Divergence of views, divergence of allocations

Islamic asset management seems to be moving against global trends. The results may not be positive, writes **John Sandwick**

WE ARE WITnessing a divergence in global versus Islamic asset management trends, a divergence both troubling and problematic for professional asset managers. Yet at the same time it provides important opportunities for development of the Islamic asset management industry.

Islamic asset management seems to be moving not only against world trends but also encouraging them. The initial conclusion of some observers is not positive.

The world asset management industry had about US$62 trillion in assets under management at the end of 2006. This most certainly increased in 2007 and the first four months of 2008, perhaps by 2–3%, following trends that began in the early 1990s.

Modern portfolio theory

Global asset allocation reflects the principal conclusions of modern portfolio theory (MPT)—that is, the allocations of professional asset managers generally average along the lines of a contemporary balanced strategy portfolio in whichever currency you wish to name.

MPT underpins the professional asset management industry. With MPT, managers have a tool to evaluate all asset classes objectively, as well as their respective, expected future performance, and match a combination of these asset classes to the long-term investment needs of clients, whether they be individual or institutional.

MPT centres on diversification of risk while attempting to achieve the highest possible risk-adjusted return. Six decades and many Nobel prizes highlight the near universal acceptance of MPT. While some, such as Taleb and Mandelbrot, have shown that MPT has its inherent weaknesses by depending on historic data, neither critic has developed any realistic alternative as the core tool for making professional investment decisions.

MPT forces professional asset managers to map out a client's long-term investment objectives, creating a combination of cash yields with capital gain yields—which are balanced with tolerance to risk—to achieve investment goals. Normally an asset manager will choose among the four major categories of assets to create an investment portfolio that overall has a high degree of probability in achieving investment goals.

The four asset categories are cash (money-market funds, deposits, or other interest-bearing, short-term instruments), bonds, equities and alternative investments. Without exception, all investments fit into one of these four categories.

Each asset category has its own expected future risk and reward. Certainly no one would argue that cash and bonds are lower in risk than equities or alternative investments. Risk is often misunderstood as meaning only variation in future price. However, universally accepted definitions of risk also include liquidity risk, or the risk that an asset cannot be converted to cash when and where desired by the client. Cash has a high degree of liquidity, and so in this definition is much less "risky" than alternative investments, which generally would have the highest risk when liquidity risk is considered. Modern portfolio allocations, therefore, will reflect both price volatility and liquidity risks.

A low-risk, low-reward portfolio strategy is often labeled "income" by asset managers and has a resulting high concentration of cash and bonds. A high-risk, high-reward strategy is often called "growth" with high concentrations of equities and alternative investments. Between the two is the universally accepted strategy we call "balanced", which combines cash and bonds with equities and alternative investments in such a fashion to enjoy the best of both extremes of risk and reward. Balanced investing is the most common strategy for world asset allocation.

Commonly we see a balanced portfolio comprising 5% cash, 45% bonds, 35% equities and up to 15% alternative investments. Of the 15%, we often see at least half invested in real estate. The remaining allocation in alternative investments comprises hedge funds, private equity, and other investment classes, such as foreign exchange and commodities.

Private equity is, therefore, a small percentage of globally managed assets. While it has been growing annually because of historically cheap credit during the last decade, counter-trends are evident as a result of the global credit crisis. Perhaps the days of high growth in the global private equity industry are history.

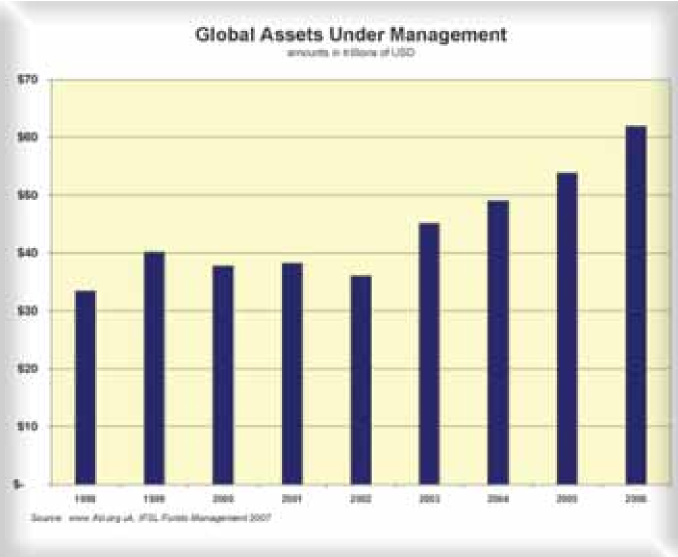
We have seen an increase in the proportion of global allocations being directed towards alternative investment strategy. Whereas 30 or more years ago this category barely existed, alternative investments now account for about 5% of total global assets under management (excluding real estate). For high net-worth individuals, the allocation is higher —about 20%. Why this is the case for individuals and not institutions I shall explain shortly.

