Islamic Asset Management

By Dr Natalie Schoon and Jason Kabel

The principles of Islamic finance are applicable to asset management in the same way as they are applied to Islamic financial institutions. Investing in enterprises and assets that advance the economy and allow others to increase their wealth is deemed to be an exhibition of good stewardship.

Conventional and Islamic investors have common objectives such as capital preservation, yield maximization and ensuring a balance between liquidity and profitability. The only difference is that Islamic investors look for Shariah compliance.

Direct investments are not always an option, since not every investor has the time to manage investments actively, or the investable amount is relatively small, which reduces the potential of diversification. In such instances, managed funds can provide an attractive alternative.

Fund structures are typically similar to conventional structures, although Shariah compliance is a key factor. A Shariah supervisory board (SSB), which is involved from the start of the fund, is not responsible for any operational and strategic decisions made by the fund manager, but is solely concerned with Shariah compliance.

There are two generic types of funds: equity and fixed income.

EQUITY FUNDS

Equity funds occur in the following main variations:

- **Private equity**: Funds investing in non-public companies either by direct investment or obtaining shares. Investment in private equity is particularly suited to Shariah due to the partnership and profit and loss sharing principles underlying the transaction. The performance of funds investing in private equity is, however, difficult to determine due to the fact that a private enterprise does not have a market value since the shares are not tradable, and the enterprises are relatively small.

- **Listed equity**: Funds can either be actively managed and invest in listed companies via share purchases on the open market, or passively managed in which case they track the performance of an assigned index. All major index providers have also introduced Shariah compliant indices, such as the Dow Jones Islamic Markets Index and the FTSE Shariah Global Equity Index Series. Besides the fact that these indices contain only those equities that are Shariah compliant, they are similar to other equity indices.

When investing in a company or a stock market index, there are two basic screening processes prior to deciding whether or not a stock should be included in the investment universe. Within Shariah, a number of business activities are deemed haram, in which one should not invest.

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) guidelines are defined in Shariah Standard 21, but the implementation of these guidelines for individual funds can vary.

- **Industry screen**. This defines which industries are acceptable within the investment universe of the fund. Although it is preferable to allow only fully Shariah compliant funds, increasing globalization, diversification and market demand do not always make this possible.

  As a result, a particular share or business can be a Shariah compliant investment opportunity, even though an insignificant amount of their turnover (typically up to 5%) is deemed to

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Example of the application of screening criteria to different indices

Individual Islamic indices may apply different screening criteria, depending on the requirements defined by their Shariah boards. Below are a few examples.

The **Dow Jones Islamic Market Index** (DJIM) applies the AAOIFI industry screen and three financial screens to exclude companies which have:

- Total debt/trailing 12-month average market capitalization < 33%
- (Cash + interest bearing securities)/trailing 12-month average market capitalization < 33%
- Accounts receivable/trailing 12-month average market capitalization < 33%.

The trailing 12-month average market capitalization is applied to reduce volatility.

The **FTSE Shariah Global Equity Index series** applies the AAOIFI industry screen and adopts the following financial screens:

- Debt/total assets < 30%
- (Cash + interest bearing securities)/total assets < 33%
- (Cash + accounts receivable)/total assets < 50%

The **MSCI Islamic Index Series** applies the AAOIFI industry screen and also specifically excludes hotels, cinema and music from its investment universe. It applies the following financial screen:

- Total debt/total assets < 33.33%
- (Total cash + interest bearing securities)/total assets < 33.33%
- (Total cash + accounts receivable)/total assets < 33.33%

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be haram. Any income made from haram activities will be purified by giving it to charity. The AAOIFI standard identifies conventional banking and insurance, alcohol, pork, gambling, tobacco, adult entertainment, and arms and defence as prohibited industries.

- **Financial screen**. Companies that apply too much leverage are also excluded from the acceptable investment universe. Although the exact financial ratios can vary by SSB, the generally accepted financial ratios are as follows:

  √ Conventional debt/total assets < 30%
  √ (Cash + interest bearing deposits)/total assets < 30%
  √ Accounts receivables/total assets <= 45%
  √ (Total interest + income from non-compliant activities)/revenue < 5%

Non-compliance

No matter how thorough the screening, a situation could occur where an investment becomes (temporarily) non-compliant. In an actively managed fund (whether private or listed equity), it is the responsibility of the fund manager to report this to the SSB together with his recommendation on how to proceed. When disinvestment is required, the sale of the assets is normally executed over a period of time to protect investor's interest.

