Chapter 6

Islamic Wealth Management

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6.1 Introduction

This chapter attempts to dispel myths about Islamic asset management and give readers a practical guide to Islamic asset management generally, but also define what is meant by the subset of Islamic asset management that is called Islamic wealth management.

First and foremost, it may be argued here that there really is no separate body of work called "Islamic asset management" whatsoever. The fundamental principles of asset management are universal, applying to persons of all faiths. To call anything "Islamic" asset management may be considered as a bit of a misnomer, as asset management is asset management for all people, all the time. Just as there is no Christian dentistry or Muslim heart surgery, there is a case for disputing a specific professional discipline named Islamic asset management if the modern principles of asset management are applied. The business of Islamic asset management can be practiced by anyone because it is the same as the universal term "asset management." Having said that, Islamic wealth management is a common term used in Islamic finance to emphasise that all the activities and investments are managed in accordance with Islamic principles of finance and investing.

There is a very big difference in the selection of securities for Muslims who wish to follow the precepts of Shari'a in their investing. But, since security selection is the very last step – and arguably the step with the least overall impact – of a complicated, disciplined and scientific process called asset management, this chapter will leave the "Islamic" portion of Islamic asset management to the very end of this paper.

Finally, we of course all are aware of the global industry and professional activity commonly called asset management. Over the last few years the term wealth management was introduced, first as a marketing tool and then as an actual distinction for a specific type of asset management. For clarity, this chapter refers to asset management as that practice generically involving the professional investment of money into securities, most often for institutional investors. The nomenclature of "wealth management" is reserved to mean the professional investment of money into securities, but only for individuals or families. Wealth management is inherently identical to asset management, except that it usually involves smaller amounts of money and the particular characteristics of individual – rather than institutional – wants and desires.

Islamic asset management, and its sister Islamic wealth management, therefore refer to the same general areas of investment activities as their traditional counterparts.

This chapter is expected to give the reader a better understanding of not just the application of Shari'a principles to investing, but to the general world of asset management, whether for individuals or institutions. The chapter is prepared for the lay reader, not the professional, and hence advanced terminology and concepts are deliberately left out.

6.2 Asset Management: How It Begins?

While faith and religion are an important part of the spiritual journey through life, they really do not have any role to play in the analytics surrounding asset management, in the construction of portfolios appropriate for a client's long-term investment needs, or in the monitoring of portfolio performance over time. Correlation coefficients, portfolio diversification and expected return are concepts existing in a disciplined profession context, and have no role in religious matters whatsoever. Just as defibrillation is to heart surgeons, client profiling, macro asset allocation and timing are to asset managers. Religion is relevant to ensure that security selection for clients who wish to invest according to Shari'a principles remains in compliance with the specific requirements. In many ways it is analogous to the discipline of ethical investing. In this respect, Islamic asset management remains in line with the universally accepted principles of asset management.

The professional activity called asset management was one of the many marvels of the second part of the 20th century, a period of time that witnessed explosive growth in the application of statistical tools and mathematical models to virtually every part of the human experience. Asset management, like rocket science and

brain surgery, benefited from the development of more complex methods to "see" the future by creating quantitative models, which is a basis of expected outcomes. As a corollary, one may think of metallurgists performing repeated stress testing on various types of aluminum, then applying the overall statistical performance of that testing to the design of pieces of the NASA space shuttle. This kind of statistical modeling is behind many of the greatest achievements of the last 60 years, from pharmacology to aeronautics to food production, and of course to asset management.

Statistical modeling and analysis is at the heart of asset management. The simplest explanation is as follows: One observes the behavior of the stock market price of Company A. Over time it goes up, down and moves in tandem with some stocks, and not at all in tandem with other stocks. From the observed historic data certain statistically relevant conclusions can be made: Company A's stock price will "probably" move up 1.5 times more than the market, or Company A's stock price will "probably" suffer 0.8 times the market's decline during the next recession.

This same kind of statistical analysis is then applied to other stocks, creating a universe of known historic behavior within an entire market. Then, one takes this same quantitative analysis and applies it to other asset classes: corporate bonds, emerging market bonds, sovereign bonds, hedge funds, real estate, foreign exchange trading, commodities, and just about any other relevant asset category.

At this point if that one (asset manager) has done their work, they are now armed with the historic statistical behavior of every single security in every single asset category. That's obviously a big job as there are over 3 million traded securities in the world today and more if one counts each and every structured product and index-derived product. From this statistical data set an asset manager can now look at entire asset classes – stocks, bonds, real estate, whatever to make predictive statements about their future prices (and price volatility, or risk).

Some asset categories have more risk than others, where risk is generally defined as the variation of future price. The price of most bonds varies little over time, and at the same time they provide a cash-on-cash return. The price of stocks can vary much more over time. If a portfolio consisted of only 50 percent diversified bonds and 50 percent of diversified international stocks, then we can predict the portfolio's future performance with a relatively good degree of certainty.

Adding additional asset classes – hedge funds, real estate, commodities, or any other kind of asset – is not really much more complicated. Because we can generally predict the long-term performance of each asset category, we can predict the performance of a portfolio that mixes a bit from each category.