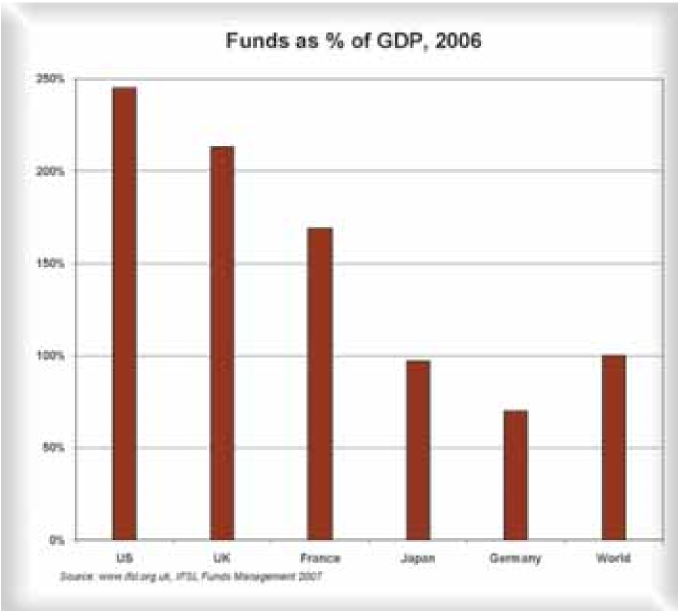
Private equity

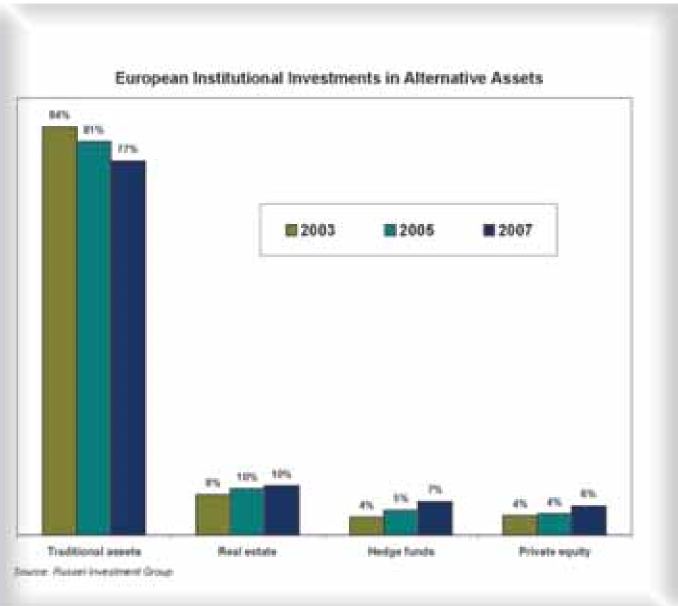
Private equity is a subset of the alternative investment universe. Assets under management in the private equity industry are measured through the assets held by private equity funds (as opposed to mutual funds), which account for about $1.5 trillion of total managed assets, or about 2.4% of global managed assets.

The world's private equity industry has grown from nearly zero 30 years ago. It has grown exponentially since 2002. The majority of assets are managed by not more than 15 firms. One can think that perhaps the growth of private equity is linked to the catastrophic losses experienced in the western markets during 2000-2003, and many emerging markets thereafter. Some investors may be tricked into thinking unlisted, illiquid investments without daily pricing is less risky than assets priced daily.

However, by their very nature private equity investments are among the riskiest of assets, primarily because







of liquidity risk and because of their dependence on cheap credit. Cheap credit seems to have been delegated to history, at least for now.

Mutual funds comprise about 22% of globally managed assets. Mutual funds provide an efficient way for most investors to invest in all asset categories.

There are hundreds or even thousands of choices in each. Global mutual funds total more than 60,000, covering nearly every conceivable asset category and sub-category. World-wide, mutual funds manage more than $11 trillion in assets.