FIXED INCOME FUNDS

Fixed income funds can be divided into five types, depending on the level of liquidity and risk that is taken within the fund. A simple asset allocation model would suggest that any fund, whether Shariah compliant or not, that has limited short-term liabilities should hold a proportion of its assets in cash and cash equivalent instruments to avoid any unnecessary risks and volatility when meeting its obligations.

Cash investments that earn interest are against Shariah law and investments that do not have a return are not attractive from an investor's perspective. A successful fixed income fund will make use of Shariah compliant money market instruments with an appropriate mix of liquidity, security and return, and can invest in any combination of instruments such as cash, Wakalah, commodity Murabahah, collective schemes, Sukuk and Ijarah to generate a return on liquid assets.

The majority of the outperformance of an income producing fund will be generated by investments in instruments with longer maturities such as Sukuk, and potentially large Ijarah positions. The necessary liquidity in the fund will be generated from short-term instruments like Wakalah and commodity Murabahah transactions.

The exact allocation of the different instruments in the fund will not only depend on the framework of the fund and its objectives, but also on the availability of the instruments in the primary and secondary markets as well as the economic circumstances. As a broad rule of thumb, the fixed income funds can be divided into the following types:

- **Deposit funds**: Invest in deposit type instruments that have an average maturity of 60 days with a maximum of one year per individual asset. Investors can generally redeem on a daily basis provided with a high level of liquidity. A deposit fund typically invests in the most conservative assets, such

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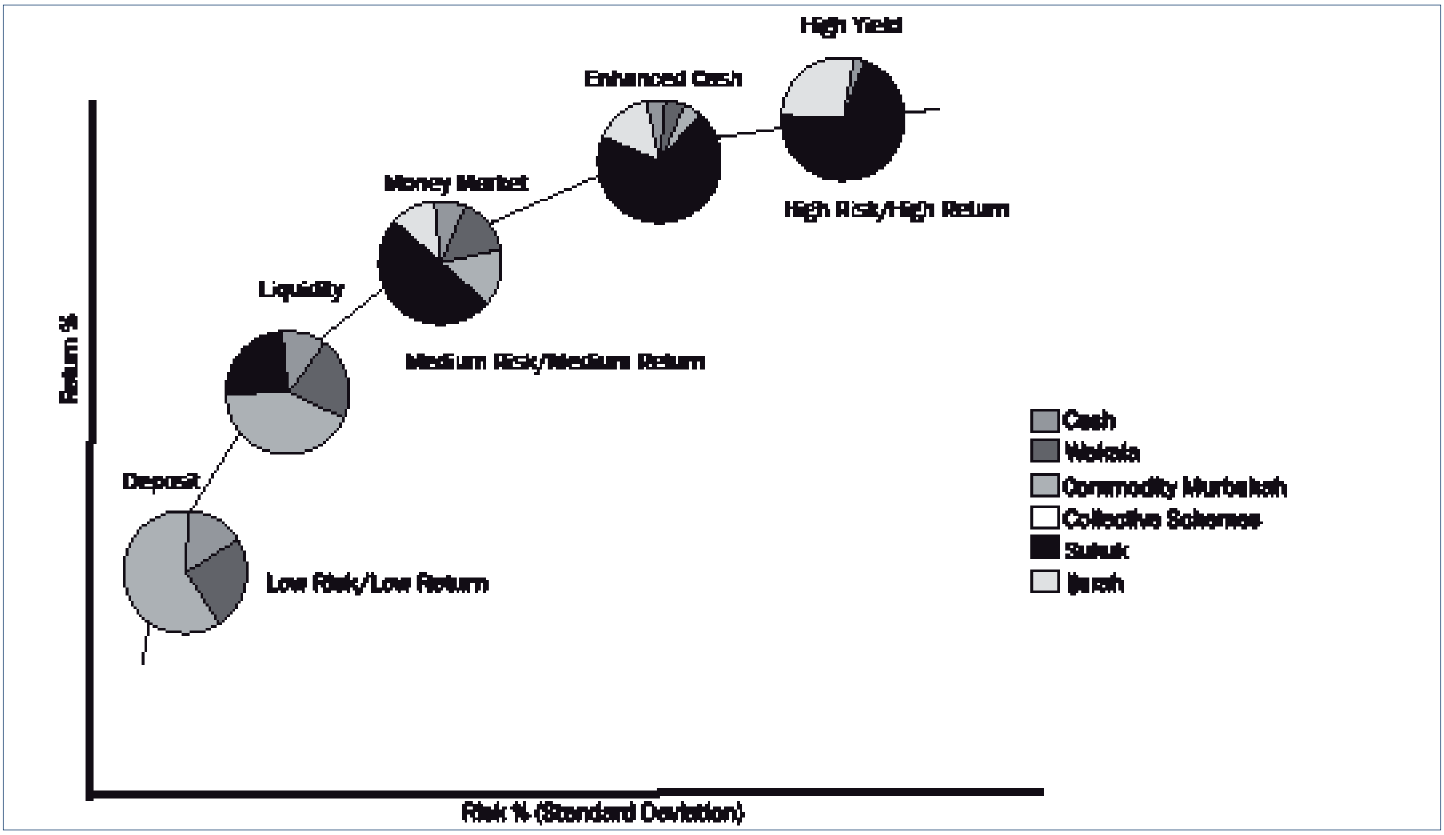