Now comes the good part – modeling of personal long-term savings needs of investors. It can graphically be indicated what kind of investment returns need to be generated to achieve investment goals, whatever they are. Everything possible and probable can be modeled mathematically.

The earliest conclusions reached by the great minds of asset management were simple enough: there is a combination within the universe of all asset classes that is perfectly right for a chosen investor. What this means is just as simple. If one has a very specific investment objective (*eg* retirement at 60, funding university education, leaving a million for kids), then one can make efforts to confidently achieve that objective by purchasing securities that, when combined appropriately, will reflect one's own definitions, needs and desires for risk and reward.

6.3 Traditional Asset Management

When a client approaches a professional asset manager, the first step of the asset management process begins – client profiling. The client profile starts with a verbal description of the client today, in the future, and all the time in between. For example, a client may be a small pension fund for a private petrochemical company with 750 employees. The asset manager must know in advance the beginning balance of money that will be deposited for management. He should also know the starting number and ages of active employees, and the monthly cash contributions they and the employer will make into the pension fund.

For setting up a pension fund for this client, the asset manager must determine the number of the 750 employees reaching retirement each and every year, and the pension fund's obligations to pay retirees for their estimated days left on earth. A number of statistical analytical tools exists to calculate likelihood of each employee's year of death, and therefore the average number of years the employees will be taking cash benefits from the pension fund. Of course the pension fund starts this exercise knowing in advance the definitions of those cash benefits: say monthly payment of 80 percent of a man's last salary from the day he retires until the day he dies.

This is how the pension plan's future can be mapped out. Today's cash plus additional cash (employees and employer) over time, the returns on investment over time, and the withdrawals of cash over time. These are expressed numerically in simple columns of cash in, cash out, for the next 10, 20, 30, or any number of years in the future.

Clearly a major financial shortfall could occur if the pension fund does not achieve certain investment objectives. Pension funds make a contract with employees: they guarantee monthly cash payments to ease an employee's life during retirement

until they die. They take employee's contributions today, along with co-payments from their employer, and make investments that will achieve a minimum rate of growth over time to guarantee their retirement payments.

A tall order, but of course one that is satisfactorily met year after year by the large majority of the world's pension plans. How do they do it? They do it by following the basic rules of asset management.

Remember, if a pension fund starts with a pile of money today, and going forward there are contributions and withdrawals from that pile of money, then the asset manager can mathematically calculate the annual average profits that the pile of money must make to insure sufficient funds are available for all future liabilities.

It is taken as a given that the average U.S. pension fund, for example, must achieve about 8.5 percent per year on all its investments to keep pace with the pension fund's future obligations. Of course there will be years when the pension fund makes less than 8.5 percent, and other years when it will make more than 8.5 percent. But, on average, it must make 8.5 percent per year to meet future obligations. Even a difference of only 0.5 percent below this average will eventually bankrupt the pension fund, leaving the pensioners left with nothing but empty promises.

Because of the explicitly strong contract to perform in the pension fund industry, governments everywhere long ago set up regulations and government agencies to enforce them. Hardly a modern society exists where the pension fund industry doesn't absolutely dominate in terms of the total amount of money under management in that society, or where local governments don't strictly enforce the types of investments pension funds can and cannot make.

The U.S. pension fund industry, with about 6,000 funds holding perhaps about $14 trillion in total assets, is by far the largest pool of investment money on the planet (pension fund assets of the leading 11 economies totals $23.3 trillion). Arguably, too, it is perhaps the most professionally managed money in the world, professionally in terms of the application of fundamental asset management concepts to the actual management of money.

California Public Employees' Retirement System, or Calpers, is perhaps the biggest single pool of "smart" money on the planet (Abu Dhabi, Norway, Holland, and a few other places have more, but this chapter uses Calpers as an example because of their very long investment history and transparency). The word "smart" is used to delineate the professionalism with which the money is managed.

Obviously, Calpers has a lot at stake. With over $253 billion the fund oversees the

pension assets of over 1.5 million past and current employees. Calpers has a hard and fixed contract with these people: It will (emphasis on will) deliver a cash payment every month for each and every one of its member employees from the time they retire to the day they die. Calpers' allocation today by asset class (where "cash" is part of the Global Fixed Income line), is given in Table 6.1.

