The Islamic Wealth Management Industry (IWMI):
Is the Current Financial Crisis A Blessing In Disguise?

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Presentation Outline

• Islamic Finance and the Financial Crisis
• Current State of IWMI (Magnitude and Performance)
• Current Islamic asset classes
• Investment Objectives not currently addressed by IWMI, and appropriate mutual funds
• SWOT Analysis
• Recommendations
Islamic Finance Immune to the Crisis

• France plans regulatory and legal adjustments, to attract Islamic finance business

• French Finance Minister Lagarde "Islamic finance is calling out to us"

• The Vatican recommended adopting the principles of Islamic finance to "ease the dangers of excessive credit generation."

• Prof. Rodney Wilson: no Islamic bank has failed in the crisis
Crisis has Slowed-Down Islamic Finance

• “Credit crunch has impacted asset prices,
  – ➔ not a good crisis for Islamic banks.

• “Islamic finance is based on the sharing of risk between institution and depositor
  – ➔ clients will see what exposure to risk really means”.

• “Crisis led to **freezing** of overly innovative structures,
  – ➔ delays in Islamic derivatives and hedge funds”.
Current State of IWMI

Main drivers for Shariah-compliant financial product innovation and growth:

• Surge of oil prices

• Rising Muslim wealth & financial sophistication

• Increasing interest in investing according to Shariah
IWMI’s Magnitude

- Islamic finance about 1% of global market;
  could reach $4 trillion in 5 years.

- 20% of Muslims in Asia and GCC “would opt for Islamic financial products if given the opportunity”.

- Shariah-compliant investments worldwide are between $1 trillion and $1.5 trillion.

- Shariah-sensitive investable assets in GCC and Asia were about (2008: $736b) up from (2007: $267b).

- ➔ a potential annual revenue pool of $3.86b for IWMI.
IWMI’s Growth Potential

• “the market has witnessed
  – enormous demand, yet almost no supply”.

• Tareq Al-Rifai  Director of Dow Jones Islamic Indexes
  – “the Islamic investing business in general, and indexing in particular, are both so relatively new
  – only a small fraction of the Muslim public is even aware of its existence (and opportunity)”

• % of households in the Middle East who own stocks < USA figures
  – if the public is educated ➔ potential growth of Islamic funds’
Muslim investors

- *The entire industry is competing for 10%-20% of the global Muslim population”*

- IWMI needs to take Islamic finance to the **masses**, by *looking at their profile and risk appetite*

- A “*client pull rather than product push*” strategy is needed.

- HNW investors fin. assets at least US$1m; UHNW assets > $30m,

- Both “*prefer Shariah compliant products, but it is not compulsory*”.

- “*the longer the global downturn continues the more appealing will Islamic financing become to HNW and UHNW Muslim investors*”.

-
Evidence of Non-Muslims’ Interest In Islamic Investing

- “67% of new money now flowing into the sharia-compliant Amana Funds at Saturna Capital in USA, comes from non-Muslims”.

- “European and Asian investors are buying into Middle East Islamic bonds in a bid to diversify their portfolios.

- Japanese investors are intrigued by Malaysian Islamic investments.

- “half of HSBC's Islamic mortgages in Malaysia went to non-Muslims the first year the company offered them”.
Current IWMI Asset Classes

• **Conventional funds’ 3 asset classes:**
  – cash equivalents, bonds, and stocks.

• **Islamic funds’ asset classes** include Islamic products such as: Murabahah, Mudarabah, Ijara and Sukuks.

• There are 2 types of Islamic products,
  – “**A-Z Shari'ah-compliant structured products**”
    • both the structure and underlying asset are shariah-compliant,
    • favored by Islamic banks
  – “**Islamic bridge products**”
    • “a Shari’ah-compliant structure exposes investors to economics of non-Shari’ah underlying assets.”
      • specialty of Western banks,
      • criticized by shariah scholars,
      • their use on the rise.
Building Blocks of IWMI

• Deposit Accounts
• Mudarabah or a Wakala accounts
• Money Market Accounts
• Sukuks
• Commodity Murabaha Transactions
• Ijara Certificates
• Private Equity
• Venture Capital
• Derivatives
Islamic Fund Choices

- **E&Y (2009) prediction:**
  - The Shariah-compliant funds industry can "catalyze the next phase of growth" in the Islamic banking industry

- Over 300 different companies currently manage Islamic mutual funds.

- **Shariah indexes**
  - Shariah-compliant investing more affordable for the public

- # of Shariah-compliant funds grew by **22.7% CAGR** over the period **2003-October 2008**.

