# If there's a will, there's a way

Shariah-compliant asset management has to address a number of issues to match the sophistication of Western models, writes John A Sandwick. But the Muslim world has faced harder tasks

In 1952 the economist Harry Markowitz first published his treatise on modern portfolio theory (MPT), which later led to him winning the Nobel prize with Merton Miller. MPT is at the heart of every professional asset manager's basic investment strategy. First and foremost among Mankowitz's findings was the need for diversification of assets. As the saying goes, you buy a portfolio, not a security.

We now have other important tools for asset management: Sharpe's capital asset pricing model (CAPM), and Tobin's development of the concept of the efficiency frontier, to name two.

These models were developed in the West, using observations of changes in market prices and volumes of publicly traded securities. They are deeply embedded in the thinking behind professional asset management in nearly all the world's markets. They underlie the basic concepts used by investment managers to create and execute their investment strategies.

By comparison, the Islamic banking community has delivered almost nothing of value to professional asset managers—whether inside or outside the Muslim world—in terms of investment products that permit the construction of modern portfolios that responsibly meet client needs. Professional Islamic wealth managers are at a loss. How do we construct an efficiency frontier? What data goes into the capital asset pricing model? Where can we go to find securities that will fit into modern portfolio theory?

First, look at a normally constructed Western portfolio: think about why it was so constructed, and then look at how it meets the "social responsibility test" for wealth managers. Then try to create a parallel Islamic portfolio and see whether you can find one that meets the social responsibility test. I'm afraid you'll be disappointed with the results.

### Western portfolio

Western portfolio management has as its key ingredient the matching of expectations of the future performance of assets held today with the requirements of the owner of the assets at some point in the future. That is what wealth management of any kind is all about.

Whether for an individual or an institution, wealth management means investing today to achieve some specific future goal. If we know, for example, that the client is a 37-year-old businessman named Bob, and that Bob has three children, expects to retire in 28 years with specific payment obligations expected throughout his working and retired life, we can develop a portfolio allocation strategy that will have a good degree of probability in achieving Bob's objectives. Or, in the same vein, the client could be a private pension fund.

The only difference in establishing the investment strategy would be, of course, that payment obligations last as long as there are pension fund members, which conceivably could be forever. First, using MPT and CAPM and other tools from Western economic science, we establish some kind of allocation strategy that will achieve our goal. We'll come up with a portfolio of assets that meets standards for risk, liquidity, income and potential for capital appreciation. Bob's portfolio might look like the example "Western model for middle-aged man".

Looking at the historic average performance of these asset categories, let's assume history repeats itself. We can construct an average annual performance calculation and determine whether we're going to meet our client's long-term savings and income needs in the table below.

Now, let's assume our client, Bob, has an initial balance of $1m, must pay something like $60,000 a year in various expenses not covered by his salary (until he retires at 65), will have retirement expenses of $150,000 per year, and wants to pass on not less than $1m portfolio value to his children at the end of his expected 75 years of life.

We can now complete the picture by drawing out Bob's full retirement plan and modify our investment allocation to make sure Bob will make it (see "Full retirement plan", right). Thankfully, Excel makes this easy.

Fortunately for Bob, things look pretty good. He'll make it, with almost $400,000 to spare. This does not take the effects of inflation into consideration; it is simplistic by design.

The nice thing about the way wealth management has developed in the West is that we can sensitivity-test the various

**Western portfolio for middle-aged man**

| ASSET CATEGORY | NOTES | ALLOCATION |
|---|---|---|
| Cash | Safe, liquid, used for opportunistic buying and client emergency needs (no risk) | 5.0% |
| Bonds | A full range, from highly rated to junk, from domestic to international, but all guaranteed by the issuer (lower risk) | 55.0% |
| Equities | A full range, from large- to small-cap, domestic & international (riskier) | 25.0% |
| Alternative investments | Various, including hedge funds, private equity (venture capital), forex, other exotics (much riskier, somewhat illiquid) | 5.0% |
| Real estate | Mixed, if possible, providing both cash yields and capital gains (less risky, but illiquid) | 10% |
| Total | | 100.0% |