Table 6.1: An Example of Professional Asset Management: The Case of Calpers

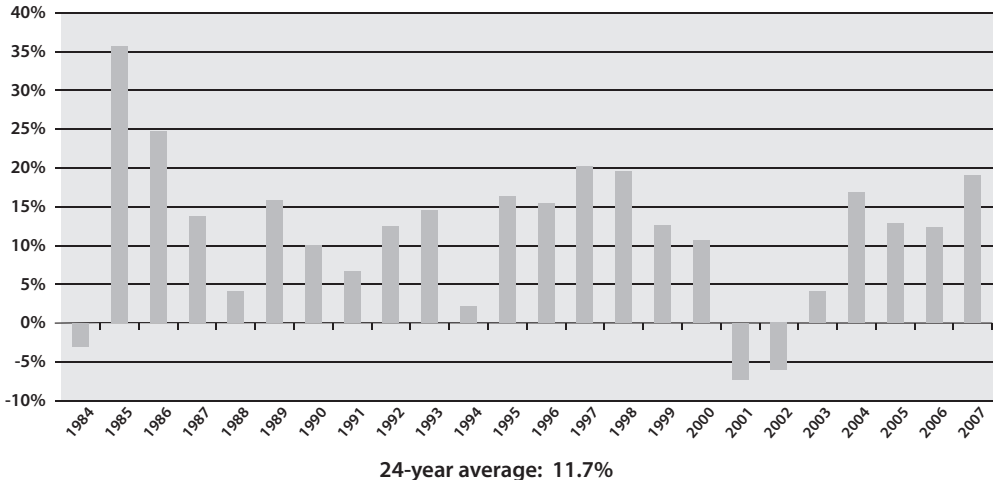
BREAKDOWN BY ASSET CLASS (END 2007)	VALUE (US$ BILLIONS)	% TOTAL
Cash	1.9	0.8%
Total Global Fixed Income	68.3	27.0%
Total Global Equity	140.2	55.4%
Total Alternative Investments (Private Equity & Real Estate)	42.6	16.9%
Total Market Value (in USD billions)	**253.0**	**100.0%**

Source: http://www.calpers.ca.gov/

As will be discussed below, this allocation falls into the "Growth" category, with a higher allocation to "riskier" assets than either Balanced or Income strategies, typical of a major pension fund like Calpers.

The results of Calpers commitment to professional investing of all this cash is stunning: very few institutional asset managers anywhere in the world can boast annual returns equal to Calpers. On a risk-adjusted basis there is just about no one else anywhere who invests better (*see Figure 6.1*).

Figure 6.1 Calpers Investment Performance 1984-2007



24-year average: 11.7%

Source: http://www.calpers.ca.gov/

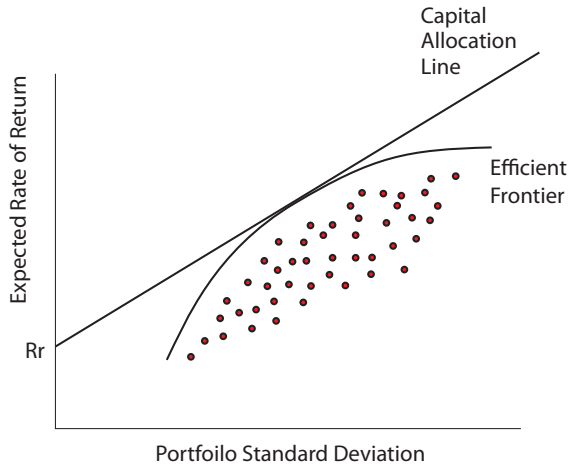
So, taking a top-down approach – where we start with the leaders of asset management and then try to assess what they do – we will look into the secret of Calpers' success. This is easy, as the data and information on investments is available to everyone.

Calpers starts with the same declaration we made above: there is a combination of some of the many assets available in the world that is the best for Calpers. Over time this combination of assets will be subject to modest changes, but overall the investment targets cannot and do not change.

Here we are at the basics of asset management: Calpers like any other institutional investor seeks that portfolio of assets that has the composite risk and return profile that is right for Calpers. Among the more than 3 million securities available in the world today, managers of Calpers' money invest in that set of securities that produces a highly probable outcome with a highly probable amount of risk.

What is another way to define this? Let's look at the Efficient Frontier, the graphic construction designed by Professor Markowitz to illustrate portfolio efficiency (*see Figure 6.2*)

Figure 6.2 Markowitz's Efficient Frontier



Source: http://www.striplingdata.com/mpt/000415.htm

In Figure 6.2, vertical axis measures the expected performance for any given combination of assets, from one asset to thousands of assets (or more). On its horizontal axis the chart shows expected risk, as measured by historic price volatility (an unknown future price is the worst of all risks in any asset).

We can see that all possible combinations of assets are measured inside the Efficient Frontier. There is no combination of assets that can have higher profits, or lower risk, than those combinations up to and including the curve itself.

We say that any combination of assets that actually achieves a point on the Efficient Frontier has reached optimality, *ie* no combination of assets can achieve more profits or less risk than any point on the actual curve.

So, the goal for all investors is to reach a point of optimality. That is clear. But, which point of the curve is most optimal for a given individual? Here we must add another concept, the risk-free rate. Professor Tobin gives us this. There is a point on the Y axis of our Efficient Frontier model that shows the expected return of holding risk-free assets (90-day Treasury bills, as an example). Then a straight line (the "Capital Allocation Line") can be constructed where less than 100 percent assets are risk-free. This line will angle outward and upward to the right from the Y axis, as obviously risk and return will increase from the risk-free rate.

A portfolio's optimality is achieved where Tobin's Capital Allocation Line intersects the Efficient Frontier. It is at this point that things cannot be improved in terms of achieving the maximum return with the minimum risk an investor desires.

