

**Beyond the Transaction:  
Pairing Islamic Wealth and Asset Management**  
By Douglas Clark Johnson

The Islamic banking business is poised to move “beyond the transaction” as it wrestles with unprecedented growth. It is fast evolving from a niche within the global banking system to what may become—in the next generation—a track parallel to conventional financial services. Certainly the wealth management business will factor into this transition, as wealth advisors partner with Islamic investors for the benefit of their underlying investment portfolios.

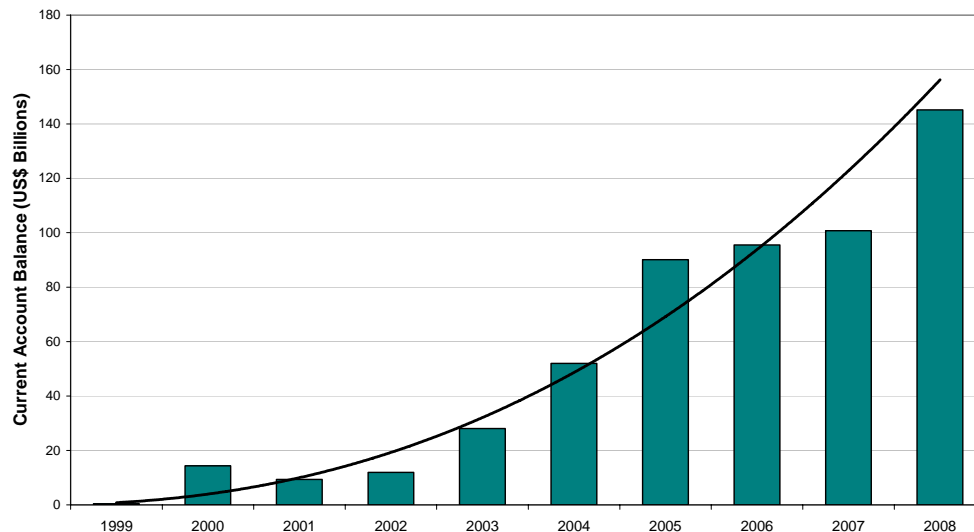
Renewed momentum in *sukuk* issuance (a.k.a. Islamic bonds) during early 2008—following some suspension in activity related in part to the sub-prime crisis—is fully consistent with what you would expect from a young industry. Such bond-like issuance is an early-stage activity, along with project finance and real estate development, that provides generous transaction income for many players in our business. I believe this focus will change as the industry matures and looks to stabilize its revenue flows with income based on relationships, such as fee-based wealth and asset management.

**Missing Requisites: Segmentation and Ideas**

The Islamic industry has yet to focus on wealth and asset management, in my view, because wealth management requires better segmentation of the individual-investor client base, and asset management demands more forthright product ideas. Neither of these requisites is broadly in place within the Islamic banking industry at this time.

If anything, the need for these disciplines has been masked by unprecedented growth in savings surpluses in both the Gulf and Southeast Asia. This relative lack of attention to date for wealth and asset management creates opportunities for profitable business-line growth among both established and newly formed Shariah-compliant institutions.

## Rapid Savings Growth Has Led to Transaction Focus Saudi Arabian Current Account Balance



Data as of April 2008. Figures for 2007-08 are estimates. Source: IMF.

This is familiar territory for anyone with broad industry experience. Pairing wealth and asset management is a longstanding practice in the conventional financial-services sphere. Indeed, Zurich-based UBS has staked its future on these areas as it attempts to recover from its sub-prime woes. Yet bringing an Islamic wealth/asset management nexus to fruition requires Shariah-compliant organizations to think in terms of “solutions” rather than simply to push product. I find it ironic that the notion of providing investment funds to (1) fulfill global diversification parameters and (2) implement asset allocation decisions currently seems foreign to an Islamic world that is steeped in traditions of research and debate.

I am reminded of my days as an investment strategist during the late 1980s and early 1990s, when I spent a great deal of time speaking with US investors about the benefits of international investing. One of the first points I made in my standard presentation was “Common Issues When Going Global:”

- *Diversification is not asset allocation.* I emphasized that simply putting one’s eggs in many baskets was not the same as putting them in the right baskets. Never mind the character of each egg.
- *Good economics are not always good markets.* I wanted to shift investors’ thinking from mere GDP analysis to focus on what might drive capital-market prices more comprehensively.
- *Global investing is not global entertainment.* My material outlined a basic framework for applying a thorough investment discipline. I have always held that success, especially internationally, depends on organization and rigor.

