

LOOKING EAST

Mark Smyth, managing director of **Failaka International**, provides his regular monthly commentary on the Islamic funds scene

“Go east, young man, and grow up with the country.” This twist on the nineteenth century American ideal is taking shape in the world of Islamic fund management. Continued evidence of this trend has been present everywhere in recent weeks

The theme was certainly noticeable to keen observers at the KLIIF (Kuala Lumpur International Islamic Forum) conference in Malaysia this month, where presentations by fund managers dwelt heavily on Asia, promoting KL as an Islamic finance hub, deregulating Asian fund businesses with an aim towards faster growth rates, Middle Eastern funds scouring Asia for new deals. The theme of the conference itself, Islamic finance: Maturing towards a globalised market, hinted at this Asian expansion. When one considers that Islamic managers have traditionally dwelt in global equity funds, with heavy concentrations in the US and Europe, and GCC equities, what direction must this globalisation be heading?

It is therefore not surprising that one of the more well-received presentations was given by Saqib Rashid of Abraaj Capital, who explained his firms’ vision of developing human capital with their proposed \$2 billion Infrastructure and Growth Capital Fund. Interestingly, the fund’s geographic concentration is on the MENASA region. For the uninformed, that is Middle East, North Africa, and South Asia. Again, we see the traditional MENA region adding a couple extra letters and yes, expanding to the East.

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Participants at KLIIF also seemed quick to agree that private equity, as an asset class, was naturally ‘Islamic’ at its very core, containing, as it does an element of shared risk, a concentration on fostering new growth within the community, and profit sharing. The prime Shari’ah concern, agreed ‘guaranteed’ or ‘minimum’ rates of returns for certain class of partners, was an obstacle overcome, according to Saqib.

Bankers behind this new Infrastructure and Growth Fund, which was jointly structured by Abraaj Capital, Deutsche Bank and Ithmaar Bank, are also keen to trumpet the social focus of the fund

that includes a geographic mandate that includes several Muslim countries. Another aim of the fund is to improve transport systems in countries where the needed infrastructure, so vital to fostering growth within a nation, is lacking. In many cases, the demands on roads and bridges resulting from existing levels of economic expansion have made the need more acute than even a few years ago.

The fund also has an appetite for private firms linked to education, a sector that, aside from its more basic humanitarian function, plays a major role in economic development. More commercially, firms linked to education also tend to have more secure government contracts, which can make for safer ‘top-line’ growth.

With private equity becoming the latest, and arguably most promising, new asset class in the region, we expect to hear more from this group and many others in the near future. When one considers that private equity players are in many ways in competition with listed shares for new capital, given the currently downward and frequently volatile nature of the region’s listed shares, it would seem that the appetite for private equity should be quite healthy. We will be following this trend carefully in coming months.

Returning to the world of listed shares, Deutsche Bank has also been raising eyebrows this month, announcing the launch of five new Shari’ah funds under its DWS Noor brand. Not surprisingly, we see that three of the five new funds have an Asian focus: China Equity Fund, Japan Equity Fund, and Asia Pacific Equity Fund, to go along with the more traditional Global Select Equity Fund and their Precious Metals Sector Fund. The addition of five new Shari’ah compliant funds from a major global bank is further evidence that demand remains strong and that demand for Asian products remains a focus.

According to the literature, these new funds will be domiciled in Dublin and include both institutional and retail share classes. We note also that the managers have also adopted an actively managed approach over the passive index model, something that can be helpful during corrections in the market.

In Asia itself, we notice a new fund emerging from mid-sized money manager Pheim Unit Trust Berhad. The Pheim Asia Ex-Japan Islamic Fund is one of the first trickles of what may become a flood in the world of Malaysian Shari’ah funds in the coming year. Due to recent changes at the Security Commission of Malaysia, local fund companies now find it easier to offer non-Malaysian assets in their funds. This year, the first full year since the liberalisation, saw a spat of



Most larger conventional funds find it beneficial to hedge, at least a percentage, of their currency risk with a number of readily available conventional derivative products. Such products are just now being devised and debated within the Shari'ah compliant industry and it would be safe to assume that there are few funds in this sector currently utilising any Shari'ah compliant currency hedging tools.