Now, given the definitions of optimality that Tobin and Markowitz imply, we can know with a high degree of certainty what *our* portfolio should look like. Let's make this very clear: *My* portfolio will always be by definition different to *your* portfolio, and also by definition different to *their* portfolio. Because there are no two client profiles that are identical, there can be no two perfectly identical optimal portfolio allocations.

Now, how is it that we choose a portfolio that is optimal from the millions of securities among the four or five major asset classes? We look at the future expected risk and return of each asset class, and then find an optimal allocation among these classes of assets to achieve our optimal portfolio allocation.

It is no accident that the universally common "balanced" investment strategy is just that: a selection of relatively low-risk assets such as deposits and bonds combined with a selection of relatively higher-risk assets such as stocks, commodities, real estate, hedge funds and other "riskier" assets. Balanced investing blends the safety of the first two asset categories (generically cash and fixed income) with the riskier but richer results of the subsequent two categories (generically stocks and alternative investments). Today, or indeed at almost any time, a balanced portfolio would look something like the one given in Table 6.2.

Table 6.2 Typical Balanced Allocation

ASSET CATEGORY	ALLOCATION
Cash (deposits)	5%
Bonds	45%
Stocks	35%
Alternative Investments	15%

While the above portfolio doesn't make any effort yet to select any actual securities, we have achieved the second major step of asset management, asset allocation (the first major step being client profiling, of course, which helps us establish our investment strategy). With asset allocation we've made conscious decisions to put so much of our client's money into cash, bonds, stocks and alternative investments to achieve a point on the Efficient Frontier, diversifying the investments in such a fashion as to achieve our goal of portfolio optimality.

Stop here: Did we achieve our investment goals? Already we have made nearly all the decisions that an asset manager needs to make. Numerous studies since the early 1970s in what is called "attribution analysis" have shown that more than 90 percent of the success or failure of any asset manager in achieving a stated investment objective is found in asset allocation. As confirmed by Table 6.3, it is asset allocation that is at the heart and soul of asset management.

Table 6.3 Consistent Findings of Attribution Analysis

PORTFOLIO ACTIVITY	CONTIBUTION TO SUCCESS OR FAILURE
Macro Allocation	>90%
Security Selection	<10%
Timing	<10%

From this point the final tasks of an asset manager are easy: security selection and timing, followed by monitoring. We have made the big choices, with so much to cash, so much to bonds, so much to stocks, and so forth. Within each of these categories we must now select the most appropriate securities, using any one of a number of methods for security selection. A typical "balanced" security selection is given in Table 6.4.

Table 6.4: An Example of Security Selection Under Balanced Approach

ASSET CATEGORY	CATEGORY ALLOCATION	SECURITY ALLOCATION
Cash	5% money market	60% USD money market 40% EUR money market
Bonds	45% bonds	45% investment grade, sovereign 35% investment grade, corporate 20% speculative grade, emerging markets
Equities	35% equities	40% developed market large caps 20% developed market, mid caps 25% emerging market, large caps 15% emerging market, mid caps
Alternative Investments	15% alternative investments	45% global commercial real estate 15% global residential real estate 25% hedge funds, various 10% others (forex, commodity, etc.)

There is not much more to the professional discipline of asset management. As stated, most of the important work is done simply in the client profiling and asset allocation processes. Over time the success or failure of a strategy will result in one or more categories falling behind or ahead of the game, forcing occasional rebalancing of the entire portfolio to maintain the strategy. And, of course, certain clients may have substantial changes over time to their investment needs and resources, thus forcing the change of strategy (and subsequent changes in allocations). Monitoring can become as important as the earlier processes of asset management, especially when the resulting investments handily beat (or fail to achieve) the original investment objectives.

SIDE NOTE: A BRIEF TECHNICAL REVIEW OF MODERN PORTFOLIO THEORY

MPT is founded on nearly six decades of research and analytics, and enjoys several Nobel prizes among those who first formulated the basic rules of investing. Understanding MPT requires somewhat advanced knowledge of statistics, as from statistics we derive the terminology of investing and an understanding of the interaction of securities in portfolios.

First and foremost, MPT assumes all investors are risk averse, meaning they would prefer a portfolio of investments with lower risk and equal return to a portfolio of higher risk and equal return.

Measures of volatility (mean return and standard deviation) are used to quantify risk. The risk of a portfolio comprising a single asset is equal to the risk and expected return of that asset. The risk and expected return of a portfolio with two assets is equal to the risk and expected return of those two assets times their weighting in the portfolio. And so it goes with more than two assets, where each asset's weight, risk and expected return are multiplied and then summed for total portfolio risk and expected return.

In other words, a portfolio's expected return is equal to the proportion-weighted return of all the assets in a portfolio.

Correlation is the degree a security will increase or lose value compared to another security. High correlation means they increase and decrease almost in equal amounts, and low correlation means less amounts. No correlation means two securities act completely independent of one another. Risk is reduced when more assets are introduced to a portfolio, but only if the additional assets are not perfectly correlated to the other assets.

