

Retail is the key

This month's insight comes from Mark Smyth, managing director of Failaka International

It is perhaps not surprising that there exists an institutional/retail split within the Islamic funds industry. Given that Shari'ah compliant funds have their recent roots in catering for the affluent, like many industries, there is a perceptible divide between sophisticated high-end fund products and basic retail products.

Presently, there is much discussion about the need, practicality, Shari'ah compliance, and demand for a whole host of new products, ranging from commodity funds, sector specific funds, long/short funds, and various other hedge fund strategies. This is a valid and needed debate.

On the other hand, large gaps remain in terms of plain vanilla products. While this is not the case everywhere, indeed in many Gulf countries and especially in Malaysia, retail clients have a wide choice of products, from a geographical point of view, many Muslims do not have access to Shari'ah compliant products.

Part of this divide relates to where a fund is registered. Whereas knowledgeable institutional investors and high-net worth individuals have built-up over the years huge assets in the offshore markets, ordinary retail investors prefer the safety of registered onshore funds. Building a broad retail base within the industry requires institutions to register more funds onshore, with all of the legal and consumer protections that are offered by the respective government bodies. Offering registered onshore products helps to alleviate investor concerns about credibility, which is a cornerstone of banking at all levels.

In the case of mutual funds, it is true that they have at root just this sort of retail clientele. Fund investing has traditionally been, and remains, the preferred asset class of the world's middle classes, offering access to high-return assets (equities), with a degree of built-in diversification, for only a modest initial investment.

From a macro point of view, the wisdom of mutual funds-making ownership available to middle income investors cannot be overstated. It has contributed immeasurably in bringing a degree of wealth, recently thought unattainable, to ordinary



investors. And with this new wealth, mutual funds have nurtured the pride of ownership, encouraged higher degrees of savings, drastically improved investor knowledge, and made more capital available to entrepreneurs. The same results will be seen in an Islamic context, when the mass of retail investors can be enfranchised into the process...and the signs are encouraging.

We are already noticing conventional borrowers from the west utilising Sukuk in order to meet their financing needs. Might we see the day when conventional companies adjust their balance sheets in order to attract Muslim equity capital?

Raising awareness, changing mindsets

As in all parts of the world, an essential ingredient is investor education. It is here where the job of the Islamic bank is twice as hard. Not only must the Islamic banker educate his retail client on the need for matching his long-term financial goals with appropriate investments, they must also explain the principles of Shari'ah compliant investing. While there is twice as much to explain to a novice retail investor, it is surely important work. As every banker can attest, it is an eye-opening calculation comparing the long-term compounded effects of a balanced portfolio against a portfolio comprised of only risk-free bank deposits. Given the financial burdens placed on families around the world, the opportunity costs of not investing properly can be heartbreaking. The room for growth in the field of Islamic asset management, however, is immense by any estimate.

Indeed, in many parts of the Muslim world, there are signs that a 'savings and investment' culture, as opposed to a 'trading' culture is taking shape. In the Gulf, a sustained commodity boom, maturing equity markets, a renewed interest in local markets, and the listing of local firms are helping to sharpen the focus. Surely the lessons of the recent correction should have a maturing effect as well. By now, it should be painfully obvious, given the extreme volatility of the past year, that there is an urgent need to nurture a genuine investment culture; one that stresses the wisdom of balancing risk with reward, utilizing prudent diversification, and properly aligned ones' wealth among appropriate asset classes.

From an Islamic point of view, one might argue that advising clients to approach the market as long-term investor, rather than a short-term speculator, a key principal of Islamic banking, would have saved many individuals from the precipitous declines of recent months.

The path ahead

Advising clients of the benefits and risks of mutual fund investment is a long process, but great strides can be made in a relatively short space of time. Take the US market, which is home to over half the world's mutual funds. In 1980, less than 6 per cent of US households owned any kind of common stock. As of 2005, nearly half did. When looking at college graduates, the number rises to 56 per cent.* Similar figures are true in Japan and many places in Europe. The same dynamic can easily happen in the Muslim world. In fact, it must.

