

Islamic Equity Funds: Workshop

An overview of Islamic finance and
the growth of Islamic funds

Presented to Islamic Funds World 2003

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Presentation Outline

- ◆ Islamic Banking Market
- ◆ History of Islamic Funds
- ◆ Types of Funds and New Developments
- ◆ Sharia Aspects
- ◆ The Role of Islamic Indices
- ◆ Selling & Covering Issues of Concern
- ◆ Questions & Answers

Islamic Banking Market

- ◆ Islamic banking as an industry is very young (38 years old)
- ◆ Compare this to the conventional banking system, which has had over 400 years to evolve and develop
- ◆ The first recognized Islamic bank was Dubai Islamic Bank launch in 1975, this was follow by Kuwait Finance House in 1977
- ◆ This new concept quickly spread to the rest of the Gulf and Southeast Asia (Bank Islam Malaysia opened its doors in 1983)
- ◆ These banks offered a very narrow product line (deposits and savings)
- ◆ It was not until the 1990's that Islamic banking began to branch out and develop investment funds, with a few exceptions...

Islamic Banking Market

- ◆ Islamic banking assets worldwide are estimated at over \$200 billion from 180 to 200 institutions[1]
- ◆ International banks and financial institutions are taking notice of the growing demand for Islamic financial services, Citibank, HSBC, BNP Paribas, UBS (Noriba) have dedicated subsidiaries
- ◆ In 1997, Islamic banking accounted for only 8.5% of total deposits and 7.1% of total bank assets in GCC countries[2]
- ◆ In 1997, Islamic banks in the UAE represented only 3.9% of the total banking assets and 6.6% of total deposits in the country[2]
- ◆ Today, Islamic banking accounts for nearly 30% of deposits in Kuwait and 20% in Saudi Arabia

[1] Institute of Islamic Banking & Insurance (www.islamic-banking.com)

[2] PSI Global, Survey Study, 1997.

Market Potential

- ◆ The PSI survey concluded that demand for Islamic financial products and services is quite high in GCC countries.
- ◆ 55% of survey respondents preferred Islamic banking products to conventional banking products while only 21% had an account with Islamic banks
- ◆ The above suggests that there is further potential for Islamic banking products in the UAE
- ◆ It is anticipated that the Islamic banking industry will be responsible for managing at least 40-50% of the total savings of Muslims worldwide in 8 to 10 years^[1]

^[1] "Islamic Banking – Market Study," Arthur Andersen, 1999.

Reasons Behind the Development

- ◆ Growth in the wealth of the Middle East
- ◆ Improved standard of living and education
- ◆ Growing awareness of ones religious beliefs
- ◆ Cost of Islamic products have come down to conventional product levels
- ◆ Role of financial markets in daily life