The risk and expected return of all investible assets can be graphically shown in an Efficient Frontier. The risk-free rate is that rate where there is 100 percent expectation of a given return. Adding riskier assets to risk-free assets in a portfolio increases risk proportionately, so the risk-free tangency is a straight line with an upward slope. Where the risk-free line is tangent to the Efficient Frontier an investor can achieve portfolio optimality, *ie* the optimal combination of securities for a given investor's desire for return and aversion to risk.

There are significant problems with MPT, not least of which is its reliance on standard deviation as a measure of risk. Some analysts have pointed out the absolutely unknown variables of future performance, and the fact that nature is not so predictable. However, despite these shortcomings no one can dispute the inherent logic of MPT and its utility as a common guide for investing.

6.4 Asset Management: Individuals versus Institutions

It may come as a surprise to most persons who are not professionals in the asset management industry that there is essentially no difference in the theory of asset management for individuals and institutions. Other than a reduced universe of available investments, and perhaps more advanced methods of security selection and portfolio monitoring, the actual practice of asset management remains much the same for individuals and institutions.

Why, in fact, would they be different? When mapping out the investment strategy for a pension fund we measure today's balance, cash coming in and going out, and the need for some kind of ultimate final amount of assets under management. This would be no different an exercise for an individual. A person with a certain known age today, a certain known amount of assets today, and a reasonably probable expectation for cash in, cash out and ultimate retirement and death, will have an easily mapped-out client profile. Quantitatively we achieve the same results with essentially identical input and output data.

The term "asset management", as mentioned above, has come to mean in the industry that kind of asset management that applies to institutional clients. Generally it refers to more resources, more talent, more of just about everything (including money) for each asset management assignment, as the clients are generally pension funds, insurance companies, foundations, or agencies.

Wealth management, however, as it applies to individuals, is essentially the same business. There is no true difference in the methodologies, understanding, practices and procedures between asset management and wealth management.

6.5 Islamic Wealth Management

Sections above illustrate the path to wealth management – a disciplined and scientific methodology that requires consummate knowledge and experience, just as in any profession. To accomplish wealth management objectives one must start the process, continue the process, and finish the process following a well-known path. Table 6.5 lists four basic steps of asset management. There are no other steps, no other formulae and no other elements outside of these four basic steps.

Table 6.5 Four Steps of Wealth Management

STEP 1	STEP 2	STEP 3	STEP 4
→ Client Profiling			
	→ Asset Allocation		
		→ Security Selection	
			→ Portfolio Monitoring (and periodic rebalancing)

As pointed out earlier, there is essentially no difference between asset management and wealth management other than the type of client one is dealing with. All of the theory and much of the practice are identical between the two. Now, let us determine what exactly is different in what we will call Islamic Asset Management and Islamic Wealth Management. First, let us agree that like their traditional cousins, there is no fundamental difference between the two. Asset management is wealth management in a different guise, whether Islamic or traditional. So, where and how does the religious content in Islam enter the equation? Let's go through the steps and try to find out.

6.5.1 Step 1: Client Profiling

Client profiling starts the asset management process. Although it may be argued that with no exceptions there is essentially no religious content in this exercise, there is a growing trend in the market that an individual or institution would like

to be recognised, and hence profiled, as a Sharia-compliant client. In fact, it is this stage that an asset manager may take a preliminary view on its security selection (Step 3 below). Quantitative aspect of client profiling, however, seeks to establish facts as they are today about a client's assets, and to establish long-term goals and methods to achieve those goals. The mapping out of a client's current and future wealth, annual income and expenses, and terminal value of the assets is the same whether the mapping is done for a client in Riyadh or Reykjavik.

Client's financial needs, in other words, are essentially the same. Of course each client varies enormously, but the process to establish the basics of wealth management is identical among all persons.

There are, of course, some important distinctions for Muslim investors. For example, he very large majority of them have a religious obligation to pay an annual asset tax, or zakat. However, this is essentially no different than any asset tax anywhere else, and can be easily input into the formulae developed from client profiling. The second important distinction is distribution of assets on the death of a client. Again here the actual modification of a traditional profile is easy. Shari'a compels a Muslim to ensure certain family members get certain portions of an inheritance. Information on this distribution is no further than the nearest copy of the Holy Koran, although most Muslims already know the basic distribution formula by heart. Furthermore, Shari'a sensitivity towards certain investments (interest-based, gambling etc.) may also be included in the profile of a Muslim client.

However, it is probably not entirely untrue that whether the client is named Abdullah or Bob one finds the client's financial profiling almost identical with some exceptions mentioned above. Both Abdullah and Bob may be 37 years old, both may have $150,000 annual net after-tax income, and both may already have 3 children who need to be put through university. Abdullah and Bob may be identically risk averse, expect to retire at the same age, and except for Shari'a guidance on inheritance both men want their families to inherit the majority of their wealth.

In short, technical side of client profiling is essentially the same for traditional and Islamic investors.

6.5.2 Step 2: Asset Allocation

Just as client profiling very similar in case of Islamic and conventional wealth management, asset allocation in both cases has similarities. If Abdullah and Bob both may have similar profiles, and identical end objectives, then there is not much difference in the strategies selected for their investments.