In moments of *deja vu*, I sometimes feel like these truths could just as easily be applied to the Islamic space today. The good news of course is that there is opportunity in the private banking business like never before.

## Expanding Beyond Borders

Islamic private banking—the pairing of wealth and asset management—can readily expand beyond the early localization we have seen in the Gulf and Southeast Asia. An effective approach will include ways to bolster international distribution, launch globally oriented product, and enhance multilateral credibility. Certainly there is more to Islamic private banking than a retail network, a small set of me-too funds, and a Shariah label. The faster the Islamic industry embraces globalization, the more apparent the commercial opportunity will become as Islamic bankers aim to compete with the conventional names on price, pedigree, and performance.

This process is not without its risks. I am reminded of one controversy surrounding a *wa'd*-based swap in which Sheikh Yusuf Talal DeLorenzo of the United States argued that the use was misguided. What I found most instructive about his comments at the time were the implications for the future of the Islamic banking industry, rather than the specifics of the actual product using the swap. More publicly, the *sukuk* business was set in turmoil by opinions articulated by industry leader Justice Taqi Usmani of Pakistan on the Shariah standards and quality of most issuance. These and other such issues have important implications for Shariah governance.

I acknowledge that innovation is not always commercially expedient. Many organizations will find it beneficial to offer “common” products to meet market expectations. For context, I recall a visit to a gift shop in Gujarat, India, with a placard boasting of its “*unique* handicraft items.” After surveying the store, I remarked to the shopkeeper that some of his products could be purchased all over South Asia. His poised reply: “Selected goods simply have a high commercial value in our merchandise inventory.”

## But How to Design and Manage a Portfolio?

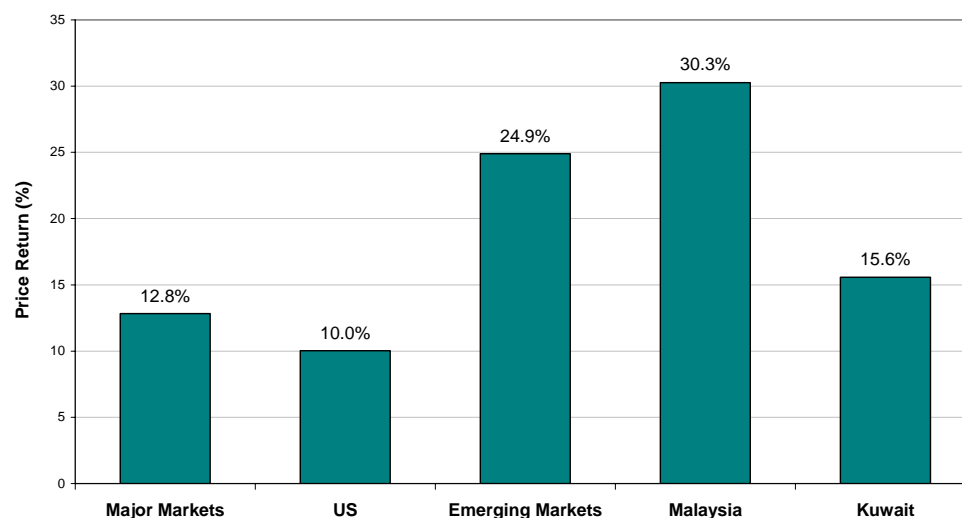
One missing ingredient needed for the development of a true Islamic private banking industry encompasses preparation of investment-strategy insights and portfolio analytics. Granted, high growth has obscured the need for such research. But I challenge any firm aspiring to make an impact on this sector to start addressing issues like mean-variance optimization, home-market bias, and global allocation strategies within Islamic guidelines. I have never seen such work broadly disseminated, let alone debated.

Admittedly, the execution of mean-variance optimization may be challenging because the available historical data is limited with many “Islamic” asset classes, if it exists at all. But that is fast changing. The competent analyst can meanwhile work around these constraints by constructing proprietary indices and/or factoring out the impact of heavy-weighted conventional financial exposure. This is not unlike the situation in which many of us operated some 20-to-25 years ago when international investing was still a thin chapter in the back of most investment textbooks.