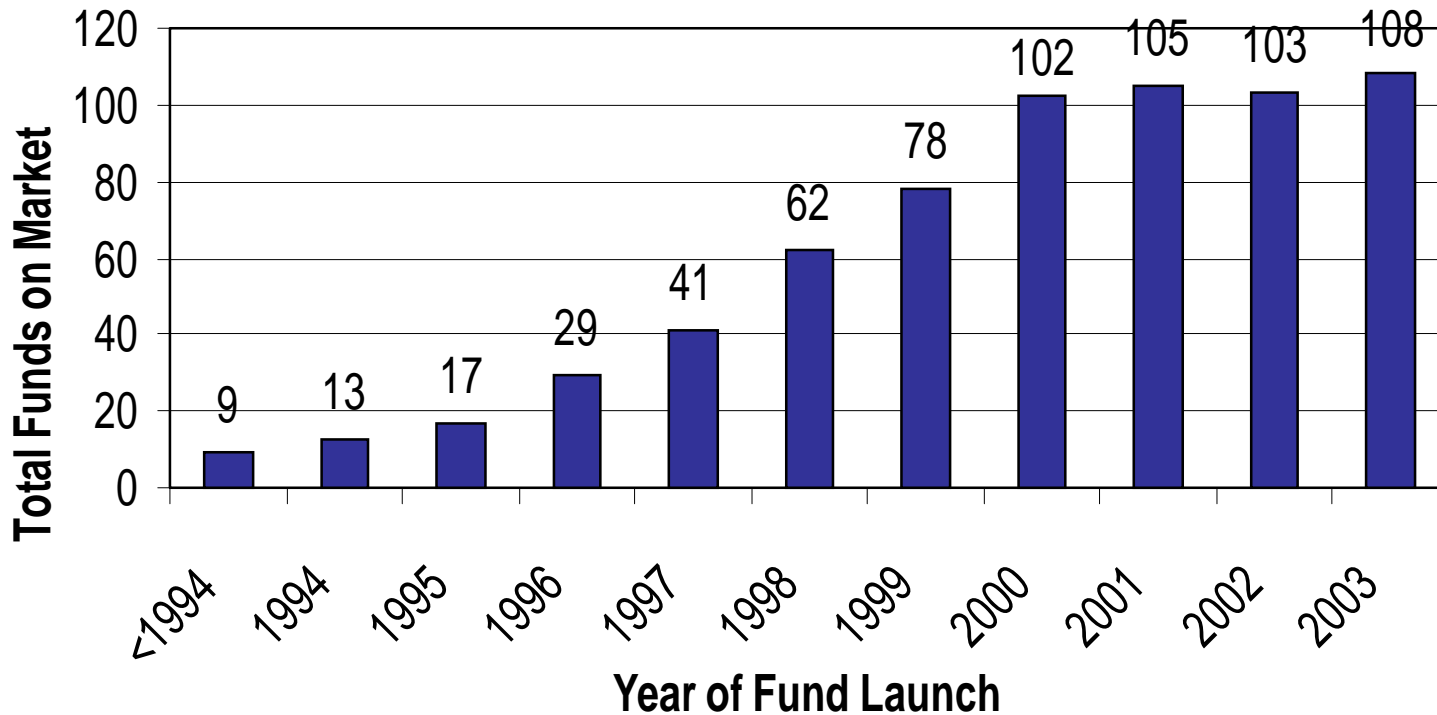
History & Development of Islamic Equity Funds

- ◆ The market size is estimated at \$3.3 billion today and has been growing at over 25% over the last seven years (see chart)
- ◆ There are over 100 Islamic equity funds on the market
- ◆ Many major US and European fund managers are active in the field, including AXA, Brown Brothers Herriman, Citibank, Commerzbank, Deutsche Bank, HSBC, Merrill Lynch, Permal, Pictet & Cie, UBS and Wellington Management
- ◆ This rapid growth is expected to continue as new players enter the market and new products are developed

