

Islamic funds come of age

Failaka International is moving to Dubai in order to be closer to the action. Mark Smyth, managing director of Failaka International reports

The field of Islamic finance is garnering increased media attention all over the world. On any given day, it is not uncommon to see a feature story in the Financial Times, Wall Street Journal, or any of the world's major newspapers. As such, it is perhaps an ideal time to increase the amount of data that is available to interested parties, many of whom may actually be prospective investors. It is our hope that with expanded disclosure and improved data, strong growth will continue in the field of Shari'ah compliant investment funds.

History

Failaka International was founded in 1996 and has, over the past 10 years become the recognised leader in the field of Islamic equity funds. Failaka's cornerstone product is the Failaka Islamic Fund Review, which compiles vital data on the world's Shari'ah compliant equity funds. This report has proven to be a widely used resource for bankers, industry insiders, and outside observers. Over the years, data users have included fund managers, rating agencies, and universities. In the early days, it was Harvard University's Islamic Financial Information Program (HIFIP) that was the first organisation to license the fund research.

Following on from the success of the funds report, Failaka branched out into event planning and now hosts the annual Failaka Funds Award, the premier global event that recognises excellence in the field of Islamic money management.

The event brings great media attention to the fast growing industry and is held in March each year, recognising achievements made in the previous calendar year. In 2005 the event was held in Bahrain. In addition to the fund report and awards event, Failaka also offers customised research and consulting services.

Changes at Failaka

There are many changes ahead for Failaka. For the past 10 years Failaka has managed its business from Chicago, with a small office in Kuwait. Now, in an effort to be closer to the marketplace, Failaka has recently relocated to Dubai.

Perhaps the most encouraging development with the 'new Failaka', however, has been the recent strategic investment in Failaka by CPI Financial, publishers of Islamic Business & Finance, Banker Middle East and many other leading industry



publications. The synergies that exist between the two firms are enormous and in collaboration with CPI Financial, Failaka feels that continued success guaranteed.

A bright future

Failaka would not be expanding and moving locations, if it did not believe in the future of Islamic equity funds. While the pace of change in the industry has not been as rapid as some had hoped, and a definitive 'ebb and flow' pattern is detectable at times, the overall trend is upwards. From a macro-level, if one considers that the vast majority of Muslims do not own shares of any kind, economic growth alone should work to benefit of Shari'ah compliant funds.

It is important to remember that 20 years ago in the United States, very few individuals owned shares. As investor confidence, education, and personal incomes converge, a sustained push in global equity investment should continue to take shape and work to the benefit of fund managers. It is also likely that institutional flows will continue to grow as money managers develop longer track records and continue to build trusted relationships. It is Failaka's role to keep tabs on developments and report on them in the Failaka Funds Report and award achievers at the Failaka Islamic Funds Award...and again, the prospects look good!

According to Merrill Lynch and Cap Gemini, high net-worth individuals (HNWI) in the Middle East control assets worth over \$1.1 trillion, half of which is held by Saudi individuals. The bulk of the remaining wealth comes from individuals in Kuwait and the United Arab Emirates. In short, the number of HNWI individuals in this region has been growing at a rate of 9.5% over the past few years and is projected to continue through 2009. These levels represent the fastest rate of growth in the world. Given that the fast majority of these HNWIs are Muslim, it would follow that Shari'ah compliant money managers are well positioned.

It is important to remember that industry growth often comes in fits and spurts. Islamic equity funds experienced excellent growth during the 1990s. The progress equity funds made over that decade would have been unimaginable in the previous decade, as the industry was virtually non-existent before 1994. In the early 90's there were only a few funds scattered across the globe. Today, there are over 206 Islamic equity funds managed by some of the world's top fund management companies, such as Citibank, Deutsche Bank, HSBC, and UBS.