Home market bias, on the other hand, integrates elements of behavioralism to assess an investor’s propensity to invest outside a given local market. Countless international fund ideas have failed to raise meaningful assets across the Islamic marketplace, not because of design, but simply because the return

structure was not seductive enough for the Gulf or Southeast Asian investor who was generating exceptional returns locally. In the real world, when faced with such tenacity, diversification arguments are often pointless. After all, an investor's own logic is rational by definition. I think that I finally capitulated on this matter after a three-hour debate with an investor colleague over lunch at the Hilton Abu Dhabi Hotel in January 2006. In a bit of turnabout, after the subsequent regional market correction, this person called me and invited me to lunch again. He remains a friend of the firm today.

### Stock-Market Returns Offer Context for Home-Market Bias Three-Year Average Price Return for Islamic Market Index



Tabulated as of 30 May 2008. We use the Dow Jones Islamic Market series to proxy returns for the Shariah-compliant investor. Data in US dollars, except Malaysia and Kuwait, which are reported in local currency. Source: Dow Jones.

Investors in emerging markets have a natural bias to staying close-to-home with their allocations because of the return potential associated with known opportunities. Risk becomes relative. Unfortunately, most of the academic work to date has focused on implications of global investing for major-market institutional investors, such as endowments and pension funds. Very little has been done *the other way around* since emerging markets are supposed to be capital importers, not necessarily capital exporters. Ironically, two of the most important geographic sources of cross-border capital in the sub-prime era are China and the Gulf. It is of course not reasonable to expect academia to move as fast as capital markets.

Once we address the diversification issue, imposing an asset allocation discipline is a different matter altogether. In other words, how do we twist, turn, and tweak a portfolio to take advantage of near-term cyclical shifts in the global landscape. Questions that come to mind in mid-year 2008 range from positioning a portfolio in the face of an oil-induced inflationary spiral; to the currency impact of a potential dollar rally; to a decoupling (or re-coupling) of the emerging markets to the US economy. These issues matter as much for the Islamic investor, as they do the conventional investor. In some respects, they may matter more, given an Islamic investor's unique portfolio characteristics, such as potential overexposure to real estate and underexposure to equities.

An effective private banking business is research-based and market-responsive. Certainly the ability to provide a portfolio planning process will help to ensure stability and growth within a firm’s client base. Most conventional firms have a multi-step process for setting up portfolios for high net worth clients. Elements might include addressing investment objectives, determining the appropriate asset mix, and choosing specific vehicles for implementation. These analyses should not be dismissed as mere “sales noise.” Ascertaining expectations about changing wealth circumstances, as well as shifts in the global economy and market landscape, help to ensure a vibrant client dialogue—and the fees that come with it.

### **Representative Portfolio Planning Process**

The portfolio planning process is dependent on thorough engagement with the investor client. In addition to ascertaining a “Shariah preference” or “Shariah requirement,” an approach to this dialogue might include the following steps:

**1. Establish investment objectives, time horizon, and risk tolerance**

Given that there is no “free lunch,” what trade-offs can be made on performance, liquidity, and volatility?

**2. Determine the appropriate asset mix**

Is the client a current income or aggressive growth investor? How should the portfolio be aligned across various asset classes?

**3. Resolve degree of international exposure**

Is there a home market bias to which the investor is sensitive? Are there any currency exposure issues?

**4. Identify sectors, groups, and themes**

Are there ideas which align with the client’s affinities? For example, is there an interest in a theme such as life sciences or rural empowerment?

**5. Choose specific vehicles for implementation**

What types of securities—whether funds, notes, or individual stocks—are most appropriate for populating the portfolio structure?

Much of this process can nowadays be quantified, if not automated, based on standard portfolio modeling methodologies. Yet a successful client relationship likely depends on crafting an asset allocation overlay, based on one-on-one exchange, making tilts and adjustments as market conditions change.

Source: Calyx Financial

## Strategy Requires Implementation

Building this advisory role suffers from a “chicken versus egg” problem. While Islamic wealth management is an increasingly attractive business, the industry cannot reach high-impact activity without a broader array of investment vehicles. However, the ability to increase the breadth and depth of the product universe is held back by weak demand from underdeveloped Islamic wealth management.

We have yet to reach this virtuous circle of “wealth management, promoting asset management, fostering wealth management.” But progress has certainly been made in developing an array of Shariah-compliant investment products, notwithstanding the debate over some structures. Moving beyond the early days when banks simply offered basic *murabaha* instruments, we now see a fuller line-up of products consistent with the need to implement portfolio tactics and strategies. More work of course needs to be done, especially in deepening the selection globally; I believe the industry remains far too localized for its own benefit.