**Annual performance calculation**

| ASSET | EXPECTED PERFORMANCE | WEIGHT | WEIGHTED PERFORMANCE |
|---|---|---|---|
| Cash | 2.5% | 5.0% | 0.13% |
| Bonds | 5.5% | 55.0% | 3.03% |
| Equities | 10.0% | 25.0% | 2.50% |
| Alternatives | 10.0% | 5.0% | 0.50% |
| Real Estate | 7.5% | 10.0% | 0.75% |
| Total | | | 6.90% |

| Full retirement plan | |
|---|---|
| INITIAL VALUE | $1,000,000 |
| Average annual return | 6.90% |
| Payouts 37–65 years old | –$60,000 |
| Payouts 65–75 years old | –$150,000 |
| Future value at 75 years old | $1,391,988 |
| Required future value | $1,000,000 |
| Over funded future value | $391,988 |

possible outcomes. We can increase Bob's pre-retirement spending (but not by much) or we can factor in expected future inflation. We can change the allocation mix to increase future value by taking more risk, or decrease it by taking less.

Once we've established these parameters for Bob, we can select a portfolio in each asset category that fits the investment requirements. The final selection will give us a high degree of comfort and confidence because we've got mountains of data on each asset category, and on almost every security available.

For a single individual or family, this is an easy job. Take this to the level of a pension fund, and things get a lot more complicated. However, the tools are the same in both cases.

**Western capital markets**

Western capital markets have evolved over many generations and provided us with a wealth of securities in all asset categories. By "western capital markets" I mean any market modelled on Western markets, which would include, in this case, nearly all of the capital markets of the OECD member states.

There are something like three million or more traded securities in the world, and the number is growing fast. Five years ago I counted about 2,500 hedge funds. This has increased to more than 12,500 (including funds of hedge funds), a growth of 400%. Mutual funds numbered around 100,000 at least—now perhaps 50% more. These totalled about 75,000 10 years ago.

Western markets are liquid, vast and heavily traded. Securities change hands at lightning speed and in large volumes, and they have been doing so for decades. This market liquidity and history drives the large databases established by the likes of Reuters, S&P and others—databases that permit us to select carefully a portfolio of securities that will meet Bob's future investment objectives.

Clearly, the Western markets have developed tools for responsible wealth management; these tools rely on databases showing historic performance of securities; these databases exist because there are enormous amounts of highly diversified assets traded in the Western markets; and combining the vast diversity of assets with an abundance of security and market information and modern portfolio tools allows a professional wealth manager to perform his job responsibly.

**Comparison with Islamic model**

Now I shall perform the same exercise for Abdullah, who wants his assets allocated to the best Shariah-compliant assets. Abdullah is a lot like Bob. From a wealth management perspective, the assignment is the same.

Abdullah is also 37, has three kids, will retire in 28 years, and will expect to live until he's 75. Although he lives in Riyadh, Abdullah has the same spending expectations as Bob, and also wants to pass on the same $1m fortune to his kids on his expected death (although, allowing for a different distribution of assets, which does not change our assignment). For the past five years I've been openly challenging everyone from the Islamic wealth management community to give me a solution to Abdullah's needs. In the same time, I've met with disappointment after disappointment. No one yet has solved this problem.

While Abdullah's needs are exactly the same as Bob's, the Islamic banking community has given us almost nothing to select from to fulfil his investment requirements. We must resort to guesswork, shortcuts, and opaque securities and markets to get close to what we want. In Abdullah's case, what does change is the securities we put into that allocation (see "Islamic banking asset categories").