Importantly, nearly all mutual funds are liquid—they may be redeemed for cash by investors, usually at daily, weekly, monthly, or quarterly redemption periods. Liquidity, it is to be remembered, means lower risk.

Assets under management in mutual funds equal about 100% of global GDP. However, the absorption of mutual funds in developed economies is higher than in developing economies, implying per capita higher income levels lead to higher absorption of mutual funds.

Assets in mutual funds among OECD member states, for example, are 150% of OECD GDP. The figure for the UK is 213% and for the US it is 245%.

No data is available for ownership of mutual funds in the Muslim or Arab worlds. We can guess from anecdotal evidence it is not more than 1.5% of GDP in both cases. In other words, Arab-world absorption of mutual funds is vastly less than global averages and developed-world averages.

If one assumes that Arab absorption of mutual funds will eventually reach global averages, then one can assume a subsequent huge increase in the availability and distribution of mutual funds in the Arab world, in particular Islamic mutual funds.

Trends

Data in the Arab and wider Islamic worlds is difficult to obtain. When available, it is often out of date. Much of the following discussion is based on empirical evidence, not reliable data. But the ultimate release of data will confirm these speculations.

We see a high concentration of wealth among individuals and institutions in the Arabian peninsula, most notably the GCC member states (Saudi Arabia, Kuwait, Bahrain, Qatar, the UAE and Oman). It is assumed that cumulative managed wealth of the GCC is reaching close to $7 trillion, including sovereign wealth funds, professional investment firms and households.

We also see an ever-increasing ratio of assets managed according to Shariah principles. There are $20bn in assets among the more than 600 mutual funds labelled Islamic. There is supposedly about $500bn in assets in the Islamic banking system world-wide, of which most would be among the banks and investment companies of the GCC region.

As mentioned, the absorption rate of mutual funds of any kind is low in the GCC, with perhaps not more than 1.5% of GDP. This is expected to increase, as investors in the GCC achieve the same mutual fund absorption of developed economies (if GCC GDP is nearly $1 trillion in 2007, then one can assume not less than $1 trillion in mutual funds is held by investors in the GCC). It is expected the absorption will be via Islamic mutual funds, as Islamic investing is increasingly preferred among GCC investors.

What is troubling is the slow rate of creation of mutual funds in the Arab world overall and the GCC region in particular. Potential demand is nowhere near being met—$20bn in Islamic mutual funds today versus at least $200bn or more potential in Islamic mutual funds alone. As of this writing in May 2008, there is still no known dedicated Islamic mutual fund company in the GCC. There is one company in Jeddah, Saudi Arabia, that could fit in as a subset of the broader definition of mutual fund management firms, but only this one.

There are also the asset management units of regional banks, which sometimes have a healthy array of mutual funds, but these are bank units, not independent mutual fund investment companies one finds in the traditional global mutual fund industry, such as Fidelity or Franklin Templeton. The lack of dedicated mutual fund companies in the GCC—in particular, Islamic mutual fund companies—is surprising.

More surprising, and somewhat troubling, has been the explosion in the number of private equity firms in the GCC. The GCC's private equity industry barely existed before 2000, when HSBC Dubai created the region's first dedicated local private equity fund.

Today, however, there are nearly 100 private equity firms operating within the GCC and are dedicated mostly to GCC-region investments, with new entities being announced almost weekly. Importantly, nearly all of the funds in the GCC's private equity industry are managed according to Shariah principles.

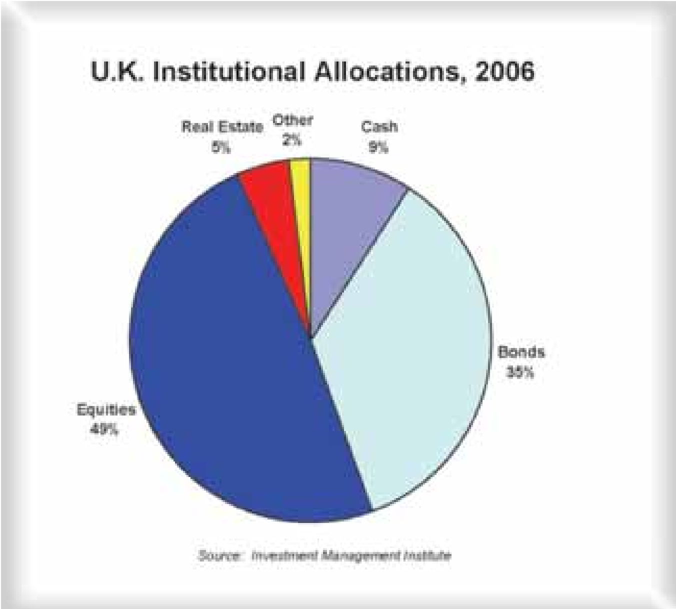
Regional assets under management by these firms has increased to something like $9bn. That means Islamic private equity in the GCC comprises about 50% of the total found in Islamic mutual funds. This is a vastly different ratio when compared with private equity as a percentage of mutual funds worldwide, which is not more than 15%.