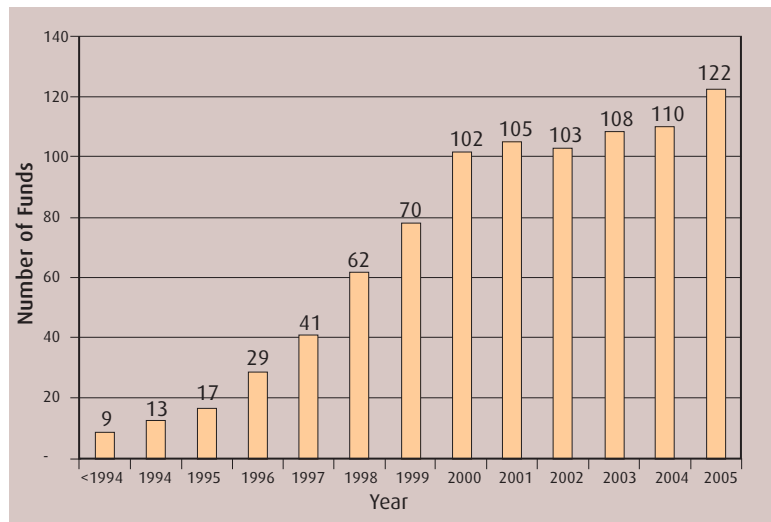
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Figure 1: Total number of Islamic equity funds at year end (excluding Asia)

The earliest funds were broad in their focus. Funds offered in the Middle East tended to be global equity funds, US, or European equity funds. The early funds tended to stick with the shares listed in either New York or London and, with the guidance of an external Shari'ah board, selected stocks in accordance with an Islamic screening process. Since that time, the field has expanded geographically with many funds specialising in Gulf markets and many in Asia. To a lesser extent, the field has expanded into specific sectors, with a handful of funds specialising in technology and communications. Over the years there has also been a drive to develop other, more sophisticated products, including balanced funds, private equity funds, and exchange traded funds.

Arguably the biggest boost to fund managers came when Dow Jones and FTSE launched their Islamic indices in 1999. This development not only gave credibility to this industry by having these prominent names affiliated with Islamic finance, but it also spawned a new and viable investment category; index funds.

At present, there is quite a lot of talk about the pros, cons, and feasibility of an Islamic hedge fund. There are many, too, who are keen to explore various other types of derivative products.



Before the 'tech bubble' of 2000, the preceding 'tech boom' helped facilitate mass acceptance of equity funds as an investment solution, which helped the Islamic industry (which tends to favour less debt-ridden tech firms) grow rapidly from just \$800 million in total equity assets in 1996 to over \$15 billion in 2005. One key reason for the second big lift in Islamic fund assets has been the extreme growth of GCC stock markets, which have, in recent years, been fueled by a spat of widely popular IPOs, a heavy dose of speculative fever, and a general increase in real estate prices.

While capital flows from the region into foreign equity funds have slowly recovered from the early 2000s slump, flows into local markets have ballooned. The Saudi market in particular has experienced tremendous growth as a result of continued high liquidity. Many analysts expect this growth to continue through 2007 despite the correction that occurred in early 2006.

As with any industry, not all players have succeeded. With many new funds on the market, it is easy to forget about those that did not make it. A number of fund managers have lost interest in the Islamic market over the years. Very often, it is distribution that is cited as the greatest obstacle. Just as in the conventional fund business, finding that right mix of basic success factors remains a challenge. Devising a new and demand-driven product, finding the right managers, obtaining Shari'ah approval, securing adequate distribution, and naturally, achieving noteworthy results are challenges that must always be met. Simply branding a fund 'Islamic' is by no means a guarantee of future success.

At one time, Flemings was considered a pioneer in the industry for having launched its Oasis International Equity Fund.

The Oasis fund, however, was closed and its assets liquidated in 2000, as a result of a lack of interest and poor distribution. At its highest point, the fund had approximately \$35 million in assets under management.

