Islamic Wealth Management

John Sandwick was born in California, but he and his family spent much of the 1970s and 1980s living in the UAE, Bahrain, Kuwait, London, and Washington, D.C., in the 1990s. John has a master's degree in development banking from The American University. He frequently publishes and speaks professionally on investment and finance issues, in particular on Family business and real estate investments. John was formerly a private banker at Deutsche Bank and Credit Suisse Group before founding Encore in the fall of 1998.

Money doesn't drop from the sky or bubble from the ground. Most of us know it's got to be earned, or at least you've got to work hard to find it.

Historically, a great deal of the money needed to generate economic growth in the Muslim world was delivered in the form of expensive, illiquid and often hard-to-get equity, and very little else. There has not been a large volume of funds for businesses, projects or governments delivered through the wide variety of investment securities that are common in the West.

Fortunately, things have changed and continue to change rapidly. The Islamic banking space is making more room for investment products that channel funds from savers to users of capital. In between these two is the Islamic wealth management community, populated by people like me who must direct a Muslim client's wealth into productive, efficient Islamic investments.

A Wealth of Tradition

In most Western countries, people take it for granted that companies and governments obtain money by borrowing from a bank or issuing stocks or bonds. Western markets are rich and Western banks have long histories of corporate and government lending. Financial intermediation between Western savers and users of capital can be considered highly efficient, in large part due to the very large diversity and volume of "investible" securities dreamed up and delivered during 300 years of financial innovation.

But, outside of bank deposits funding bank loans, where does all the money really come from? Stocks and bonds and other paper assets are created by investment banks, representing ownership of an enterprise or debt guaranteed by it. Investment banks don't actually invest their own money in these assets, though, or at most only very little. The money comes from investors, those millions of individuals who have stashed away a bit of their money for a rainy day. Even when the investor is represented by

The ultimate funding source for Muslim-world economic development

By John A. Sandwick

a large pension fund, nearly all the money is ultimately coming from individuals and households.

Over time, the amount of savings becomes truly monumental. There's no doubt that U.S. pension funds alone now account for something close to $20 trillion in all. Add to that the money "saved" by endowments, charities and foundations, and you've got a few more trillion dollars in the pot. The channeling of massive volumes of capital between savers and users is done efficiently and frequently, feeding economic growth at the widest possible level.

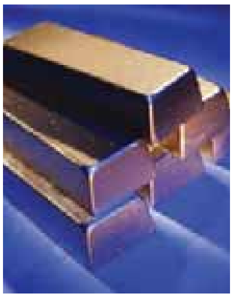
Bridging the Gap

Most of this money - the tens of trillions of dollars in the U.S. and the nearly equal trillions of euros in Europe, money that finances nearly every aspect of economic growth - is subject to the scientific principles of modern wealth management. Wealth managers invest client money into every conceivable asset, from stocks to bonds to funds to real estate to projects to simple deposits, and everything else in between. Wealth managers are the "bridge" between the two sides: those with savings on the one side, and those who need cash for their businesses, projects or governments on the other.

A good number of people involved in the establishment and study of wealth management's theoretical and practical applications would agree that they are immune to religious beliefs. They are, as you might say, free of faith. Consider this: If you are a professional wealth manager, you aren't concerned (up to a point) whether your client is Muslim or Christian or Hindu. The assignment is always the same: Today's savings plus tomorrow's savings must be allocated into assets with somewhat predictable behavior so that some kind of future goals can be achieved.

When Religion Matters

Take for example Abdullah and Bob. Both are 37 years



old, both have three children of varying ages, and both inherited $1 million. They are working men, envisioning retirement sometime in the coming 30 years. They need to save for their retirement today, plus save for the expected costs of their children becoming adults (university, marriages, etc.).

The assignment for both men involves mathematically mapping out the path from today to tomorrow. To achieve their retirement and inheritance goals, a series of assets must be purchased today, over time they need to occasionally be rearranged and ultimately they need to be cashed out for final distribution.

Only when you go from finalizing the investment strategy to actually investing the money does religion come into play. Securities selection for Bob is simple. There are something like 250,000 mutual funds in the world, and more being produced every day. And there are something like 2 to 3 million securities available worldwide for investing: stocks, bonds, funds and other investment vehicles. In fact, the choice of assets is so enormous that the process of securities selection for Bob's portfolio actually gets pretty complex. How to choose from an apparently unlimited selection of assets to meet highly specific allocation targets?

Abdullah, on the other hand, has made it clear that Islam is involved in all parts of his life. He is pious and devout. He will not violate his religious prohibitions, not even when it comes to his long-term family savings. He is not alone. Most of the world's 1.2 billion Muslims will agree on one thing: God's laws over man are immutable, including on how we manage our savings.