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as cash, Wakalah and commodity Murabahah. Contrary to liquidity funds, deposit funds do not invest in any non-cash type instruments.

- **Liquidity funds**: Invest in deposit type instruments with a small portion (likely up to 20%) of the funds invested in short dated Sukuk. The average maturity of the assets is 60 days with a maximum of two years per individual asset. Investors can generally redeem on a daily basis.
- **Money market funds**: Invest in a diversified mix of cash, Wakalah, commodity Murabahah, Sukuk and Ijarah. The proportion of funds invested in Sukuk and Ijarah is likely to be up to half of the total holdings. The average maturity of the underlying assets is one to two years with a maximum maturity of 10 years for an individual instrument. Although redemption is daily, the settlement period is three to four working days.
- **Enhanced cash fund**: Invests in a diversified mix of cash, Wakalah and commodity Murabahah and, in addition, allocates a large proportion (50% to 80%) to Sukuk and Ijarah. The average maturity of the underlying assets is one to five years with a maximum of 10 years for an individual instrument. Redemption is daily, with an average settlement period of three to four working days.
- **High yield funds**: Invest in a diversified mix of cash, Wakalah and commodity Murabahah and in addition, allocates a large proportion (up to 80%) to Sukuk and Ijarah. The average maturity of the underlying assets is one to five years with a maximum of 10 years for an individual instrument. In addition, unhedged currency exposure could be part of the investment strategy. Redemption is daily, with an average settlement period of three to four working days.

Comparative risk, return and liquidity

The chart on the previous page provides an indication how these funds can be compared, given their risk, expected return and level of liquidity. It goes without saying that a higher risk is not necessarily accompanied by a higher return; after all, the value of investments can go up as well as down. However, funds with a lower level of liquidity typically do have higher returns associated with them due to the fact that the money can be invested for a longer period.

Islamic fund market

The funds mentioned above are largely similar to their conventional counterparts, and are generally available in Shariah compliant form. When surveying the Islamic fund market, it becomes clear that some fund managers have historically charged significantly higher fees for Islamic funds than for a similar conventional vehicle.

With the increasing number of funds on the market, greater competition is resulting in the reduction of these fees. As a result, we are starting to see a more competitive offering with a more reasonable fee structure.

At this point, a lack of new Sukuk issuance implies that the fund maturity profiles may be shorter than what would be preferable. The impact of current market circumstances on future developments will remain, although even these challenging circumstances offer opportunities for investors.

(The views presented in this article are those of the writers and do not necessarily represent BLME's)

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