A few Islamic equity funds that closed down

Fund	Sponsor	Year Closed
Ibn Khaldoun International Equity	PFM	1999
Islamic Multi-Investment Fund	American Express Bank and Faisal Finance	1999
Oasis International Equity	Flemings	2000
Egyptian Equity Fund	Faisal Finance	2000
AlKawthar Global Equity Fund	GAM	2001
Ibn Majid Emerging Markets	The International Investor	2002
Global Equity 2000 Sub-Fund	First Investment Company	2002

PFM, a small London-based asset manager, was also one of the first to launch an Islamic global equity fund back in 1996 called the Ibn Khaldoun International Equity Fund. The fund never managed to attract more than \$20 million in assets and closed down a few years later just as world equity markets were in the middle of a huge bull market.

Although these cases are not unique, when a new Shari'ah compliant fund undertakes a well-executed strategy, there is every chance of great success. Like most new businesses, one key determinant of success is research.

There has been a growing need for adequate fund monitoring since Islamic equity funds first began to appear on the market. There are two major problems that continue to restrict the growth of Islamic funds. One is the investor education, an obstacle that affects not only the Islamic market, but also nearly every investor

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market in the world. As government-sponsored retirement programmes are scaled-back, due to the financial realities of an aging planet and the pressures of globalisation, the greater the need for investor education.

A deeper understanding of private investment vehicles will, in the short, medium, and long-terms serve to drive new investment. When one considers that roughly a fifth of the world is Muslim, this macro-level trend should be a source of broad encouragement to those involved in Islamic funds. The second obstacle is disclosure policy, or more generally, transparency. Failaka believes that the greater the transparency, the better it is for the industry in terms of winning over the skeptical retail investor.

Traditionally, Islamic funds tended to be registered in offshore markets for various reasons. With roots in catering to local family groups and institutions, few felt the need to register their funds in regulated onshore markets. It could easily be argued that disclosure at that time was unimportant; sophisticated institutions can take care of themselves and many family groups would have handpicked their own managers. The trend today, however, is to be registered

onshore, affording smaller retail investors certain legal protections. Thus, monitoring and disclosure is of great importance.

Serving the industry through openness

Seeing this trend developing in 1997, Failaka International became the first entity to follow Islamic funds with the publication of its quarterly performance report. The first report was only able to provide data on half the estimated 45 funds. Now, others such as S&P and Bloomberg have formally recognised the growth in the Islamic fund sector and have been keen to take on more Islamic funds within their tracking databases.

The increased demand for better fund monitoring does not come exclusively from fund managers themselves. Indeed the driving force comes directly from individual investors. And it follows that wealth managers must now be more diligent about advising their clients on the best Islamic funds. Without proper data, however, they are ill prepared for the task.

Increasingly though, Islamic funds have realised the need to provide their performance data and have become more receptive to closer monitoring. The more information that is readily available, the more likely the industry is to grow and attract more investors. It would seem that the next step in the monitoring process is to assign ratings to funds, which would enable professional advisors to recommend funds based on a recognised and consistent standard, much like what the firm Morningstar has done for many conventional funds.

Presently, it appears that every entity involved in Islamic funds is interested in obtaining fund data, whether it is to monitor their peers or to gauge market trends. Gathering this data remains, however, a rather tedious endeavour. Some banks, such as HSBC Amanah have employed a full-time analyst to gather fund data. Others have hired outside consultants or engaged in ad-hoc research, which typically involves culling data from a number of helpful, though incomplete, web-sites that are presently available. As is always the case, it is never easy for a bank to ask a competitor for performance data.

It is in this environment that Failaka looks to assist the industry in reaching the next level. Failaka's period of transition is coming to an end the year-end 2006 report will be ready in early 2007. Quarterly reports will follow throughout 2007 and beyond.

The Failaka Islamic Funds Award will take place in March 2007 and are sure to remain the single event where the banks, fund managers and other industry practitioners get together to celebrate another fascinating year and forge partnerships for the year ahead. ■