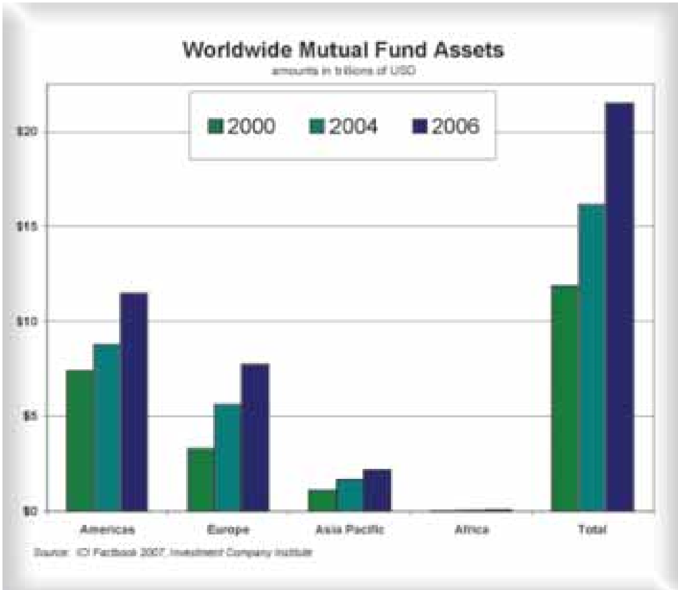
Outcome

Again, while the data is mostly empirical, the conclusions are clear:

- the GCC region already has trillions of dollars of assets under management, both inside and outside the region;
- the GCC has slowly evolved a small mutual funds industry, which manages only a tiny fraction of the region's wealth;
- the region's Islamic assets are growing but apparently not in Islamic mutual funds, which is surprising;
- Islamic assets in the region seem to be flowing in large quantities towards private equity funds—not Islamic mutual funds—which is even more surprising. This reflects a misallocation of assets when compared with global allocations. GCC Islamic investors, it seems, are investing their funds into regional Islamic private equity at a rate vastly greater than that of Islamic mutual funds;
- instead of achieving a global average of 1.2% of assets under management, GCC Islamic private equity seems to have achieved a vastly greater share of assets under management, perhaps as high as 20% or more, and nearly 50% of Islamic mutual fund assets under management. The reason may be because there are no fully dedicated Islamic mutual fund companies providing the types of funds traditionally found in economies around the world, funds that fit into each of the major asset categories: cash, bonds, equities and alternative investments;
- modern portfolio theory, confirmed as the major underlying foundation of professional asset management, seems absent in the GCC region and, in particular, among investors in Islamic assets. The discipline of MPT has been replaced by a seemingly random, opportunistic approach to asset management;

The long-term result of these trends is not clear, but they are not positive. Certainly GCC investors understand the illiquidity of private





equity. But it is not clear that GCC investors understand this means inherently higher risk. Over time the misallocation of assets by GCC Islamic investors may result in negative performance because of the inherently higher risk of current observed allocations.

The GCC region's obsession with private equity may ultimately end as soon as there are other investment choices. Traditional mutual funds globally number well over 60,000, but only about 600 exist in the Islamic mutual funds industry. As Islamic mutual funds increase, there should be a subsequent shift of assets from Islamic private equity funds to Islamic mutual funds.

With more than $40 trillion in oil-only receipts in the next 20 years among the GCC members states alone, the reward is clear: those who deliver world-class Islamic mutual funds to the region will benefit from a reversal of the trend towards private equity. Future movement among the investors of the Arabian peninsula will be towards global averages in ownership of mutual funds. ■

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