<b>Ever-Expanding Product Line</b>			
Indicative Evolution of Shariah-Compliant Funds			
> 1995	> 2000	> 2005	> 2010
<i>Murabaha</i>	<i>Murabaha</i>	<i>Murabaha</i>	<i>Murabaha</i>
Leasing	Leasing	Leasing	Leasing
Equity	Equity	Equity	Equity
	Real Estate	Real Estate	Real Estate
		Private Equity	Private Equity
		<i>Sukuk</i>	<i>Sukuk</i>
			ETFs
			Hedge Strategies
			Multi-Manager

Source: Calyx Financial

The overall financial-services industry is somewhat unique in its ability to bring product to market quickly. There is no intuitive reason to think that the Islamic sector needs to move more slowly. One dramatic case study in the conventional business is the advent of exchange-traded funds (ETFs). During the 1998-2000 period, the trade literature was chock-full of debate about the benefits of ETFs over more traditional index funds and vice-versa. Those controversies have now been all but extinguished. Today, there are over a thousand ETFs listed on US and European exchanges alone.

Because of its new-found audiences, the industry has admittedly stumbled along the way. Enthusiasm seems to have generated a number of what I might call “HTTP 404” errors. These range from cross-liability issues with *haram* assets to dodgy valuation procedures. Certainly these matters will sort

themselves out over time as product providers are held to task by clients and scholars. The pursuit of ever greater transparency encourages higher standards of accountability.

Like portfolio management, there are two approaches to product development: bottom-up and top-down. Neither is more correct, but the top-down approach may make the most sense for an integrated private banking operation. In short, an assessment of macro trends and product gaps should drive the launch process, rather than tactical ideas as they are generated by opportunistic business relationships. Admittedly, smaller organizations are often quite successful at building a business model around this latter approach.

My own background informs my bias. As someone in the “waves and cycles” business, I prefer to exploit macro issues through asset allocation decisions, accounting for the bulk of return volatility. Thereafter, the implementation decision merely consists of which product best fits my asset allocation requirements. By way of pedestrian example, I (like many others) happen to have a portfolio tilt at this time toward Latin America because of the positive impact of the commodity price cycle on this region. That commitment drives me to identify Shariah-compliant products to implement the idea. Since there are few, if any, available, I have an obvious product initiative at hand. In the interim, I am forced to use individual securities which mesh with established Shariah criteria.

The bottom-up approach seems less satisfying. I recall receiving an email from a Singapore-based colleague who said he had a Shariah-sensitive client who wanted to earn a capital-guaranteed US dollar return of 7.5% annually over no more than a ten-year period. Leaving aside whether such an instrument even existed in my workshop or any other, the discussion came unwound when I asserted that, in my view, the Islamic element of the transaction would require the capital to remain at risk. I suspect, however, that such a tactical approach is the framework through which investment vehicles sometimes come to market.

The fact that so many Islamic funds are sub-advised back to established conventional managers has meant that the Islamic business has become an investment strategy-taker, rather than an investment strategy-giver. Having spent as much time as I have criss-crossing the Islamic world, it is easy to set out a list of secular themes from which a portfolio of funds might evolve. These range from cultural demonstration across the Muslim world; to the development of agribusinesses for food security, especially in the Middle East; to rural empowerment through microfinance and other initiatives. Granted, some of these concepts overlap with themes we see elsewhere in the developing world, while others might be uniquely relevant to Shariah-sensitive investors.

## Ten “Islamic” Themes for the Decade Ahead

The portfolio planning process also should transcend cyclical ideas, addressing the long run. In random order, ten themes for the Shariah-sensitive investor over the decade ahead might include:

