capital looking for new "investment" opportunities and this Company was created to anticipate such a shift in demand. Even so, in this imperfect world it is worth being candid about what this Company can and cannot offer.

### **Step 2 - Manage Short Term Liquidity**

Whether you define the short term as one day or one year, you need to keep enough money on call and at short notice to meet your obligations as they fall due. This is what is meant by managing your short term liquidity and we suggest that your "core" fixed income investments should always exceed your short term liabilities.

The events of 2008 will remind us for a generation that banks do not offer undoubted safety of principal. Once a remote risk, bank failure is again significant, so depositing your money in any bank (Islamic or non-Islamic) is not a guarantee you will get it back. With a modest level of due diligence, you can probably identify a well run bank in a jurisdiction where all the depositors will be government protected, and where the government in question has an undoubted credit rating. We recommend this combination to investors for whom instant liquidity and safety of principal are paramount.

The price you have to pay for such liquidity and security is a reduced return, particularly when benchmark rates are less than 0.5% per annum, as they were in most of 2009. You will earn a little more from a fixed income fund than from a bank but the reason why most people limit the amount held in fixed income is that the returns available are low and there is little or no upside potential. At the same time, investment returns rely on investment choices and last year some high grade bonds traded at below par, leading to unwelcome levels of volatility.

Whether achieved through Islamic or conventional funds, fixed income returns are not going to accumulate wealth and any nominal gains may be less than the inflation rate. Even if fixed income returns were (say) a net 2.5% after costs, it would take nearly 30 years to double your money. In

comparison, if your earnings rate were a net 12%, it would take 7 years to double your money and at 20% the period falls to 4 years. Returning to our definition of investments, we define an earnings rate of 12% as a minimum "adequate return", because anyone looking to double their money within 7 years or less is seeking capital accumulation, not capital preservation.

### Step 3 - Seek Capital Accumulation

When the objective switches from preserving to accumulating capital, it must first be admitted that making an equity "investment", rather than an equity "speculation", is one of the toughest jobs in finance. All over the world a lot of brainpower has previously been spent (and will continue to be spent) on this endeavour, unfortunately without much to show for it.

This judgment may sound harsh, so it is worth a little financial analysis and measurement. Saying the same thing another way, the question can be asked how many investors have accumulation portfolios that, over a meaningful period (which we define as *any* rolling five years) have outperformed their benchmark stock market index. Check your returns, check the returns of your favourite fund manager, and check the returns of your favourite investment bank. External studies of historic performance have typically shown that four out of five highly paid analysts and professional investors cannot beat their benchmark index over any meaningful period. We will not labour the reasons behind this grim statistic (they are not that hard to figure out) but it is fair to discuss how our Islamic asset allocation model addresses this phenomenon.

But first, if you (or someone you employ) can beat the index, net of costs, over a meaningful period then I suggest you are (or you have found) a rare example of investment competence, a member of the elite one-in-five club. Such people do not need to advertise, so finding them is harder than it may first appear. The advertising point can also be inverted: when fund managers are advertising heavily or paying hearty commissions to distributors, *caveat emptor*.

Our Islamic asset allocation model takes a different approach. Instead of trying to beat a benchmark index, we suggest that investors should lower their aims and try to match their benchmarks by investing in index trackers. This avoids the need to employ expensive analysts and fund managers. It also minimises transaction costs as index trackers have no entry fees or commissions and exit fees (if any) are for the benefit of (remaining) investors, not the asset manager, when large sums are withdrawn at outside normal dealing spreads. By keeping costs low, index trackers deliver investors a net return as close as possible to the index result.

A few well known (non-Islamic) investment managers have employed index tracking strategies for over 30 years: a very meaningful period. They started with (by definition) an average position in the performance league tables but, due to their lower costs, they gradually worked their way up into the top 20% of all fund managers. With a little patience and consistency, those managing index trackers became full members of the elite one-in-five club. That is the long term plan of this Company, and we offer the additional benefit that our operations will always be carried out in a way that our Sharia'a Supervisory Board finds wholly Sharia'a compliant.

Another point to note about most index trackers is their liquidity. They should represent portfolios of shares in the world's leading companies and such portfolios can be bought and sold in an instant and trades are settled within a few days. So you can switch out of tracker funds and into income funds or cash very easily, probably more easily than you can switch out of some income funds and into trackers.

The problem with index trackers was highlighted in the second half of 2008. Not all bear markets are this pronounced, but investors need to protect themselves against short, sharp market corrections that can destroy years of patient capital accumulation. One traditional approach is to accept temporary setbacks and to trust to a benign, longer term trend that smoothes out the painful blips of the business cycle. Unfortunately, those using this method will fail to achieve our definition of an "adequate return" over *all* successive five year periods, as results depend on *when* you started investing, not *that* you started investing. Only those who invest at the bottom of bear markets are likely to make adequate returns, and not many of us are sufficiently contrarian to buy at the bottom.