- **Financial crisis**
  - fewer new funds were launched in 2008 compared to 2007,
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<tr>
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<tbody>
<tr>
<td><strong>Assets under mgt</strong></td>
<td>N/R</td>
<td>N/R</td>
<td>$25 billion</td>
</tr>
<tr>
<td><strong>Number of funds</strong></td>
<td>61,000</td>
<td>679 funds as of Q2, 2009</td>
<td>561 funds as of Q2, 2009</td>
</tr>
<tr>
<td><strong>Fund Category Distribution</strong></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td><strong>Equity</strong></td>
<td>42%</td>
<td>52%</td>
<td>55%</td>
</tr>
<tr>
<td><strong>Fixed Income</strong></td>
<td>22%</td>
<td>7%</td>
<td>11%</td>
</tr>
<tr>
<td><strong>Balanced</strong></td>
<td>20%</td>
<td>10%</td>
<td>N/R</td>
</tr>
<tr>
<td><strong>Money Market</strong></td>
<td>6%</td>
<td>13%</td>
<td>13%</td>
</tr>
<tr>
<td><strong>private equity</strong></td>
<td>N/R</td>
<td>N/R</td>
<td>18% PE and real estate combined</td>
</tr>
<tr>
<td><strong>real estate</strong></td>
<td>N/R</td>
<td>N/R</td>
<td>3%</td>
</tr>
<tr>
<td><strong>Mixed</strong></td>
<td>N/R</td>
<td>N/R</td>
<td>17%</td>
</tr>
<tr>
<td><strong>other</strong></td>
<td>10%</td>
<td>18%</td>
<td>3%</td>
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Table (1) Mutual Fund Category Distribution  
(N/R)=Not reported
Performance of Islamic versus conventional Indices

<table>
<thead>
<tr>
<th>Index Performance</th>
<th>Global BMI 5 yr</th>
<th>USA500 5 yr</th>
<th>Europe350 5 yr</th>
<th>Japan500 5 yr</th>
<th>GCC Composite 2yr</th>
</tr>
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<tbody>
<tr>
<td>S&amp;P Shariah</td>
<td>-28.52%</td>
<td>1.07%</td>
<td>5.67%</td>
<td>-2.49%</td>
<td>-16.08%</td>
</tr>
<tr>
<td>S&amp;P</td>
<td>-28.67%</td>
<td>-2.24%</td>
<td>2.97%</td>
<td>-2.86%</td>
<td>-14.86%</td>
</tr>
</tbody>
</table>

Table (3) Performance of S&P Conventional and Shariah Indexes in Various Countries as of June 30, 2009

Performance of IWMI During The Financial Crisis

• Past five years
  – the DJIMI has declined 4%, outperforming
  – the conventional Dow Jones World Stock Index declined 8%

• The S&P Shariah indexes for USA, Europe, and Japan have outperformed their conventional counterparts for the 5 years ending June 30, 2009

• “Shariah investing has delivered a good track record in difficult times with out performance and lower volatility”.

• inverse correlation with financial stocks ➔ IWMI might fall behind once the financial sector’s recovery begins.
Current Islamic Funds Situation

- Most funds
  - invest in *equities* and focus on *growth and capital protection*.

- **Asset allocation** does not suit the **risk/reward** profile of the **average Muslim** investor who **typically**
  - does **not** have $10,000 minimum initial investment
  - prefers **stability of principal** or **current income** objectives

- **IWMI needs to consider Investors’ differences** in terms of
  - goals, time-horizon, degree of risk tolerance, constraints, and liquidity requirements
Stability of Principal (SOP) Objective

- the most conservative objective ➞ the lowest return

- The SOP client
  - prefers no chance of principal decline
  - has a limited amount of capital or is
  - less educated about investing.

- Investment Vehicles include
  - Murabahah Funds:
  - Principal Protected Funds
    - most (attractive and expensive) during volatile market cycles.
Income Objective

- requires taking more risk and generates a higher income than SOP

- Income client is typically
  - retired and tolerates a periodic principal decline.

- Investment vehicles include:
  - Sukuk Funds
  - Ijara Funds
  - Currency Funds
  - Commodity Trading Funds,
  - Equity Income Funds: dividend-paying large stocks.
Growth Of Income Objective (GOI)

• The GOI client sacrifices some current return for some protection against inflation.

• Investment vehicles include:
  – Mudarabah Funds,
  – Real Estate Funds:
  – Balanced Funds
  – Value Funds: P/E< industry average.
  – Index mutual funds, mirror an index such as DJIM
Capital Appreciation Objective (CA)

• Most aggressive objective ➔ highest return and lowest income.

• CA client is typically
  – young, wealthy, has a high tax bracket,
  – is interested in growth, and
  – does not need current income.