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Islamic Challenge

Unlike the traditional counterparts, the Islamic mutual fund world now consists of only perhaps 450 different funds. That itself is about 0.25 percent of the funds available to a traditional wealth manager.

So, how does one go about investing Abdullah's money? Certainly we are already limited enough when it comes to mutual funds, but with an estimated $2.5 trillion in total wealth, we can imagine the world's Muslims deserve more.

There's another major identifiable problem. Of the $33 trillion in savings held by the world's wealthiest people in 2005, about 3.6 percent of that was owned by Arabs of the Middle East. That equals about $1.2 trillion, which by any measure should be allocated professionally and responsibly, but also should be allocated according to a client's religious beliefs.

Sukuk on the Horizon

In the world today, about 45 percent of all managed wealth is invested in bonds and other types of fixed-income securities. Bonds are favored as a key asset class because they are generally safe, guaranteed and provide known annual interest payment. In the Muslim faith, however, all these features are considered haram, or unlawful. Contracts embedding financial guarantees like those found in typical bonds are not allowed.

One would think that with at least $530 billion in play (this excludes Islamic institutional wealth, by the way, which would multiply the amounts several times); the Islamic banking community would be quick to replace the traditional bond with sukuk, or the "Islamic bond."

We haven't been so lucky. Through the end of 2005, the total amount of sukuk issued (outside Malaysia) was barely $15 billion. Compare that to the $25 trillion or so issued and outstanding just in the United States, and you'll understand how small $15 billion can seem.

Thankfully, 2006 is going to be a banner year for new sukuk issuances. By June 2006, the amount of new sukuk reached $13.4 billion, nearly the entire amount of sukuk outstanding at the end of 2005. Moreover, we can envision a total new issue of sukuk during 2006 of well over $20 billion, adding in total over 108 percent more sukuk than in 2005.

Still Far to Go

But when you're talking about potential demand in the hundreds of billions of dollars, you'll quickly realize just how small the total issuance of new sukuk really is, and how far traditional and Islamic banks still must go to fulfill the Islamic wealth manager's objectives.

What makes this even more unfortunate is the supply of assets in the world that can be easily financed through traditional Islamic contracts. Sukuk in all cases must have an underlying hard asset. Sukuk exist to provide cash for underlying assets such as aircraft, ships, railway stock, buildings, commodities and other identifiable assets that you can touch and feel.

Just in the Muslim world alone, there must be a few trillion dollars of such fixed assets. Until today, most regional borrowers in the Arab world have opted to finance these assets with traditional loans or bonds. And the regional and international banks have been eager to respond with large volumes of traditional debt. While the Islamic banks are an ever-growing feature in the Muslim world's banking sector, their total assets are still a minority compared to traditional banks. Further, they have not yet accrued the internal credit analysis resources that traditional banks have long enjoyed. Without a doubt, one of the biggest stumbling blocks to more creative and expansive Islamic financing of Muslim-world assets is the lack of large armies of trained and skilled credit analysts.

Taking the Easy Way Out

Slowly, things are changing, of course, but in the meantime we're witnessing some relatively abusive behavior by many of the Arab world's banks and investment banks. Taking the easy way, and choosing the "flavor of the month," they have opted to produce veritable tidal waves of nearly identical real estate and venture capital investments under the shariah banner. A lot of their so-called "private equity" funds, for example, are really nothing more than high-risk venture financing sources, cleverly labeled to confuse investors who often don't understand the differentiation between the two types of investments.

Then there is the average life of a lot of the funds produced by the existing and growing pool of Arab Islamic investing banking companies. I have yet to see one that

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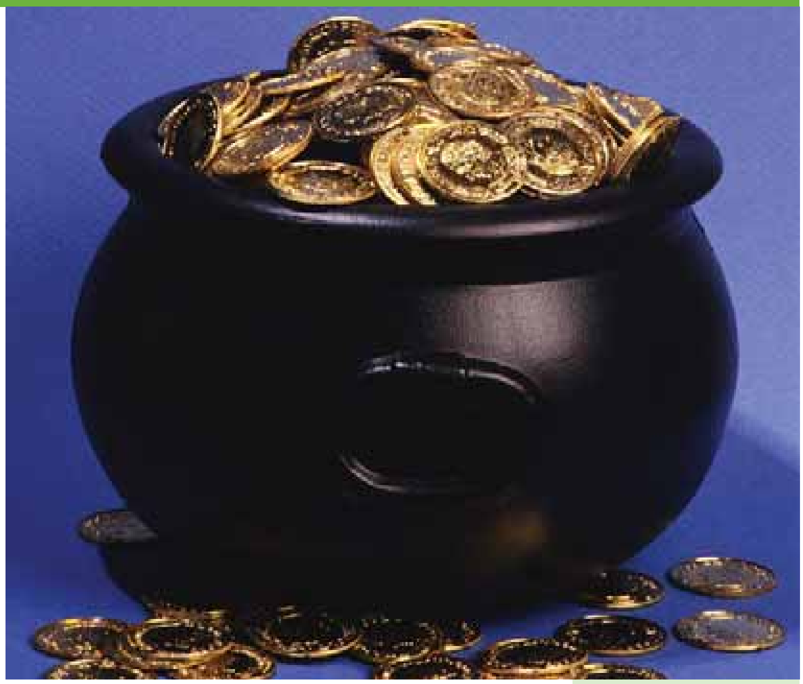
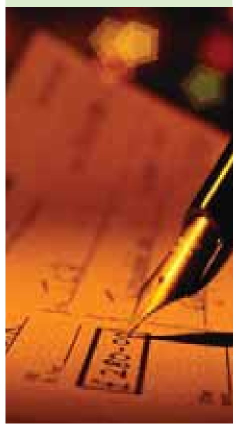