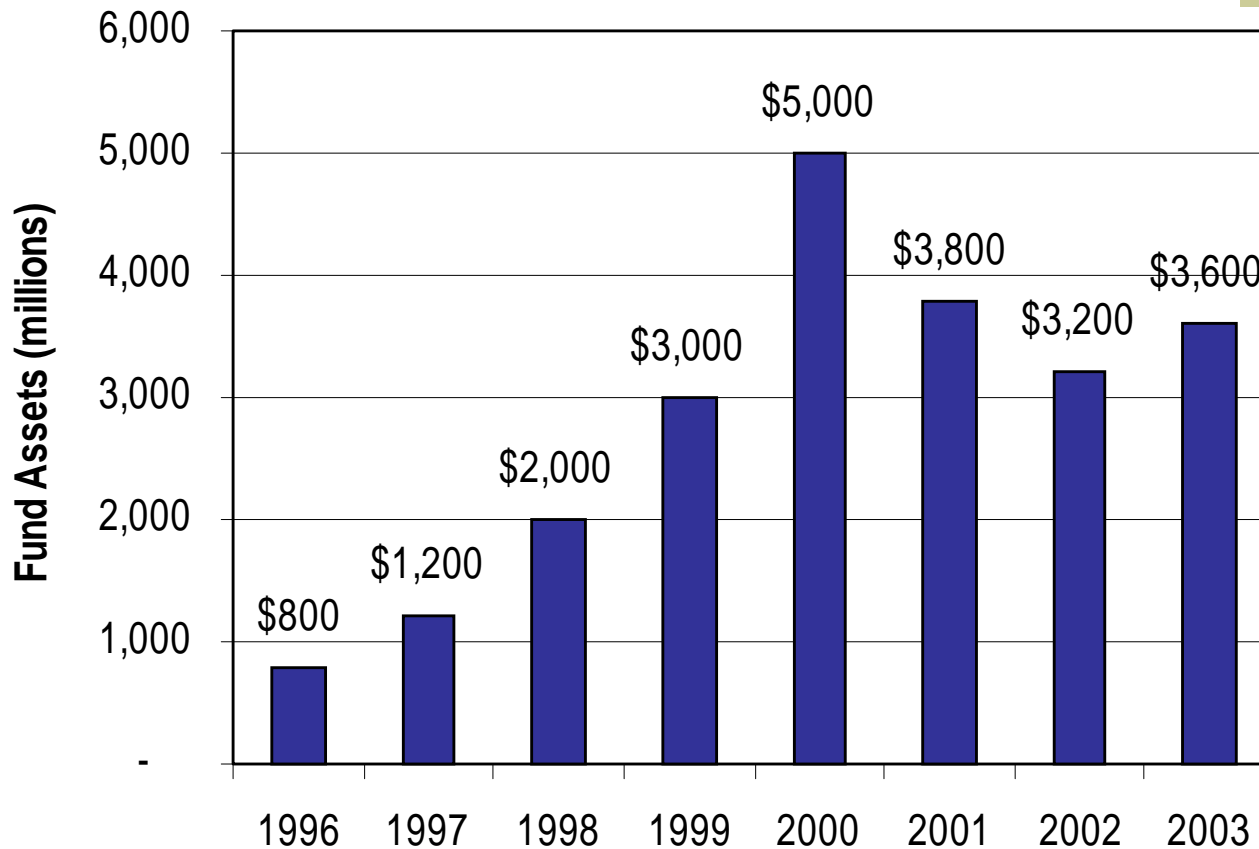
First Islamic Funds

Fund Name	Fund Manager	Location	Inception Date
Dana Al-Aiman	Mara Unit Trust	Malaysia	May-68
Tabung Amanah Bakti	Tabung Amanah Bakti	Malaysia	May-71
Amana Income Fund	Saturna Capital	USA	Jun-86
Mendaki Growth Fund	Mendaki Holdings Pte. Ltd.	Singapore	May-91
Pure Specialist Fund	Futuregrowth Unit Trust Mgmt	South Africa	Jun-92
Al Rajhi Local Share Fund	Al Rajhi Banking & Investment	Saudi Arabia	Jul-92
Al-Ahli US Trading Equity	National Commercial Bank	Saudi Arabia	Jan-93

Growth in the Number of Islamic Equity Funds



Growth in Islamic Equity Fund Assets



Growth & Diversification of Funds

Fund categories:

- ◆ Global Equity (Al Dar World Equities)
- ◆ Asian Equity (Mendaki Global)
- ◆ US Equity (Alfanar US Capital Growth)
- ◆ European Equity (Al-Sukhoor European Equity)
- ◆ Emerging Market (Ibn Majid Emerging Markets)
- ◆ Single Country (RHB Mudharabah)
- ◆ Small Company (TII Small Cap)
- ◆ Technology (Alfanar Technology)
- ◆ Capital Guaranteed (Al-Ahli Global Equity Secured)
- ◆ Balanced/Hedge/Hybrid (Al-Rajhi/Alfanar/Al-Hilal)

Growth & Diversification of Funds

◆ Largest Islamic Funds

- | | |
|--------------------------------|--------|
| ■ Al-Ahli Global Trading (NCB) | \$503M |
| ■ Alfamar/SEDCO (Permal) | \$171M |
| ■ Al-Ahli Small Cap (NCB) | \$171M |

◆ Largest Islamic Managers

- | | |
|----------------------------|--------|
| ■ Wellington Mgmt (Boston) | \$727M |
| ■ Permal (New York) | \$336M |
| ■ Deutsche Asset Mgmt (EU) | \$134M |

◆ Largest Islamic Sponsors

- | | |
|--------------------------------|--------|
| ■ NCB (Saudi Arabia) | \$935M |
| ■ SEDCO (Saudi Arabia) | \$336M |
| ■ Keppel Insurance (Singapore) | \$98M |

Current Market Trends

- ◆ The development of indices by TII/FTSE and Dow Jones has led to global exposure of Islamic funds
- ◆ Growing demand for capital protected funds
- ◆ Demand for hedge funds, but how?
- ◆ More conventional banks are offering Islamic products (increased competition)
- ◆ Growing pressure in Muslim countries to develop Islamic financial services
- ◆ Overall market trends are lagging behind Europe and America

Sharia Aspects & Screening

Sharia scholars & their views on equity investments:

- ◆ The vast majority of Sharia scholars are in agreement that investment in stocks are allowed, provided they meet certain criteria designed to minimize un-Islamic activities (since eliminating them would be impossible in most cases)
- ◆ These criteria were designed to help Muslims participate in the growth of equity markets while at the same time adhere to their religious beliefs
- ◆ Sharia scholars continue to push for uniform rulings on investment guidelines and the need to develop equity markets in Muslim countries

Sharia Aspects & Screening

Role of the Sharia/Islamic Advisor:

- ◆ Establish guidelines for fund manager
- ◆ Monitor fund operations
(usually done in quarterly reviews)
- ◆ Make updates to guidelines when and if needed
- ◆ Set proper accounting/dividend cleansing procedures if requested by fund manager
- ◆ Offer investors peace of mind knowing that their investments are managed properly

Sharia Aspects & Screening

Screening Criteria:

Sector Screens

By way of guidance, stocks whose core activities are or are related to the following are excluded:

- a) banking, insurance or any other interest related activity
- b) alcohol, tobacco, gaming (gambling)
- c) any activity related to pork
- d) activities deemed offensive to Islam
- e) sectors/companies significantly affected by the above – based on a threshold of 5% of operating income

Sharia Aspects & Screening

Screening Criteria:

Financial Screen

Debt ratio:

If a company's Interest-Bearing Debt divided by Assets is equal to or greater than 33.33% it is excluded (<33.33% is acceptable)

Dividend Cleansing:

"Tainted dividend" receipts relate to the portion, if any, of a dividend paid by a company that has been determined to be attributable to activities that are not in accordance with Islamic Sharia principles and therefore should be donated to a proper charity or charities.

Reasons for the development of Islamic Indices

- ◆ Fund managers needed to benchmark their performance against an “Islamic” peer (compare apples to apples)
- ◆ Created an opportunity to develop new Islamic products based off indices (i.e. index funds)
- ◆ Increased awareness and interest by both fund managers and investors

DJIM vs. FTSE Global Islamic Index

Interim Tolerance Parameters

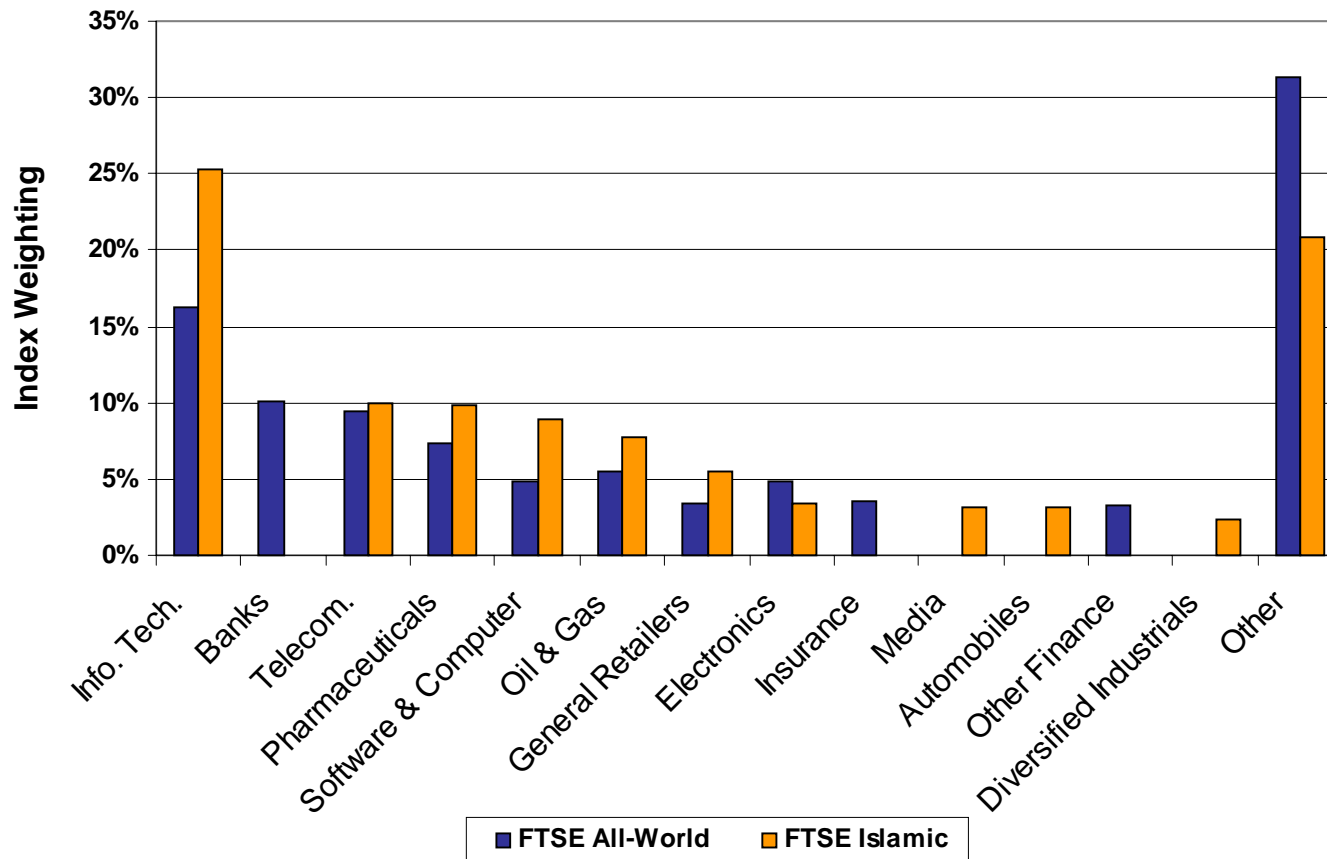
- ◆ DJIM- 2/9/99
- ◆ Five Shariah Board members
- ◆ Shks. Usmani, Abu-Ghuddah, Yaquby, Elgari, DeLorenzo
 - D/MC <33%
 - AR/Assets <45%
- ◆ DJI Calculates/Maintains 1640 stocks
- ◆ Quarterly review
- ◆ 30 Islamic Indexes
- ◆ Nearly 30 licensees
- ◆ FTSE 11/99
- ◆ Four Shariah Board members
- ◆ Shks. Al-Yaseen, Faidhulla, Al-Madhkpur, Al-Sharif
 - D/A <33.33%
 - Purify all impermissible income
- ◆ FTSE Calculates/Maintains 944 stocks
- ◆ Semi-annual review
- ◆ 5 Islamic Indexes