• Investment vehicles include:
  • Growth funds
  • Small-Cap funds
  • Mid-Cap Funds
  • Sector Funds
  • International funds.
  • Islamic Hedge Funds.
  • Exchange-Traded Funds (ETF’s)
  • Private Equity funds
SWOT Analysis of IWMI: Strengths

• **Conservative practices:**
  – IFI’s are moderate investors.

• **Risk Sharing**
  – represents an investor’s safety net.

• **Valuable Screening Criteria**
  – Screening helps in avoiding bad stocks,
  – Serves as a "**valuable analytical tool**".

• **High Growth Potential**
  – "**people are buying this product for a very simple reason - the Middle East is going up**".
Weaknesses of IWMI

- Reservations about Islamic Finance Industry Practices

  - “*Islamic financial system has not come out of the straitjacket of conventional finance*”

  - “*Islamic financial products as Shari’ah-compliant caricatures of conventional offerings*”.

- **Humayon Dar**: 75% of Muslims
  - “*reject Islamic banking and finance, it does not offer any real economic value, different from conventional products*”.
Weaknesses of IWMI

• Diverse Regulatory Requirements

• A Fragmented Industry ,
  – divergent views ➔
    – “it's difficult to set up a geographically diversified Islamic fund”.
  – More than 50% of Islamic funds have $20m or less in AUM,
  – 67% have <$100m AUM ➔
    • higher expense ratios,
    • an inability to benefit from economies of scale.
Weaknesses of IWMI

Fund Construction and Management

• Limited Availability of Islamic products in some countries
• No Generally Accepted Investment/Screening Guidelines
  – Screening dissimilarities lead to "insecurity and distrust of Islamic investors into financial products like funds" and
  – may hinder IWMI’s growth.
• Disputed Income Purification Standards
• High Set-Up Costs
• High Research Costs
Weaknesses of IWMI

Sales and Marketing

• Narrow Product Offerings
  – Muslim investors resort to “products that replicate the performance of conventional assets in a Shariah-compliant way”.

  – IWMI needs diversity “both in terms of management style as well as in underlying assets”.

• Short Track-Record
  – difficult to compare relative performance with conventional funds.
Weaknesses of IWMI

• **Human capital**
  
  – Shariah Scholars’ Shortage
  
  – Professional Managers’ Shortage
    • best managers are mostly from the conventional sector.

• **Distribution delays**
  
  – “the local Islamic banks re-approve every product they distribute”

• **Misconceptions about IWMI**
  
  – “Islamic investments products still perceived to be fairly niche & not totally understood”
Weaknesses of IWMI

Risk Exposures

– Shariah Risk
  • “the risk that the product you thought was shari'a-compliant may turn out not to be”.

– Reputational Risk
  • reputation-damage if there are doubts about the products’ shariah-compliance.

– Suspicions of Links to Terrorism

– Scholar’s Non-Consensus Risk

– Exposure to Volatile Real Assets (oil, real estate, commodities)

– Weak Risk Management Tools
Opportunities

• Increasing Scrutiny by AAOIFI of Islamic Products and Services.

• Re-Evaluation Breather
  – *Crisis ➔ Scholars reassess the sharia-compliance of some of the products that emerged in the boom years*.

• Major Cities’ Interest in Islamic Finance

• Rising Interest In Professional Management (due to Recent Stock market volatility)

• Less Restrictive Regulatory Framework (foreign investments allowed in)

• Portfolio Diversification Benefits (for Western investors, low correlation with West)

• Untapped Muslim-Investor Demand *in the West and Muslim countries*

• Rising Interest from Socially Responsible Investors
Threats to IWMI

- Inactive Secondary Markets
- Increased Competition
- Double Taxation
- Uncertain Regulatory Environment
Recommendations

• Establishing a Global Regulatory Body

• Improving Governance

• Innovation Leadership by IFI’s not the West!

• Enhancing Secondary Market Liquidity
  – distribution of Islamic Sukuk funds,
  • ➔ smaller retail investors invest in Sukus
    – ➔ better liquidity

• Product Standardization (Controversial!)
  – reduce transaction costs and
  – lower entry barriers for international players
    • ➔ Increasing competition
    • ➔ benefit of customer
Recommendations

• Educating the Public

• Marrying Shariah and Corporate Social Responsibility (CSR)

• Diversifying Product Offerings

• Improving Marketing/Distribution

• Targeting New Investor Segments

• Standardizing Screening Criteria
Conclusion

Professor Mehmet Asutay calls for taking an inward look at Islamic finance’s ethicality

- "there is little indication that the industry is entirely ethical…"
- Their perceptions of CSR remain within the framework of zakat distribution and other non-systemic charitable activities rather than
- working towards capacity building for developing communities".
• Questions?