Given the general condemnation of the Islamic banking community's delivery of responsible investment products, let's try to be a bit more objective and make a comparative scorecard of what is available in the market (see "Islamic versus Western wealth management" overleaf). If you've spent as much time as I have in Islamic banking, you'll probably come up with similar results. My scoring is made on a scale of 1–10, with 10 representing the highest trading activity, liquidity,

| Islamic banking asset categories | |
|---|---|
| ASSET | NOTES |
| Cash, 5.0% | There are a relatively rich supply of deposit-like substitutes, but also amazing weaknesses. The largest *murabaha* fund is NCB's Riyal Trade fund, with more than $1.7bn. But where in the world does a bank put $1.7bn of riyals? The bank's dollar version is a paltry $290m. And both funds are presumably allocated almost entirely to finance the steel inventories of selected Western steel companies. More than 90% of the allocation for both mentioned funds is to a category called "metals"—a short form of saying they are providing inventory financing to a few steel companies in the West. There is little diversification. While good, this is far from a perfect place to keep cash. |
| Bonds, 55.0% | There are more than $25 trillion in bonds outstanding just in the US, not to mention Europe and the rest of the world. But the entire issuance of sukuk today is only about $10 billion, or about 0.4% of the US total. Worse, almost none of the existing sukuk trade on any exchange, so there is no real market price, meaning no historic databases for performance measurements. Plus, few sukuk are rated, meaning little to go by in terms of credit analysis. This is the worst of all possible worlds: scant supply, illiquid, opaque. Would you buy them for your customers? |
| Equities, 25.0% | Here the situation is vastly better. A relatively large, deep pool of reasonably well capitalised shariah-compliant funds exist all over the world in many categories. Unfortunately, the total number of funds is still a minuscule percentage of their western counterparts, and many shariah-compliant equity funds are themselves so small you wouldn't accept them as a single client! While we see substantial improvement versus cash and bonds, there is still a long way to go before we have a reasonable pool of good equity funds to choose from. |
| Alternative investments, 5.0% | Again, a terrible situation. What do you choose? There are an abundance of opaque venture capital funds (deceivingly called private equity by many Islamic banks), nearly all of which work on the margins of the mostly Western world's venture capital industries. They charge huge fees, are enormously expensive, and no one really often knows who manages the funds. We've seen some silly efforts to create hybrid Islamic hedge funds, none of which has yet to impress me one bit. In short, a terrible situation for Islamic wealth managers. |

information, transparency, and the other factors that go into the ability to select investments for the clients of our wealth management services.

If you believe this summary is even half right—and part of the problem is there's almost no way to make this comparison even partially objective given the lack of data from the Islamic banking community—then you'd still come to the same sad conclusion. There is still no possible way to manage Abdullah's long-term family assets responsibly.

**Shariah-compliant assets**

As you can guess, I am bearish on the Islamic banking community's ability to deliver the securities we need to invest our clients' money. Imagine in Abdullah's case: you have $550,000 you must invest in sukuk alone, but you cannot purchase illiquid, long-term assets, you cannot buy unrated assets, and you cannot buy an asset that is not exactly what it claims to be. If you can't do this with $550,000, you certainly cannot do this with $550m or $5.55bn of client money.

Too many times I've seen some wacky sukuk issuance that is nothing more than equity in disguise. I'll be the first to admit that a sukuk should, by nature, carry more risk than a traditional Western bond. But, what do you call a sukuk that is used to pour sand into the sea to build villas and apartments for homeowners that haven't even bought a single home yet? I've seen more than enough of those extreme-risk sukuk. And what do you call a sukuk that can't be bought or sold for seven years? Plenty of those are around. Further, what do you call a sukuk that's not had a single independent rating for credit worthiness? Lots of those are in the market.

The sukuk market has gone nowhere and even today is barely going anywhere. That is a true shame, as the sukuk market is where nearly every Islamic banking house in the world should be pushing huge human and capital resources.