Top 10 DJIM Holdings

<u>April 2001</u>	<u>August 2001</u>	<u>Jan. 2002</u>
◆ Cisco Systems	Microsoft	Microsoft
◆ Intel	Exxon Mobil	Exxon Mobil
◆ Exxon Mobil	Pfizer	Pfizer
◆ Pfizer	Intel	Intel
◆ <u>IBM</u>	BP Amoco	<u>IBM</u>
◆ BP Amoco	Glaxo SmithKline	Johnson&Johnson
◆ Vodafone Group	Johnson & Johnson	BP PLC
◆ GlaxoSmithKline	Merck	Vodafone
◆ Merck	SBC Communication	Glaxo SmithKline
◆ Microsoft	Cisco Systems	Cisco Systems

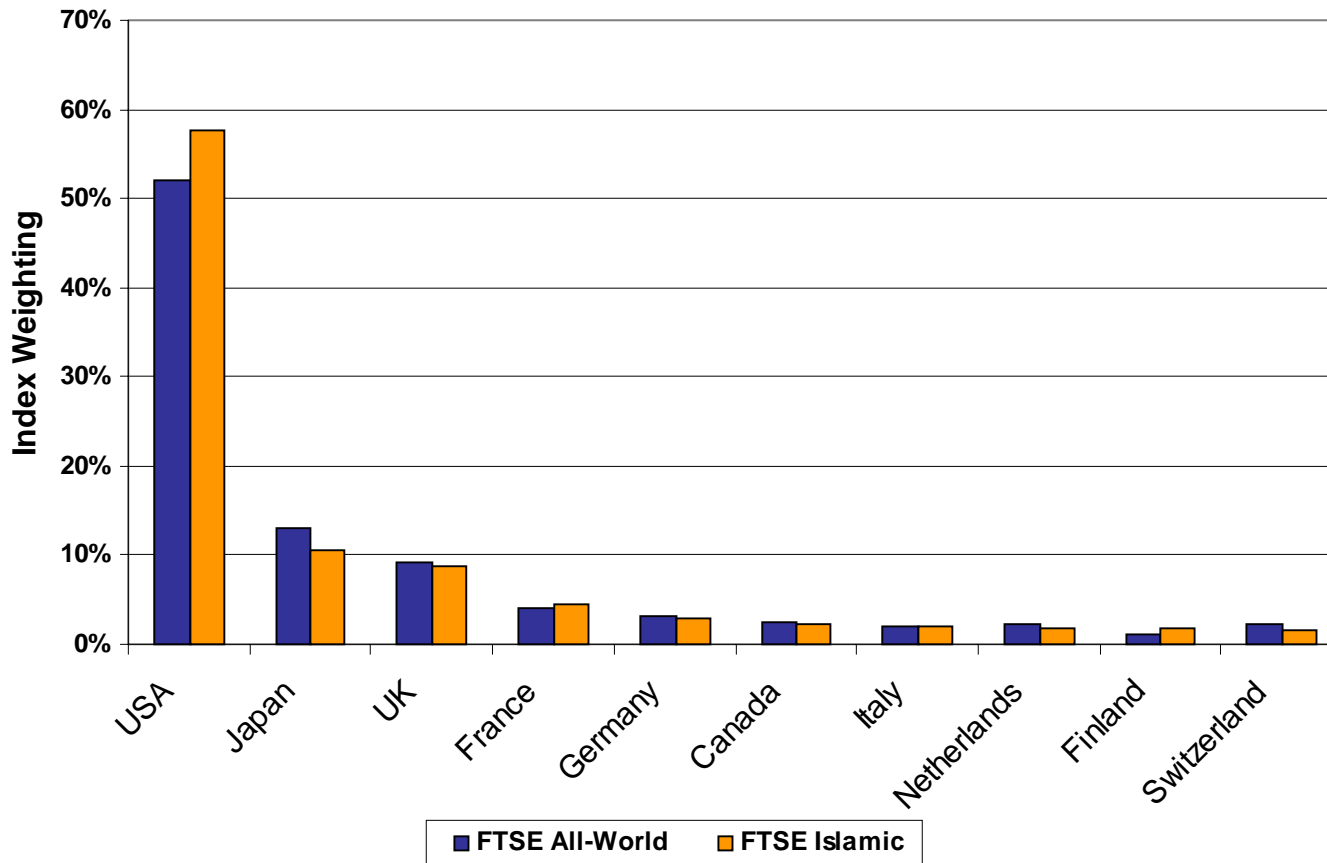
Portfolio Construction Islamic vs. Conventional

FTSE All-World vs. FTSE Islamic



Portfolio Construction Islamic vs. Conventional

FTSE All-World vs. FTSE Islamic



Muslim Country Situation

- ◆ 56 Muslim countries
- ◆ 30 have stock exchanges
- ◆ 16 allow direct FPI (ex. Not Saudi Arabia)
- ◆ Situation in OIC countries:
 - GCC/MENA not investable map
 - Capital Flight (\$800B from GCC)
 - Currency, Inflation, & Political risks
 - Regulatory environment & Corruption
 - Illiquid, Free float (ADR alternatives)
 - Malaysia & Indonesia in DJGI
 - Lack of opportunities

Limitations on Optimal Portfolio Diversification

- ◆ Islamic portfolios have a higher technology gearing
- ◆ Some industries are completely eliminated (such as banking and insurance)
- ◆ Speculation and most hedging techniques cannot be used since they are non-Sharia compliant
- ◆ Liquidity management issues (what to do with cash?)

Selling Islamic Funds

Key selling points:

- ◆ Long-term benefits of equities vs. other asset classes
- ◆ Risk/return relationship & benefits of diversification
- ◆ Islamic investors no longer need to compromise religious beliefs in order to participate in equity markets
- ◆ Investment in equities are acceptable investments for Islamic investors provided that they meet Sharia guidelines
- ◆ Evolution of equity screening process
- ◆ Sharia compliance is the #1 concern

Covering Issues of Concern for Investors

Common Questions & Concerns:

- ◆ Are equity investments Islamically acceptable, such as buying Microsoft stock?
- ◆ What is the reasoning behind choosing 1/3% debt to asset ratio in the screening process?
- ◆ What happens with interest (*riba*), if any, that a fund earns?
- ◆ What is the Sharia scholar's role?
- ◆ Will I sacrifice return if I invest in an Islamic fund instead of a conventional one?



Questions & Answers (Q&A)

