

Islamic Asset Management: Beyond the Thobe

By Douglas Clark Johnson

“I’m so relieved,” the woman said as I walked into her office, at a money-center based asset management firm. “I have to admit, when I heard ‘Islamic,’ I thought white robe and prayer beads.”

This comment on my Brooks Brothers suit was not quite how I expected to begin this meeting with a potential subadvisor for one of our Islamic funds. Aside from the obvious intercultural issues, the quip hits at the core of how many conventional players still view the Islamic banking and finance business.

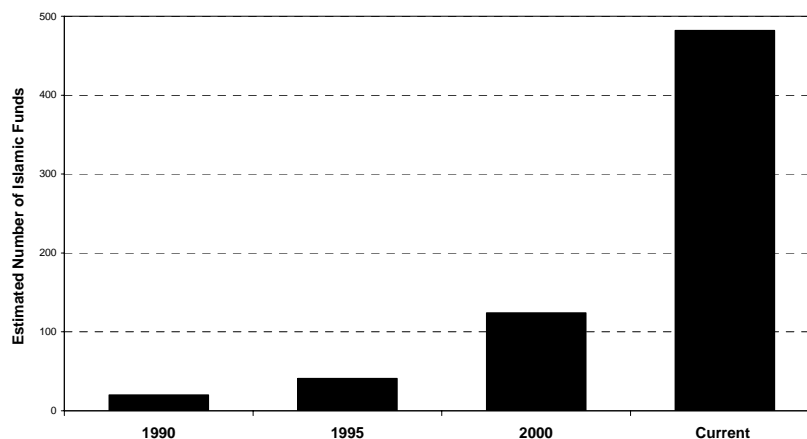
At a level of stereotype somewhat more sophisticated than this one, there’s a set of semi-truths that constitute the current conventional wisdom about Shariah-compliant asset management. Our firm’s experience, on the other hand, dispels many of the myths that inform casual comment about the field.

The term “Islamic banking and finance” is a little sloppy—long used to identify a niche sector with little definition among discrete functions like retail banking, origination, private banking, and asset management. These segments now are sorting themselves out as the industry struggles with its success.

Our specific experience falls within the asset management business. As a Wall Street firm, we are often asked by conventional colleagues about our reception in the Islamic marketplace. Our journey as a start-up has been met with forthright and generous reception, as we’ve established a cadre of relationships with informed players across the Islamic world.

Islamic Funds: Relentless Pace of Growth

The Industry Has Almost Quadrupled Its Offerings This Decade



Data as of 30 September 2007. Offerings include equity, sukuk, balanced, and cash funds (such as murabaha and trade finance), as well as non-traditional funds (e.g., private equity, real estate, leasing, hedge funds, fund-of-funds, and structured products). This census encompasses programs that have been announced but not yet launched. Source: Failaka, Calyx Financial.

We are now coming to market with our first Islamic investment vehicle, a Shariah-compliant fund-of-funds program authorized by the Central Bank of Bahrain. The two-year research and development process that birthed this product informs our sense of misperceptions of the Islamic asset management business. Here are three “precepts” we often run across:

“The Islamic investment business has an inherent extra compliance expense.”

Granted, Islamic investment funds carry the additional burden of Shariah oversight, but to some extent this expense can be amortized across multiple products within a single company. And with careful cost accounting, these expenses can be absorbed into a competitive fee structure. More importantly, we view our scholars as an integral part of the product development and design process. We embrace the “overhead” they represent for the benefit of our client strategies, just as a conventional firm might hire a former government official or policy luminary as a vice chairman.

“Islamic principles inhibit investment strategies.” Shariah law does indeed prohibit certain types of investments, most notably financial stocks because they earn money from interest-related businesses. This strikes out about one-quarter of world market capitalization (excluding of course the small slice of Islamic banks). Accordingly, Islamic investors have a developing sense of sector rotation and industry cycles. One approach to managing typical early-cycle outperformance by financials, for instance, might be to focus on sectors such as consumer-discretionary groups and information technology. Arguably more Shariah-compatible, these sectors tend to mimic the performance patterns of financials during both expansionary and restrictive periods of the monetary-policy cycle.

“Islamic asset management is an investment backwater.” The Islamic asset-management business is often accused of merely adapting conventional ideas and products. Yet to be fair, the entire Islamic industry has expanded from a kernel of an idea to the world’s fastest-growing financial segment in a mere 30 years—with most of this growth in the past decade. In the context of the current accelerated pace, innovation has kicked in throughout the industry, although with controversy in some areas. One classic debate centers on Islamic hedge funds, given that Shariah law prohibits selling what you do not own. Other areas of advancement range from microfinance to sukuks (so-called Islamic bonds).

Not surprisingly, the product-development expectations for Shariah-compliant asset management are similar to the conventional arena. Clients need products that understand their risk/return tolerance, that do more than mimic what others bring to market, and that offer rigor in meeting performance goals and in reporting. The twist in this field is the comfort that many Islamic investors seem to have with higher volatility, given that so many are based in the Middle East and Southeast Asia. Their home-market bias, if you will, is native to emerging markets.

Trends to Come

Our New York perch, outside the adrenalin-filled atmosphere of Gulf growth, may provide useful dimension in forecasting both “weather” and “climate” for the Islamic investment industry. Based on a series of forthright conversations across the Islamic world, we think three major shifts are likely to manifest in the distribution of Islamic investment product over the next three-to-five years:

New Geographic Markets. To date, the two epicenters of Islamic finance have been the Middle East and Southeast Asia. That is fast changing. India, for instance, is home to one of the world’s largest Muslim populations (perhaps second only to Indonesia). Aggressive growth rates here suggest plenty of opportunity for Shariah-compliant financial services to thrive, especially if regulators begin to encourage development. Meanwhile, Pakistan’s role in the industry is under-appreciated, in our view, while there are important developments taking place in Sri Lanka.

Universal Acceptance. Shariah-compliant products have long been treated as “Muslim only,” but there is no logical reason for it—especially in view of our observation that the designation should carry little or no expense penalty. Indeed, the CEO of one Gulf-based Islamic bank reminds us that some 20%-to-25% of his client base is represented by non-Muslims. Attached to a world-class competitive product, the “Islamic” label is a form of style designation and even an attractive feature, not a discriminatory sales crutch.

Wealth-Management Approach. As a sub-sector, the stand-alone Islamic private banking business has floundered thus far. There are many academic reasons for this, including lack of qualified advisors and limited product offerings. Traditionally, private banking initiatives servicing Shariah-sensitive clients have been, if anything, niche efforts associated with the established global franchises. Now underway are several concentrated local efforts in the Shariah-compliant wealth-management arena that will begin to hammer away at the traditional players. This is especially likely in Saudi Arabia, because of its inherent wealth, and the UAE, because of its entrepôt character.

Someone once asked me if the advance of Islamic banking and finance was another example of the “clash of civilizations.” That apocalyptic argument, fortunately, doesn’t relate to the reality we observe, any more than it relates to international politics. Rather, we see the context as a “cultural demonstration,” with all the attendant economic benefits of reinforcement and satisfaction.

Islamic finance is largely about the ability of a major part of the world’s population to express financial preferences in a unique ethical manner. The advent of this industry relates to a rational desire for choice, among institutional and individual participants in the sector. This phenomenon may ultimately prove to be one of the most important trends in the global financial services industry this decade.

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. This article originally appeared in somewhat different form at www.wealthbriefing.com.

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