No one can tell me that there are not vast quantities of long-term fixed assets in the Muslim world that could not be immediately securitised into debt-like instruments that meet all Shariah criteria. Aeroplanes, trains, container ships, industrial equipment, even consumer assets such as automobiles and refrigerators could be bundled into multi-billion-dollar asset pools from which vast quantities of sukuk could be issued. There are also more than a few corporations and even governments that could enter into sukuk borrowing. There is one reason $1 trillion of sukuk is not filling the gaping hole in the Islamic banking markets: fees and commissions. Sukuk issuances will never be as rich in fees as venture capital. Nor will they come close to the fees earned by sponsors of real estate development. We'll probably have to wait a long time before the sukuk market reaches issuance and trading volumes that satisfy the needs of the Islamic wealth management community.

As for the other Shariah-compliant asset categories, one of the biggest problems is liquidity. Does anyone know the percentage of Islamic assets that are liquid? My guess is that when you remove the *murabaha* deposit substitutes and equity funds you've probably got not more 5% of all Shariah-compliant assets traded on any market, and even then traded in small quantities.

Further, how about settlement? In Switzerland as elsewhere in the developed world, we use Clearstream and other major clearing houses between our custodian banks and the markets. There is an efficient global system to administer the trade, clearing and settlement of almost any Western investment product, even the most obscure. How many Shariah-compliant products are able to settle on Clearstream? My guess is that not even 5% of all Shariah assets—including *murabaha* deposit substitutes and equity funds—can enter into that realm.

Asset managers usually play by the same rules, regardless of their jurisdiction. In Switzerland there are rules and unshakable guidelines that are pretty much replicated everywhere else. You must invest according to the basic "prudent man" principles:

- the large majority of a client's assets must be tradable and liquid
- the large majority of a client's assets must be settled in a normal and conventional fashion
- the large majority of a client's fixed-income (or sukuk) assets must be rated
- the large majority of the client's assets must be utterly transparent in terms of statutory reporting, and
- the client's assets must be diversified, with no single asset taking more than 10% (or less) of the total amount managed.

Given these standard, common sense universal rules of wealth management, can you imagine a fully Shariah-compliant portfolio constructed with modern, responsible, professional asset management methods? I can't. There just aren't enough qualifying assets in this world today to do so.

**Islamic v Western wealth management**

| ASSET | ISLAMIC | WESTERN |
|---|---|---|
| Cash | 2 | 10 |
| Bonds | 1 | 10 |
| Equities | 5 | 10 |
| Alternative investments | 1 | 7 |
| Real Estate | 2 | 8 |
| Totals | 11 | 45 |

**Full steam ahead**

Shariah-compliant wealth management is in its earliest stages of infancy. Despite more than 20 years of continual research, development and innovation, the Islamic banking community has yet to give us the securities we need to perform our professional responsibilities.

Some people will argue with the following logic. "You in the West have more than 200 years of capital market experience. We in the Muslim world have only 20. How can you expect us to evolve our systems, procedures and products so quickly? We are in our infancy because we must be there. It takes time."

I grew up in Silicon Valley, and only 32 years ago I used a slide ruler before a calculator. In that 32 years my own life transformed as the digital and information revolutions took hold. In other words, no one can tell me the Muslim world needs another 180 years to evolve responsible Shariah-compliant wealth management. If we can go from slide rulers to Excel spreadsheets in one generation, we can move to trillions of dollars of Shariah-compliant securities in less time.

The great shame is the technology and inventiveness and know-how to achieve these goals already exist in the Muslim world. There is also trillions of dollars of government and private business that can be financed with Shariah-compliant securities. The momentum is slow. To deliver vast quantities of assets for the Islamic wealth management community, we must keep up the pressure on the Islamic banks, and people like me continue noisy criticism of our colleagues on the other side of the Chinese wall, begging them to deliver what we need. n

*John A Sandwick is managing director of Encore Management SA, 40 rue du Marche CH 1204 Geneva, Switzerland*