- **Cultural Demonstration:** Geopolitics is engendering a “pride of place” across the Muslim world, manifesting itself in countless ways, such as Islamic consumerism.
- **Life Sciences:** Relative youth of the Islamic world requires greater focus on health-related issues as societies age, including medical device manufacturing and biotechnology research.
- **Frontier Markets:** Investment opportunities exist in such far flung nations as Libya and Sri Lanka, with dominant or sizeable Muslim populations, which may offer unique investments for the Ummah.
- **Agribusiness:** Especially in the Middle East, the lack of cultivated land requires more focus on food security and food-source development. We think further afield at even food technology.
- **Urbanization:** Cities from Cairo to Karachi are bulging at the seams, requiring basic infrastructure and urban management initiatives, such as pollution control.
- **Home Ownership:** Home ownership is sparse across the Muslim world, opening opportunities in real estate, mortgage finance, and construction. This is often a gap in development policies.
- **Energy-Intensive Industries:** The Gulf is extending its comparative advantage in industries such as petrochemicals, fertilizers, and steel because of its low production costs.
- **Infrastructure:** Requirements are vast, ranging from highways to airports to electricity. Look no farther than Indonesia, India, Pakistan, and Bangladesh, with some of the largest Muslim populations.
- **Remittance Flows:** Unprecedented oil-based economic boom in the Gulf is leading to a growing/enriched labor pool from South Asia. There are spillover implications for home markets.
- **Rural Empowerment:** Ideas from technology industries, outsourcing, and microfinance are combining to integrate distant communities into the economic core.

Each of these themes naturally requires more in-depth explanation. Our intention is merely to highlight some major ideas as a basis for further debate, especially as they relate to Shariah-compliant product development.

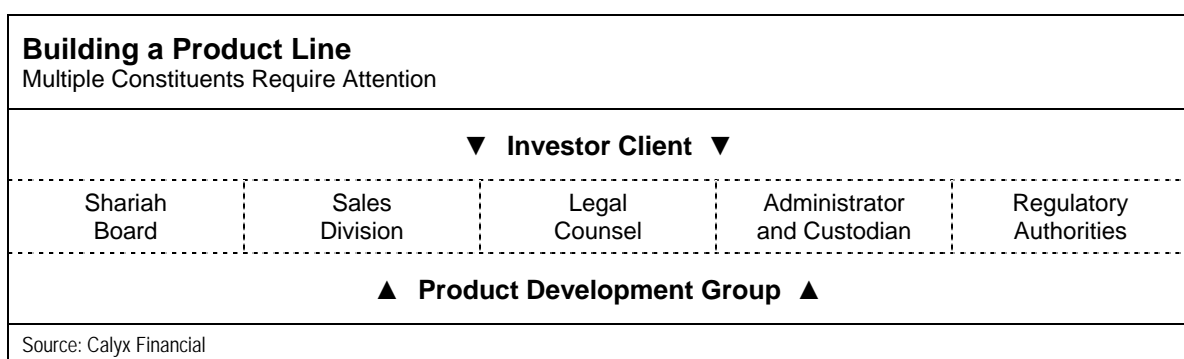
Source: Calyx Financial

Product development is a fashionable issue in the Islamic arena. As has been explored in greater detail elsewhere in the literature, “hot issues” range from scholarly debate on the structuring of *sukuk* to the authenticity of Islamic hedge funds. We further raise questions about the use of the term “Islamic” as a cloak for otherwise bad product specifications and the paltry level of Shariah disclosure that is afforded by some offering documents. Never mind outright usurious pricing. Wanting to be magnanimous, I suggest this process is a bit like learning a language. We all make mistakes at first. Unfortunately, in a few selected cases, these issues are a matter of unbridled opportunism.

### Paving the Way

Product development requires access to a critical mass of high value-added talent. Assembling such a group is easier said than done. The finite professional universe in the Gulf, even when complemented by expatriates, has simply not been able to keep up with the burgeoning demands for human capital. This in turn has led to a fair amount of poaching, especially from Malaysian Islamic institutions. In that sense, the sub-prime crisis—and the difficult restructuring it has provoked—may be a bit of a “gift” for the Islamic banking and finance business. The unexpectedly huge number of qualified candidates I interviewed in New York for one junior analyst position, posted in the first quarter of 2008, are but one indicator of a troubled conventional industry.

Institutions need staff professionals who are forward-thinking and aggressive. These qualities will support the communication of investment ideas so critical to the product development process. I am convinced more than ever that product development is actually a matter of communications strategy. The ability to convey and argue ideas with the Shariah board, sales division, legal counsel, service providers, and regulatory authorities—never mind the investor client—will ultimately determine the success of an offering.



One real-world example of this issue in practice is the challenge of communicating the nature of our own Islamic fund-of-funds program. This product, approved by the Central Bank of Bahrain, is designed as a low volatility, stable-return, global-scope vehicle. While it includes several asset classes, it is primarily a fund of long-only Islamic equity funds. Yet I still am asked questions about how we manage to create a Shariah overlay for our fund of hedge funds. Maybe this problem is caused by our New York base and the implied link with the alternative investment community. Regardless, such questions from the field are instructive.