The economic effects of globalisation are quite naturally being felt in the Muslim world, just as they are felt in other parts of the world. While the benefits of global capitalism are many, one downside is the pressure it puts on government pension schemes. Now, and likely for succeeding generations, the burden of retirement savings will fall on the individual, relieving traditional

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fixed-benefit corporate schemes and strained government coffers. Our aging planet exasperates this process; for the longer we live, the longer we must plan to support ourselves financially. Additionally, it is universal that few relish the prospect of working until past a 'normal' retirement age.

This dynamic, for better or worse, has greatly increased the importance of understanding and utilising long-term, higher-yielding assets. For many Muslim retail investors, it is Shari'ah compliant mutual funds that must carry the burden for their financially secure retirement.

It is noteworthy that here are a couple of unique and positive elements for presenting the case for the Muslim world, however, upon closer evaluation, this should not give much comfort. It would follow that the population boom currently underway in many Muslim countries would be supportive of any 'pay-as-you-go' government pension scheme, but in a rapidly changing world, it would be prudent take a hands-on interest in one's retirement 'just-in-case'.

Another insulating factor for Muslims in the Gulf region is the generous social benefits available to local residents. As good as these plans are and while matters may look tidy now, for those looking to retire in 30 or 40 years, like any long-term projection, the picture can become clouded...and few things last forever.

None of the above, however, is meant to paint a gloomy picture for the future, but rather, to stress the importance of retail investment vehicles in the development of the Islamic funds industry. It should be obvious that just as Islamic institutions need new and innovative products, Muslim retail investors have an equally great need for the basic products.

As is true in every field, for every challenge there lies the possibility for innovation and improvement. Nowhere is this more true than in meeting the challenges of long-term retirement planning. Again, take the US as an example. In the early 1990s, many US companies felt the heat of international competition and pursued strategies that emphasized improved efficiency. Although it was a painful adjustment for many, a great shift occurred in the way corporations handled their retirement schemes. Fixed benefits plans were replaced by so-called 401k plans (matching employee contributions in a tax-deferred manner). This shift, once again, greatly increased the amount of common shares held by ordinary middle class investors and continues to be an enormous boost to the funds industry.

It is these types of developments, which engage the majority of small retail investors that has made the US funds industry a mature funds market, much more so than developments in sophisticated hedge funds products.

While there is nothing intrinsically wrong with this institutional/retail divide, it is an important issue to note. Surely, a new or resurgent industry can, and arguably must, develop both high-end and mass products. Both a 'top-down' and 'bottom-up' approach assures that, in time, all sectors of a diverse market are served.

Indeed, there are few industries more diverse than the Islamic funds marketplace, whose end-clients run the extremes of geography, product knowledge, size of portfolio, and access to products.

The overreaching goal, namely the development of a robust and mature market, can become jeopardised, if only the top-end develops. Surely it will be a grand achievement if one day Islamic financial institutions have a full suite of sophisticated, competitive, and diversified products available to them. In fact, the goal of many within the industry is to have an Islamic equivalent available for every conventional asset class. While many philosophical and practical obstacles come to mind, it is hard not to appreciate the motivation and vision that such a view implies. Such a state of affairs would not, however, bring the industry to maturity.

The real key is retail. What percent of Islamic compliant funds are held by retail investors? What percent of Muslim investors have access to Shari'ah compliant products? What percentage of Muslim households own Shari'ah compliant shares?

Just as the automobile, air travel, personal computer, and mobile phone industries came into their own only when they became mass offerings, so too the Islamic funds industry. For every Ferrari, there were thousands of Hondas, and for every Rolex there are thousands of Casios. Let us not forget our base.

* Investment Company Institute 2006 Investment Company Fact Book