As mentioned earlier, asset allocation is the result of calculating future risk and reward desired by the client, and fitting that into an investment strategy that has some hope of achieving the client's objectives. More risk appetite, or a higher future reward, requires a more aggressive investment style. Less risk implies less aggressive investing, meaning more secure, safe investments. Nearly all clients anywhere and of any faith can be categorised in three basic investment styles, where today we find nearly every private wealth manager recommending any one of them to clients *(see Table 6.6)*.

Table 6.6 Basic Investment Management Strategies

	INCOME	BALANCED	GROWTH
Cash	5%	5%	5%
Bonds	55%	45%	25%
Stocks	25%	35%	55%
Alternatives	15%	15%	15%

For Muslim investors seeking sharia-compliant investing, the strategies would be the same, with the requirement that all such investments must fulfill Shari'a requirements.

6.5.3 Step 3: Security Selection

It is at this step that distinction between traditional and Islamic wealth management becomes explicit. Although general rules of security selection are similar for Muslim and non-Muslim clients, there are a number of Shari'a requirements that must be fulfilled for investing in any security. Because of direct and explicit relevance of Shari'a requirements at this stage, it is here that we find the heart and soul of Islamic wealth management, as well as the basic conundrums of this sector of the asset management industry.

Security selection requires the identification and purchase of securities for each and every asset category in a fashion where the securities selected will contribute to achieving the investment strategy's investment goals. For traditional investors the job is very easy because of the vast universe of securities. For Islamic investors the job is more difficult due to the relative shortage of securities that fall under Shari'a criteria. Table 6.7 gives an idea of the size of the traditional securities universe worldwide.

Table 6.7: Global Securities Market

ASSET CATEGORY	AMOUNT $ TRILLIONS	% OF TOTAL
Money Market	6.4	4.3%
Bank Deposits	38.5	25.8%
Government Bonds	25.8	17.3%
Corporate Bonds & Loans	17.1	11.5%
Other Mortgage Backed Securities	6.5	4.4%
Asset Backed Securities	3.5	2.3%
Sub-prime Mortgage Backed Securities	0.7	0.5%
Equities	50.6	33.9%
Total global securities	**149.1**	**100.0%**

Source: Bank of England, as of end 2006

While we speak about traditional assets in the trillions of dollars per category, the Islamic asset universe limits itself to billions. Hard data is difficult to come by, but it is estimated that total potential assets in the Islamic banking space have reached perhaps $1 trillion by now, and that number is rising in low double digits annually. How these assets will be distributed is still a perplexing question, although we can make some rough estimates to guide us.

6.5.4 Step 4: Portfolio Monitoring (and Periodic Rebalancing)

There are essentially no religious differences among all people, whether Christian, Hindu or Muslim, in their desire for regular reporting on and monitoring of their managed wealth. Modern software allows managers of every asset type – whether financial assets or real assets such as real estate – to provide themselves and customers the ongoing, updated information needed to ensure the original client profiling and asset allocation exercises have been carried out correctly.

Rebalancing is the fine art of ensuring a disciplined asset allocation strategy is carried out over time. There are periods when one asset category will outperform others, and where certain assets within a category will do the same. For example, during the period 2002-2004 many traditional bonds exploded in value, while at the same time equities also experienced growth. Rebalancing requires trimming some categories through asset sales, and increasing others through purchases, to

ensure the same ratio of categories is maintained over time. Only when the conscious decision to change the strategy is made would the normal rules of rebalancing not apply.

Having said that, Shari'a review of investment portfolios is generally required on certain frequency (normally quarterly but other frequencies are also commonly observed).

6.6 A Focus on Traditional and Islamic Assets

6.6.1 Traditional and Islamic Money Market

The global issuance of "cash" securities – that is, securities that mimic cash in terms of immediate or short-term liquidity but also provide market interest rates – is gigantic. At the end of 2006 the total volume of all cash securities was over $6.4 trillion worldwide, a sizeable number that doesn't even include the even larger volumes of bank deposits. Certainly here there are vast choices for the traditional investor.

In the Islamic space, there are simple (i) no-interest deposits at Islamic banks, (ii) Murabaha-based deposits, which are placed into commodity murabaha (a short-term Islamic instrument that mimics money market instruments), and (iii) some Mudaraba-based deposits. Murabaha deposits are offered by many Islamic banks, and large traditional banks that have interests in the Arab or wider Muslim worlds. The mechanisms underlying Murabaha deposits are discussed in Chapters 3 and 4.

6.6.2 Traditional Bonds and Sukuk

Within security selection important choices are made. For example, in the allocation of bonds for traditional investors there is a very wide choice, with over $25 trillion in total bonds outstanding at any point in time in North America alone. Bond investors have options among sovereign and corporate bonds, developed-world and developing-world bonds, and between investment-grade and speculative-grade bonds. There is also always the choice of currencies different from the client's reference currency, plus bonds that don't fit so easily into a certain category of assets, such as bonds convertible to equity. Further, with over 2,000 bond funds in the traditional space one can easily select specific allocations for even the smallest client portfolio.