At present, this may not be a major problem. As mentioned above, most Malaysian equity funds are invested in Malaysia, and there is therefore little need. But again, this is now changing.

In the Gulf, where the other half of Shari'ah compliant funds is bought, the local currencies are pegged to the dollar and many of the funds are dollar-based in any case.

Whereas academic economists may find a number of problems with this state of affairs, the immediate risk for fund local managers is not that great. The incentive, however, for local investors to seek-out non-US funds may increase if the falling dollar story proves a legitimate trend. Many Gulf-based investors will be keen to pick-up asset appreciation along with currency appreciation; if the dollar is falling, another currency is rising. While it would seem that sterling is the early winner, many have their sights set on Japan.

As yen investor get used to real interest rates again, yen appreciation could rise over time and if the Japanese growth story picks up pace, equities should theoretically receive a boost. Yet another road that leads to Asia, and we have not mentioned everybody's favourite Asian obsession: China.

Naturally there are volumes being written everyday about the Chinese economy. We must, however, leave that for another edition.

As Fitzroy MacLean described so eloquently in his masterful book, *Eastern Approaches*, the Orient, which continues to hold such allure to both travellers and investors alike, is a region full of rewarding opportunities. It can also be a frustrating place for the uninitiated. Let us hope Shari'ah compliant money managers can find real value and avoid the heartbreak that struck many of their conventional peers a decade ago.

conventional funds

offering funds with larger percentages of

holdings outside the country. Many believe that this year will see the nation's Shari'ah funds, nearly half of the industry by number of funds, follow suit, offering regional and even global assets within their onshore funds. The Pheim Asia Ex-Japan fund is one early example of an Islamic fund offering its clients access to the wider region. Geographically, the fund offers exposure to Singapore (18 per cent), Hong Kong/China (18 per cent), Thailand (12.75 per cent), Indonesia (8.78 per cent), Philippines (3.23 per cent), Taiwan (8.83 per cent), and Australia (1.53 per cent), with Malaysian equities accounting for a balanced 7.53 per cent.

These changes are helpful in many ways. Firstly, they grant the opportunity for better diversification to local investors. Although nearly all classes of retail investor prefer to hold 'local' shares, this can prove dangerous in smaller economies. There may be a familiarity with local firms, but a regulatory regime that mandates such an 'all eggs in one basket' approach can lead, unnecessarily, to hard times when the local economy goes into a down cycle, or worse.

Secondly, aside from the defensive diversification advantage, allowing investors access to outside assets gives them the opportunity to take advantage of faster rising markets. Although regional economies tend to follow similar boom/bust cycles, divergences can, and often do, occur. It would be wrong to penalise those savvy enough to see it coming. Naturally there were real concerns and motivations for the past restrictions, but the new liberalisation is sure to re-enliven and strengthen the expanding Malaysian market. We look forward to this development.

There have been other developments over the past month which have given global investors, Shari'ah compliant included, yet another reason to take a close look at Asian assets; the falling US dollar. Though currency prices can be volatile and notoriously difficult to predict, the recent falling dollar has caused much concern for those investing in dollars and earning in other currencies. Like most investment dilemmas, this 'currency risk' has special considerations for Shari'ah compliant investors.

New and pending Shari'ah compliant funds:

- DWS Noor China Equity Fund
- DWS Noor Japan Equity Fund
- DWS Noor Asia Pacific Equity Fund
- DWS Noor Global Select Equity Fund
- DWS Noor Precious Metals Sector Fund
- The Infrastructure and Growth Capital Fund L.P. (private equity)
- The Pheim Asia Ex-Japan Islamic Fund

We look forward to expanding this section in 2007 by adding relevant case studies from Islamic fund managers, timely academic studies, and insightful views from practitioners active in the field. With most equity markets set to close the year with solid returns, we look forward reporting on an even more bullish 2007. We also look forward to your participation in our upcoming Failaka Islamic Fund Report, which will be published in 2007. Watch for details at www.failaka.com.