#### **Step 4 - Remember Satellite investments are Illiquid and may be Speculative**

Although our opening asset allocations in our model assume that many investors have previously allocated around 50% of their portfolios to "satellite" investments in properties and alternative assets, we believe that these allocations should represent less than 20% of your portfolio. This is because we would consider many satellite investments to be speculative in nature rather than true investments, and they should be treated accordingly.

There is a role for debt free property investments which have the income characteristics of fixed income and the upside (and downside) of equities. There is a role for equity investments in debt free unquoted companies, whether they are start ups or established businesses. However, both are illiquid investments at the best of times. In bad times, like 2009, they only achieve the same distressed prices as speculators achieve when they are being forced to exit. For experienced investors, speculative exits at the bottom of the cycle are buying opportunities, not selling opportunities. Similarly, there are absolute return funds that are not based on gearing or short selling, and structured products that are not based on gearing, swaps and derivatives. By observation, we would suggest that these investment styles are best outsourced. Even if you are competent and experienced at one style, you are unlikely to have the time to master two.

#### **Step 5 - Use Tactical Asset Allocation**

The final part of our Islamic asset allocation model recommends that investors become expert asset allocators, capable of switching between defensive and enterprising core investments at short notice and capable of selecting the best long term satellite opportunities. At least every quarter, investors should first rebalance their income funds to ensure they can always meet their short term liabilities, and then they should carry out a thorough performance analysis of all their "core" investments plus any "satellite" data available. They should adjust their defensive and enterprising asset allocations accordingly, based on recent performance. This is our recommendation whether you represent a fund, firm, family or institution. If your asset allocators do not work in this way, we believe significant process improvements can be easily achieved by doing so, leading to greatly improved investment performance potential.

Those adopting this approach will be entering a master game called tactical asset allocation. We believe far more can be made from tactical asset allocation than from stock picking or from individual projects and the evidence is set out in these accounts. In 2008, as benchmark equity returns fell, you could have switched out of equity risk and into fixed income or cash. In 2009, as returns recovered, you could have switched back into equities. For example, if you had switched back into an All-World tracker in January 2009, you would have made over 35% by the end of the year (\*), without making another asset allocation decision. If you had chosen an Emerging Market tracker rather than an All-World tracker, you would have made over 75% that year (\*).

Tactical asset allocation may appear easy in retrospect but it is very challenging in real time and this is why it is properly called a master game. Assume at the beginning of 2009 you had made the inspired moves described above, when would you have taken your profits? If you switched back into income funds at the end of the second or third quarters, well before the year end, you would have missed much of the actual recovery.

This is a difficult arena and investors must again be frank with themselves whether they or anyone they employ is skilled enough at tactical asset allocation to make an adequate return. This task can be delegated but unfortunately the odds of finding a professional allocator who can achieve earnings rates throughout the business cycle of at least 12% are significantly less than one-in-five, which are the odds of finding a professional investor who can at least match benchmark returns. As we saw in 2008, benchmark returns can fall as well as plummet.

## Summary

So, in summary, our Islamic asset allocation model has been designed for long term investors who would like to concentrate their investments in the two asset classes we have defined as "core", being relatively liquid and secure income funds, or relatively volatile but liquid equity trackers.

This model best suits enterprising investors who are already comfortable making their own tactical decisions on when and how to adjust the balance between these two "core" asset classes. Even if you are not entirely comfortable with the process, the best way to develop these skills yourself is by practice. Otherwise, we would be delighted to help.

## Charles Peal

Chairman

**BLME Umbrella Fund SICAV-SIF - Sharia'a \$ Income Fund**

\* HSBC and FTSE sourced data

**Disclaimer:** This document has been provided to you solely for your information and may not be reproduced or distributed, in whole or in part, to any person. It is intended to provide the recipients with information and should not be construed as an offer to buy or sell securities or investment advice. The terms of any investment in the BLME Umbrella Fund SICAV-SIF - Sharia'a \$ Income Fund are contained within the Private Placement Memorandum and this must be read in full, taking legal or other professional advice as required to understand the full terms of and risks associated with any investment in the Fund. This document cannot form the basis of or be relied on by any person in connection with any contract or commitment whatsoever. Shares in the Fund should only be purchased by persons with experience. Past Performance is no guarantee of future results. Whilst reasonable care has been taken to ensure that the facts stated herein are accurate and that forecasts, opinions and expectations contained in this document are fair and reasonable BLME has not verified the information contained herein and accordingly none of BLME or the BLME Umbrella Fund SICAV-SIF - Sharia'a \$ Income Fund, its directors, officers or employees make any representation or warranty, express or implied as to the accuracy, fairness or completeness of the information contained in this document. No person accepts any liability whatsoever for any loss howsoever arising from any use of this document or its contents or otherwise arising in connection therewith. Nothing in this paragraph shall exclude liability for any representations or warranties made fraudulently.