Sharia-compliant investors are not so fortunate in their choices for fixed-income-style investments. Fortunately the sukuk market exists and is growing fast. Sukuk

(sak in the singular) are bond-like instruments backed by hard assets, and issued like bonds in many various types and flavours. Today the total sukuk market is over $85 billion, and also experiencing growth in the low double digits.

The largest traditional issuers of sukuk are Malaysian government agencies and corporations. These comprise about $50 billion of global sukuk, with about $35 billion in non-Malaysian sukuk in today's market. From this one can find a variety of securities that could easily be selected for a diversified portfolio.

Unfortunately, the secondary market for sukuk is a rich man's club. Individual trades are generally well over $1 million, and much more likely over $5 million. That makes the construction of a sukuk portfolio problematic for any but the wealthiest of investors.

Further, sukuk are nearly all variable-rate instruments, priced off LIBOR. While their maturities are nicely in the 2- to 5-year range for most issues, they are not all rated and in fact many are privately placed.

There are two bits of good news:
1) the volume of new sukuk issuances is expected to explode in the coming years, as major international players such as the government of Japan, the City of London, and G.E. Capital, among others, have announced plans to issue these securities, and
2) for smaller investors there is the Sanad Sukuk Fund, the world's first Islamic bond fund available in amounts as small as $100,000 and with an international domicile that permits investors from almost any jurisdiction to purchase them.

As of this writing, investing in a portfolio of sukuk to cover the traditional bonds allocation in any investment strategy is feasible, although with capacity constraints until the sukuk market develops further.

6.6.3 Traditional and Islamic Stocks

The universe of bonds is complicated enough, but choice among stocks is even wider and more complicated. Here we've got to select among countries, sizes of companies, stages of company growth, industries and of course currencies. The choice is vast, with almost 100,000 listings on the world's stock markets today.

But, even the most sophisticated traditional investor is not going to look at nearly 100,000 stocks for his or her investment portfolio. Rather, the very large majority of investments will be made into stocks in markets that permit foreign ownership,

stocks that display a minimum amount of liquidity, and stocks that meet certain international standards for transparency and corporate governance.

Given these filters one could distill qualifying stocks to a much more manageable number. The Dow Jones Global Stock Index, for example, contains today about 6,700 equities from companies worldwide.

Fortunately for sharia-compliant investors the subset of qualifying equities is also quite sizeable. The Dow Jones Islamic Market Index service, for example, offers now 70 different indices from a total of over 2,600 listed companies representing over $17 trillion in total world market capitalisation, out of a total global equity market capitalisation of about $50 trillion (covering about 38 percent of traditional DJMI equities, and about 34 percent of all global market capitalisation). Even with the exclusion of traditional financial institutions – which usually represent about 25 percent of all global market capitalisation – this subset of the world's equity markets should provide a minimum universe of choices to satisfy even the most demanding investor, and even ensure one achieves close to optimality in the construction of client portfolios.

Further, the Islamic equity mutual fund industry has now surpassed $20 billion in total assets among about 300 different funds. While that is a drop in the bucket compared to the trillions of dollars in traditional equity funds, it is considered by this author to be sufficient to start the asset allocation process for equity allocations.

6.6.4 Alternative Investments, Traditional and Islamic

Alternative investments, or AI, have taken a joyous ride of respectability in recent years. Even the vaunted Calpers has recently increased AI to over 8 percent of total investments, up from a base of 5 percent or less just a few years ago. This reflects the increasing pressure on investment managers everywhere to find profits in unconventional ways, even if it means venturing into the unknown waters of illiquid investments that do not provide regular pricing.

Sophisticated investors who understand the risks of AI have increased their exposure to this non-conventional asset class, but rarely does one see core AI (excluding real estate) exceeding even 10 percent of a total allocation. AI is by nature more opaque. There are generally no markets for AI investments, and they without a doubt have characteristics that leave some investors terrified.

The universe of AI comprises essentially any investment not included in the previous three categories, including:

- Hedge Funds (now over 12,000 worldwide, including funds of funds)

- Commodities
- Foreign Exchange
- Private Equity
- Venture Capital
- Real Estate

One great controversy in the world of professional asset management involves whether to include Real Estate as an Alternative Investment or within its own category. We will not enter into that controversy here, leaving that for another discussion. However, for simplicity we will accept in this argument that Real Estate is within the AI universe, primarily because of its frequent illiquidity. However, the abundance of REITs, real estate funds, and other real-estate investment vehicles makes one cautious to include Real Estate within AI.

Fortunately, AI have greatly benefited the traditional professional asset manager by providing assets with returns often uncorrelated to conventional asset categories. The introduction of AI does, without any doubt, improve the overall optimality of a portfolio, and when used judiciously can substantially enhance overall return.

The universe of Islamic alternative investments is very, very small, especially when considering the Islamic AI that could be purchased for a client of a professional asset manager, where regulations limit the introduction of risky, illiquid assets into client portfolios. At present, there are around four shari'a-qualifying hedge funds, which use contracts like arbun, salam and wa'd to effectively short equities. There are also a few non-traditional funds covering the likes of commodities with generally recognised fatawa. In terms of real estate – and meaning only real estate investments that are liquid – there is probably only one global real estate fund that carries a qualifying fatwa.