wasn't issued with an expected exit in five to seven years. These long-term assets are fine for everyone, but portfolio investing is by nature a liquid business, meaning the majority of a saver's assets should be placed into securities that can be redeemed within days, not years.

Western banks have not done much better, either. Nearly every week we're receiving calls from the derivatives desks of major money center banks, mostly European or American. They boldly claim yet another new derivative that carries fatwa, or shariah-approved certificate of compliance. We respond identically to all these calls: Don't bother calling. We are not interested in investing our clients' money into some imaginary asset, especially one that bears fees that are rich for the bank, thereby reducing even further the potential return for the buyer.

One would imagine that each global money center bank is responsible for creating tens of billions of dollars worth of debt annually through loans, bonds and other types of debt. One would imagine that a large percentage of this debt could qualify for Islamic financing. If only a fraction of one bank's annual debt creation were instead channeled to shariah-compliant financing, the result could double, triple or even quadruple the annual volume of sukuk issued every year.

But either the Western banks aren't interested or they don't see money in this activity. There is, on the other



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hand, lots of money in creating and distributing derivatives. Perhaps the reason we're inundated with calls from big-bank salesmen of Islamic derivative products is the comparatively higher earnings these products generate for the bank.

New Direction

Let's get back to the Arab and wider Muslim worlds. First, they are nearly all enjoying sustained higher GDP growth rates and increasingly sophisticated economies. Second, there is a greater degree of cross-border funding within the Muslim world each year, and an apparent reduction of at least private capital direct and portfolio investments to the traditional Western destinations. While figures are hard to come by, anecdotal evidence indicates we're seeing a new direction in the flow of capital, in particular from the oil-exporting nations of the Arabian Gulf region.

First, the economies of these states are capturing more of the newly generated wealth and liquidity than ever before. Whereas in decades past, a large amount of discretionary investment income was vacuumed up by Western banks for funding Western investment needs, a greater percentage of capital is now deployed locally. Regional deregulation and increased investor awareness in local investment assets has produced much of this new direction in capital flows from the GCC region. Antipathy toward the West and in fact a bit of fear of the West's approach to Muslim issues certainly has also contributed to local economies exporting less capital, at least from the private sector.

Second, as mentioned above, fast-growing emerging Muslim economies are proving more attractive places to place money dedicated to cross-border investments. Malaysia, Indonesia, Pakistan and other states are showing economic growth rates that most Western states would envy. Combined with their own deregulation and strengthening of financial systems, Muslim countries are often considered by private Muslim investors as a more logical and ultimately satisfying place to make investments.

As with the investment products we choose, managers of Islamic wealth are facing the same seismic shifts in the geography we choose to invest in. Our palette no longer consists of California shopping centers or a selection of NASDAQ stocks. It has expanded to Malaysian sukuk and Jakarta office buildings. It has broadened to include new GCC real estate funds and shariah-compliant emerging market equity funds. We are now delivering more capital than ever to funding the economic expansion of Muslim economies - businesses, projects and governments - than ever before.

Innovations to Come

We are still facing major hurdles in selecting our assets. As noted clearly above, there just aren't enough sukuk to go around, and we're being inundated with investments we clearly don't need: Islamic venture capital and derivative securities, to name two.

Overall, however, the future is looking very good, with some surprisingly positive developments in the Islamic banking space popping up almost daily. Encore Management is right now creating the world's first sukuk fund, in which the average Muslim can invest in shariah-compliant sukuk and achieve a scientifically supported allocation of assets for long-term family or institutional savings. There will be many more such innovations in the near future, each contributing to the more rational allocation between savers and users of capital in the Muslim world.

We have seen the Islamic banking space slowly progress over more than two decades, sometimes in fits and starts, but now showing signs of addressing the needs of investors and consumers of capital. This is good for the Muslim world, and will feed the engine of economic growth for many decades to come. ●