An organizational issue for many institutions in the Islamic private banking industry is whether to nest product development talent in the wealth management group or the asset management division. Perhaps this is a function of the “texture” of the talent itself and the expected interplay with internal and external audiences. I have seen both settings to be successful in conventional institutions; there is a fair amount of cross-fertilization. The asset management group needs the “sales” perspective, while the wealth management division needs the “investment” context. In either case, an ombudsman should be responsible for fluid and regular communications with the designated Shariah Executive.

On jurisdictional matters, much column space is devoted to discussions about which should be the domicile of choice for an Islamic investment product. While not exhaustive, a short list might include Cayman Islands, Bahrain, Qatar, Labuan, and Ireland, as well as Singapore and Dubai. Certainly each has benefits when compared to the others. For starters, a Cayman-based product can be swiftly registered, whereas a Labuan product gives the sponsor certain rights in the important Malaysian market. Likewise, Ireland can be useful for those concerned about European distribution, whereas a Gulf domicile offers a certain affinity to major Islamic investors.

From the point-of-view of a licensed sponsor issuing a straightforward product for institutional distribution, there is probably little difference among these jurisdictions. There are twists and turns along the way, but any reasonable regulatory authority will provide an appropriate framework for a qualified product launch. The definitive reasons to go with one domicile over another may be (1) the ability to engage service providers in a timely manner and (2) the likely preferences of a product’s major investors. My gut instincts tell me to go with “what you know” and “what clients want” for both expediency and saleability reasons.

The evolution of some of these jurisdictions into outright wealth management centers helps to define the nascent Islamic private banking industry. This development, most prominently in Singapore and Dubai, is noteworthy for the nucleus of professional talent located in each center. As a result, they have been able to attract a disproportionate volume of investor assets. A metaphor in this context is the grouping of honey shops alongside the Al-Dira mosque in Riyadh. If you are in the region and you want bee-related goods, this neighborhood is the retail hub. Certainly there are such stores elsewhere, but the critical mass of activity in the heart of Riyadh lends a spirit of intensity to the search for the perfect batch of Yemeni honey. Besides, the store names—such as Khalid Honey Center or Yousef Honey House—hearken sentimentally to the *souk* culture.

## Call for Action

I will conclude with a call to action for the Islamic finance industry overall. In general, we need more strategic (or rational) and less tactical (or emotional) approaches to building a private banking enterprise. I see three areas for prompt consideration:

- Fund larger research budgets for a proprietary “voice” and grounding
- Focus on organizational structures, avoiding veneer over substance
- Formulate a broad, innovative product array to support advisory work

Each of these has interplay with the other. But proper implementation should help Islamic organizations to be truly competitive on a world-class basis, as they move “beyond the transaction.”

A key step for Islamic banks is to fund larger research budgets—not as cost centers—but as a way to contribute to firm-wide profits. In this context, I think less of technical research and more of fundamental research. Such efforts effectively become the play script for firm-wide activity, both on the wealth and asset management fronts. Research gives a company a proprietary “voice” and grounding. This is all the more important in the Islamic space, especially since entities are often operating in underdeveloped and/or misunderstood market contexts. Never mind the burgeoning competition.

Another action might be to create true marketing departments, with sales as a sub-group rather than vice-versa. I am struck at the number of businesspeople who do not understand the difference between the two. Particularly in the Gulf, marketing seems to be interpreted as the veneer of the firm. My own marketing director is known to bristle when uncovering such renderings. More accurately, the positioning brochure, the color of the carpet, and the graphic identity of the firm is part of a company’s brand vocabulary. Indeed, brand management might be a part of the overall marketing responsibility, alongside sales management, market research, and even human resources.

A third step for Islamic banks might be to offer an increasingly wide range of innovative—but not controversial—Islamic investment products. As we have explored, the wealth management business needs breadth to its product array in order to be successful with its advisory work. Such product portfolios will ultimately stand the test of time if banks rely on their own source material to generate product ideas, rather than relying on me-too enhancements.

The common thread among these suggestions is the imposition of professional discipline, whether analytically based, organizationally based, or product-development based. In my view, such discipline is the route to long-term success in the Islamic banking industry.

Douglas Clark Johnson is CEO and Chief Investment Strategist for Calyx Financial, a Wall Street-based developer and manager of offshore funds for Islamic investors. He can be reached at [douglas.johnson@calyxfinancial.com](mailto:douglas.johnson@calyxfinancial.com).