6.7 Problems and Opportunities in Islamic Wealth Management

Among the four asset categories there are two with substantive problems for the professional asset manager: bonds (sukuk), and alternative investments. But, despite the very low volume of issued and qualifying sharia-compliant securities the construction of a fully Islamic private client portfolio is more than feasible today.

In statistics a universe of any quantifiable object becomes meaningful if the number of objects in that universe reaches a statistically relevant level. If we have sufficient number of objects in the universe of available Islamic assets then we can say we have achieved statistical relevance, and therefore can realistically expect to achieve some degree of optimality in our portfolio allocations.

This chapter contends that we have achieved statistical relevance in the universe of Islamic assets. While this is controversial, it is possible today to take the portfolio of a private client and achieve a degree of optimality that is professionally acceptable.

Clearly the universe of murabaha and shari'a-qualifying stocks has achieved statistical relevance. Through a sukuk fund investing itself in the universe of available sukuk we can stretch a bit, but still effectively achieve the diversification we need in this asset category. While it is difficult to assess the total number of AI in the Islamic asset universe, we know that at least 15 or 20 assets with acceptable fatawa exist, therefore making investing in this asset category also feasible.

The very small universe of qualifying Islamic assets should be put into perspective. There is some irony in the situation in one Gulf state, where a sovereign wealth fund is said to control over $800 billion in total assets. Imagine if this one fund decided it would invest only in sharia-qualifying assets. Even with a liberal tolerance of fatawa, this one sovereign wealth fund could in theory purchase every non-equity sharia-qualified asset in the world, leaving nothing for the rest of us.

Yes, the situation is changing with the creation and distribution of more and more Islamic assets every year. But, imagine the total value of North American bonds, at $25 trillion. Compare that to the $85 billion of all sukuk, which is only 0.34 percent of the former market. Clearly the sukuk market must grow, and by leaps and bounds. If there is not a very substantial increase in Islamic qualifying assets, and a simultaneous urge by Muslim investors to make Islamic investments, then the existing inventory of Islamic assets is far too small to cope with demand.

Problems with supply and demand can be looked at another way. We know that total private assets under management worldwide comprise about $90 trillion. We also know that fixed-income securities (bonds and deposits) comprise about 45 percent of that (mostly bonds). We also know that of the $90 trillion about 3.0 percent or a bit more is owned by Muslims.
If modern portfolio theory applies to people of all faiths, then Muslims today should be holding about $1.2 trillion in sukuk within their managed accounts. This is far from the case, with only about $85 billion of existing issued sukuk, or only 7 percent of implied demand. Remove Malaysian sukuk from this equation and existing supply is only about 3 percent of implied demand.

Finally, regardless of theory we can actually see what banks are selling and investors are buying today in the Islamic asset management space. While nearly all asset managers everywhere understand and believe in the efficacy of modern portfolio theory, we do not see it in actual practice. The explosion of shari'a-qualified

structured products – which in general have no place in a professionally managed client account – makes one wonder where to find professional discipline among Islamic bankers. Hundreds of millions of dollars of these assets are sold every year by the biggest and most prominent names in global asset management. Unsuspecting investors, with little or no knowledge of how their money should be managed, are ultimately the victims of this inappropriate type of security.

Even more unsettling is the larger explosion of private equity, sold in the billions of dollars in every corner of the Muslim world. Even Calpers, a disciplined and professional asset manager, would never consider today placing more than 10 percent of its investments into this asset class. Yet, the volumes of real estate and corporate private equity sold in the Middle East are astonishing. It is not uncommon today to see a Saudi investor with 50 percent of his assets in cash, 25 percent in his own real estate investments, and 25 percent in real-estate-related private equity. Clearly this is untenable over the long term. There will be victims of undisciplined investing in inappropriate, undiversified assets.

6.8 Conclusion

There are very real problems in the Islamic wealth management business, not least of which are inappropriate securities being pushed by banks and inadequate volumes of available securities. However, we know that growth is fast now, and will become faster in the future. As long as new shari'a-qualified securities from all asset classes are issued on a regular basis – securities meeting international standards for appropriateness, transparency, liquidity and performance – then long-term demand will eventually be met.

And, that demand is potentially huge. The 2006 Merrill Lynch-Cap Gemini World Wealth Report estimates Muslims own something like 3 percent of the nearly $90 trillion in global managed wealth, or almost $3 trillion. We know further there are perhaps $500 billion in assets reported in the Islamic banking system today, most of which are not invested at all. And, with fast-growing economies and ever-increasing surpluses these same Muslims will have more and more assets under management, with some predicting total assets of $10 trillion or more by 2010. One has to wonder how and when these vast sums of money will be professionally invested.

Fortunately, modern portfolio theory is a guide every asset manager can and must use to invest client funds, whether the client is Muslim or not. The sole short-term barrier to optimal Islamic asset management, and its sister Islamic wealth management, is simply the absence of large volumes of shari'a-qualifying assets. When that part of the puzzle is solved, the industry will indeed have come of age.

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